

# Loss grouping and imputation credits

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*An officials' issues paper*

September 2015

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# CHAPTER 1

## Introduction

- 1.1 The transfer of losses from one company in a group to a profit-making company in the same group is a common business practice. It reduces the profit company's taxable income and its tax liability while reducing the amount of losses the loss company would otherwise carry forward to a future period. It is commonly known as loss grouping.
- 1.2 Another established practice is attaching imputation credits to dividends paid by a company. These represent tax already paid by the company, or tax-paid income received by the company. A problem can arise for a profit company following loss grouping. By reducing its tax the profit company also has fewer imputation credits to pass on to shareholders.
- 1.3 If the profit company is not wholly owned by another company, the lack of imputation credits may result in additional tax being payable by the shareholders of the profit company upon the payment of a partially imputed dividend. This effectively negates the benefit of loss grouping, and can result in over-taxation of corporate profits.
- 1.4 Because this issue does not arise when the profit company is wholly owned by a corporate parent (as a result of the inter-corporate dividend exemption), the current tax settings may create an incentive for 100 percent, rather than partial, corporate acquisitions in circumstances where this may not be the most economically efficient outcome.
- 1.5 This issues paper proposes that a loss company be able to transfer imputation credits to a profit company in conjunction with undertaking a loss offset. The imputation credit transfer mechanism would allow the profit company to pay a fully imputed dividend despite engaging in loss grouping; thus removing any potential economic distortions created by the existing rules. This paper seeks readers' views on whether the proposed solution is workable and appropriate.

### How to make a submission

- 1.6 You are invited to make a submission on the proposed reforms and points raised in this issues paper. Submissions should be addressed to:

Loss grouping and imputation credits  
C/- Deputy Commissioner, Policy and Strategy  
Inland Revenue Department  
PO Box 2198  
Wellington 6140

- 1.7 Alternatively, submissions can be made by emailing [policy.webmaster@ird.govt.nz](mailto:policy.webmaster@ird.govt.nz) with "Loss grouping and imputation credits" in the subject line. Electronic submissions are encouraged.

- 1.8 The closing date for submissions is 27 October 2015.
- 1.9 Submissions should include a brief summary of major points and recommendations. They should also indicate whether the authors are happy to be contacted by officials to discuss the points raised, if required.
- 1.10 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. You should make it clear if you consider any part your submission should be withheld under the Official Information Act.

## CHAPTER 2

### The issue

- 2.1 This paper addresses an issue with the interaction between two sets of taxation rules. The issue is outlined below, and the associated consequences of it are also explained. The two sets of tax rules which underlie this issue are the loss grouping rules (found in subpart IC of the Income Tax Act 2007) and the imputation rules (found in subpart OB of the Income Tax Act 2007).
- 2.2 When a profit company and loss company engage in loss grouping less income tax is paid which results in the profit company receiving fewer imputation credits than it would have had it not engaged in loss grouping.
- 2.3 Having fewer imputation credits becomes an issue when that profit company later chooses to pay a dividend to its shareholders and the companies are not wholly owned. Unless the profit company is wholly owned by a corporate parent, the dividend will be taxable, and the imputation credits in the profit company's imputation credit account will determine whether it is able to fully impute that dividend. In some cases, the profit company will have insufficient imputation credits to enable it to pay a fully imputed dividend. This results in a tax impost for the shareholder upon distribution of the loss-sheltered profits, effectively clawing back the benefit of the loss grouping.
- 2.4 This issues paper discusses whether this inability for non-wholly owned companies to fully impute dividends as a result of loss grouping is appropriate; and, if not, what a feasible solution may be.
- 2.5 A brief discussion of the policy underlying the two sets of tax rules is set out below.

### Imputation rules

- 2.6 Imputation is a mechanism that allows the benefit of income tax paid at the company level to be passed through to shareholders by attaching imputation credits to dividends paid by the company to its shareholders. Resident recipients of imputation credits may use the credits to offset the amount of tax they would otherwise be liable to pay on those dividends.
- 2.7 Dividends paid between members of wholly owned corporate groups are generally exempt income (referred to as the inter-corporate dividend exemption).

## Loss grouping rules

- 2.8 The Income Tax Act 2007 permits the sharing of losses between companies that are in the same “group of companies”, that is, they have at least 66 percent common ownership. If a company has made a loss it may elect to make the benefit of the loss available to another group company that is in profit.
- 2.9 Offsetting some or all of the loss against the net income of the profit company means the profit company will not be liable to pay as much tax as it would otherwise. However a consequence of paying less tax is that the company will generate fewer imputation credits than it otherwise would have.
- 2.10 Group companies can choose whether to effect the loss offset by way of a subvention payment, or simply by electing to offset the amount (or a combination of loss offset election and subvention payment). A subvention payment is a deductible payment from the profit company to the loss company in return for the use of the loss. The subvention payment is assessable income to the loss company (thus it extinguishes the loss company’s tax losses).
- 2.11 There are several conditions that must be met in order for companies to undertake a loss offset. In particular, the two companies must have at least 66 percent common shareholding interests from the start of the income year in which the tax loss arose to the end of the income year in which the tax loss is grouped.
- 2.12 The policy underlying loss grouping is essentially a consolidation or “single economic entity” policy. If two companies have 100 percent common ownership, it is economically equivalent to conducting the same two activities through a single company. If the ultimate shareholders have a choice between operating an identical enterprise through a single company, or through two companies, tax consequences should not distort the decision – the choice should be made for commercial reasons. For historic reasons,<sup>1</sup> this consolidation policy was extended to 66 percent commonly owned companies for the loss grouping regime only. In contrast, the inter-corporate dividend exemption applies only to a true “single economic enterprise” scenario – that is, within a wholly owned corporate group (100 percent common ownership).

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<sup>1</sup> The grouping of profits and losses of companies with “substantially the same” shareholders or under common control was originally an anti-avoidance provision that was introduced when New Zealand had a progressive company tax rate; see section 141 of the Land and Income Tax Act 1954. This was designed to prevent a business being broken into a number of separate companies to avoid the higher marginal tax rates. Following amendments in 1968, the Commissioner no longer had to invoke avoidance to assess group companies (now defined to be companies with two-thirds common ownership) at the tax rate that would apply to the aggregate taxable income of the group. The corollary of this automatic aggregation of group income was the ability of group companies to use subvention payments to group tax losses. It was originally proposed that grouping of income would occur at 50 percent commonality and subvention payments could be made at 75 percent commonality. Ultimately, the two-thirds threshold was adopted for both income and losses. New Zealand’s 66 percent commonality threshold for loss grouping is substantially lower than other OECD countries – notably Australia which only allows grouping within a consolidated group (which requires 100 percent common ownership).



## **Interaction of the two regimes**

- 2.13 Issues arise, however, when the two regimes interact and the ownership is greater than 66 percent but less than 100 percent. Losses can be grouped but tax is also reduced with consequently fewer imputation credits generated. If the profit company subsequently wishes to pay an imputed dividend to one of its corporate group shareholders the profit company may have insufficient imputation credits to be able to fully impute the dividend.<sup>2</sup>
- 2.14 This is only problematic when there is a minority shareholder in the profit company, that is, common shareholding between the loss company and profit company is 66 percent or higher, but less than 100 percent and the profit company does not have additional imputation credits from past tax payments. If the loss company and profit company are within a wholly owned group of companies (100 percent commonly owned), the inter-corporate dividend exemption means that lack of imputation credits to fully impute dividends is not an issue.
- 2.15 For shareholders in a non-wholly owned profit company, the receipt of an unimputed or partially imputed dividend is an issue for them as they will be required to pay extra tax. This is particularly the case when there is an unrelated minority shareholder who may not have benefitted from the loss grouping, but still suffers as a result of the reduced imputation credits.<sup>3</sup>
- 2.16 As discussed above, this issue arises because the underlying policy approach to groups of companies for the dividend regime and the loss grouping regime differs.

### ***Example***

- 2.17 Diagram 1 sets out an example of how this issue arises in practice. It shows a loss company which has a 90 percent shareholding in a profit company (which makes those companies eligible to group losses). It shows the profit company making a subvention payment for the use of the loss company's losses,<sup>4</sup> and the subsequent dividends paid out by the profit company being only partially imputed. This results in the shareholders of the profit company having to pay extra tax on the dividends they receive, which they would not have had to pay if the loss grouping had not occurred and tax had been paid at the company level. The minority shareholder has not benefited from the loss offset, and, in fact, has been disadvantaged relative to the situation where no loss offset had occurred.

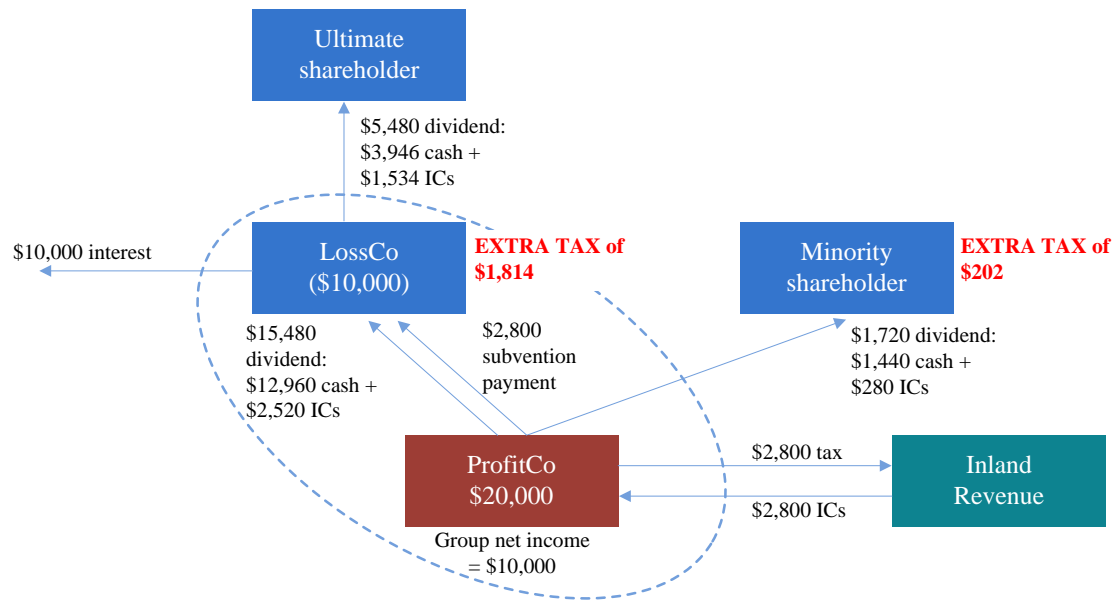
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<sup>2</sup> This will ultimately depend on whether the profit company has additional imputation credits from tax paid on other profit streams.

<sup>3</sup> We note however that minority oppression rules in company law would generally require that the loss offset was done in a manner that does not disadvantage the minority shareholders.

<sup>4</sup> In the example, the full \$10,000 tax loss is transferred from LossCo to ProfitCo via a combination of a 28 percent subvention payment and a loss offset election for the remaining \$7,200 tax loss.

**Diagram 1: A loss offset by a 90 percent shareholding company<sup>5</sup>**



2.18 The following tables set out the relevant entries in the imputation credit accounts of the loss company and the profit company.

**Table 1: LossCo imputation credit account**

	Debit	Credit
Dividend received		\$2,520
Tax paid		\$1,814
Dividend paid	(\$1,534)	
Balance		\$2,800

**Table 2: ProfitCo imputation credit account**

	Debit	Credit
Tax paid		\$2,800
Dividends paid	(\$2,520) (\$280)	
Balance		\$0

2.19 This example highlights the outcome when the loss grouping rules interact with the imputation regime. Namely, the overlay of the imputation regime effectively claws back some of the benefit afforded by the loss grouping rules. The shareholders pay extra tax of \$2,016 (\$1,814 by the majority shareholder and \$202 by the minority shareholder). The minority

<sup>5</sup> All shareholders are assumed to be on a 28% tax rate to keep the diagrams and examples as simple as possible.

shareholder is worse off than if the loss grouping had not occurred and the profit company had paid the full amount of tax. The majority shareholder is also worse off than if the loss grouping had not occurred, provided they could have eventually used the loss against other income.

- 2.20 Another way of looking at this, is that if the activities of ProfitCo and LossCo were carried on directly by the corporate shareholders, the total tax payable on the \$10,000 net income would be \$2,800 (an effective tax rate of 28 percent). However, because ProfitCo and LossCo are not part of a wholly owned group, the interaction of the loss grouping and imputation rules means that the total tax payable on the \$10,000 of group net income is \$4,816 (although additional imputation credits are generated).

### **Why is there a need to address this issue?**

- 2.21 Officials have been advised that the interaction of the regimes described above may be causing problems in practice and distorting economic decisions. For example, a company considering acquiring 66 percent or more of the shares in another company is currently incentivised to acquire 100 percent of the target company in order to access the inter-corporate dividend exemption to avoid the issue identified above which ultimately results in an additional tax cost to shareholders. This suggests that interaction of these two regimes could be distorting potential business combinations. This could provide an incentive to shut out minority investors, and could prevent an owner/operator or key employees retaining a stake in the company when they sell more than 66 percent of that company to an investor.
- 2.22 Shareholder companies may be more likely to be in tax loss when they have recently undertaken a debt-financed acquisition of another company because the acquisition vehicle normally bears the interest costs on the debt funding. This suggests that this issue may be more prevalent in the context of mergers and acquisitions.
- 2.23 Officials have also been advised that this is one factor that could act as a barrier to partial corporate listings on the New Zealand stock exchange (NZX) – because losing 100 percent common ownership via listing means the inter-corporate dividend exemption is no longer available.
- 2.24 Thus removing this issue for commercially desirable transactions could have flow-on benefits for the New Zealand economy – both in terms of facilitating New Zealanders retaining a minority stake in a successful New Zealand company and increasing the attractiveness of listing on the NZX resulting in a deeper capital market.

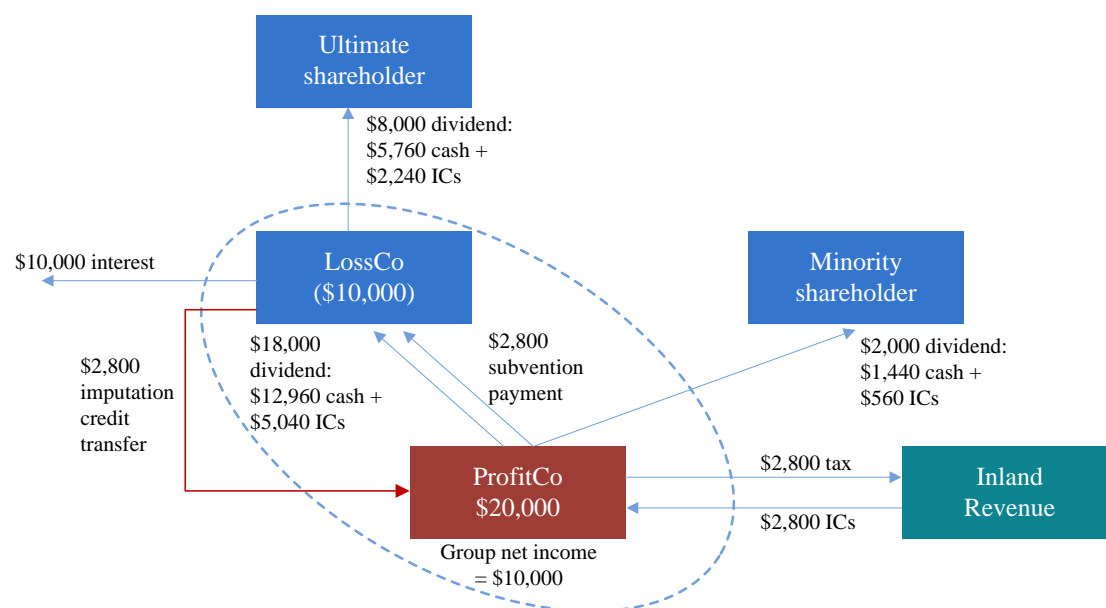


## CHAPTER 3

### Suggested solution

- 3.1 Officials want to ensure that the current tax rules do not potentially hinder legitimate business structures or distort behaviour – for example, by driving investors to acquire 100 percent of a company solely to access the inter-corporate dividend exemption. Such a decision would not ordinarily make good business sense in the absence of tax as a factor.
- 3.2 Accordingly, the aim of any proposed solution will be to equalise the tax treatment between a wholly owned group engaging in loss grouping and a non-wholly owned group undertaking an equivalent loss grouping.
- 3.3 Officials therefore suggest that companies engaging in a loss offset should, by mutual agreement, be allowed to perform an “imputation credit transfer”.
- 3.4 The imputation credit transfer would involve, as part of a loss grouping arrangement, the loss company debiting its imputation credit account and the profit company crediting its imputation credit account by the same amount. It is proposed that the respective debit and credit to the imputation credit accounts would occur at the same time as the payment of the dividend by the profit company to facilitate the full imputation of that dividend.
- 3.5 Continuing on from the previous example the following diagrams set out how an imputation credit transfer would work in practice, and the effect on the imputation credit accounts of the loss company and the profit company.
- 3.6 As discussed previously, the profit company has a taxable profit of \$20,000 and (through a combination of loss offsets and subvention payments) offsets the loss from the loss company of \$10,000 giving a net taxable profit to the profit company of \$10,000. \$2800 income tax is then paid generating an imputation credit of \$2800 as shown in Table 4.
- 3.7 Then subsequently when a dividend is paid by the profit company of its entire net of tax profit ( $\$20,000 - \$2800 = \$17,200$ ), an imputation credit transfer relating to the tax effect of loss offset \$2800 can occur between the loss company and the profit company. The debit is shown in Table 3 and the credit in Table 4.

**Diagram 2: Loss grouping by a 90 percent shareholding company with an imputation credit transfer**



3.8 The following tables set out the relevant entries in the imputation credit accounts of the loss company and the profit company once the tax has been paid and the dividend made from ProfitCo to LossCo and Minority shareholder.

**Table 3: LossCo’s imputation credit account**

	Debit	Credit	Balance	
Opening balance			0	
Imputation credit transfer	\$2,800		\$2,800	Dr
Dividend received from ProfitCo		\$5,040	\$2,240	Cr
Dividend paid to Ultimate shareholder	\$2,240		0	

**Table 4: ProfitCo’s imputation credit account**

	Debit	Credit	Balance	
Opening balance			0	
Tax paid		\$2,800	\$2,800	Cr
Imputation credit transfer		\$2,800	\$5,600	Cr
Dividend to ProfitCo	\$5,040		\$560	Cr
Dividend to Minority shareholder	\$560		0	

3.9 The imputation credit transfer would mean that the profit company received extra imputation credits. This would enable the profit company to fully

impute a subsequent dividend, as if it had paid tax on its taxable income before taking into account the loss grouping. This would consequently put the shareholders of the profit company in a better position, as the dividend they receive is more likely to be fully imputed.

- 3.10 The after-tax return to the shareholders, the tax paid by both the loss company and the profit company, and the imputation credit account balances are the same as they would be if the inter-corporate dividend exemption applied. If ProfitCo were instead a limited partnership, the tax paid and imputation credits generated would also be the same.
- 3.11 Other than the imputation shopping rules in paragraph 3.19 officials do not propose changing any other rules as a consequence of allowing companies to perform this imputation credit transfer. For example, the loss company would need to have sufficient imputation credits in its imputation credit account to undertake the transfer (although it may take into account the imputation credits it will receive when it receives the dividend) and no relief would be afforded if the loss company's imputation credit account was in debit at 31 March each year as a result of debiting imputation credits for the purposes of the imputation credit transfer.
- 3.12 In practice, we anticipate that taxpayers would manage the imputation credits in their accounts. For example taxpayers could choose to prepay tax in order to generate imputation credits, and ensure that the loss company's imputation credit account is not in debit at 31 March each year.

## **Details of the suggested solution**

### ***Optional mechanism***

- 3.13 The imputation credit transfer mechanism would apply at the option of the participating companies. Companies that chose to use the mechanism would not be locked into using it every time they engaged in loss grouping in the future.
- 3.14 The two companies would be required to agree whether or not to use this proposed mechanism – this could not be a unilateral decision.

### ***Other corporate structures***

- 3.15 The example above involves a parent company in tax loss and a profitable subsidiary. However, loss grouping can also occur between a profitable parent and a subsidiary with tax losses, or sister companies (one in profit and one in loss).
- 3.16 Officials do not believe the proposed solution needs to be extended to a corporate group where the profit company is the parent and the loss company is the subsidiary. It is the profit company (parent) that requires the additional imputation credits to pay a fully imputed dividend to its shareholders and there is already a mechanism in the Income Tax Act 2007 – the taxable bonus issue – that allows a subsidiary to transfer imputation credits to its

parent freely. Accordingly, if the loss company wanted to transfer imputation credits to its parent under the proposed mechanism, it is already able to do so under existing provisions.

- 3.17 Officials believe that the proposed imputation credit transfer mechanism should also be available to sister companies with a common corporate parent that owns between 66 percent and 100 percent of both the profit and the loss company. This is because the same issue arises if the profit company subsidiary has insufficient imputation credits as a result of a loss offset with its sister company to pay a fully imputed dividend to its parent company. The parent company in this scenario faces the same incentive to acquire 100 percent of the profitable subsidiary to access the inter-corporate dividend exemption. Therefore, the proposed solution should also be extended to this corporate configuration.
- 3.18 In this situation, as the common corporate parent rather than the profit company would receive the dividend, the profit company would not receive an imputation credit to offset the debit from the credit transferred to the loss company.
- 3.19 In this situation, compared with the examples previously outlined, there is greater potential for there to be an outstanding debit in the profit company with the attendant imputation credit shopping risks. For this reason the existing imputation credit shopping rules which apply to wholly owned groups that have loss balances will also be extended to groups where an imputation credit transfer has arisen.

***Requirement to maintain an imputation credit account (ICA)***

- 3.20 Only companies that are eligible to maintain an imputation credit account (mainly New Zealand resident companies) would be able to elect to undertake an imputation credit transfer.

***Timing of the imputation credit transfer***

- 3.21 Officials propose that the imputation credit transfer (both the debit and credit) should occur at the same time the profit company pays the dividend which utilises the imputation credits. This is the time at which the issue of insufficient imputation credits arises and mitigates the risk that this mechanism could be used as a way of imputation credit shopping. It removes the need for a claw-back mechanism if a loss company transfers imputation credits to a profit company and then liquidates with a debit balance in its imputation credit account.
- 3.22 However the imputation credit shopping risk can still arise in situations involving sister companies and so the proposal to extend those rules to companies who leave a group but have previously made an imputation credit transfer should mitigate against this risk.
- 3.23 Officials acknowledge that the profit company may choose the timing of its dividend payment unilaterally, and it could occur at a time that is difficult for the loss company in terms of a requirement to debit its imputation credit



account. For example, the dividend payment might occur very shortly before 31 March. In this case the imputation credit transfer could result in the loss company having a debit balance in its imputation credit account at 31 March and not having time to remedy this. However this is unlikely to occur as a matter of course, because:

- where the loss company is the company that is receiving the dividend, it will receive imputation credits attached to that dividend that will offset the debit that has arisen to its imputation credit account as a result of the imputation credit transfer (noting that the debit does not arise until the profit company pays the dividend);
- there is likely to be a high level of coordination between the profit and loss companies required to effect loss grouping, and the need for a mutual imputation credit transfer election, such that in practice this timing requirement should not be problematic; and
- the proposed imputation credit transfer is elective, and companies are unlikely to apply it if it were to result in a loss company having a debit balance in its imputation credit account at 31 March.

3.24 There could be a substantial period of time (even years) between the loss grouping and the subsequent payment of dividends by the profit company. This would require companies to track their loss grouping transactions and ensure they complete the relevant imputation credit transfer elections at the appropriate time.

3.25 Further detail on this process is covered below. It is also possible that when the time comes for the profit company to pay a dividend, the loss company may not be in a position to be able to transfer imputation credits or may have even ceased to exist. These practical difficulties need to be balanced against the need to protect the tax base (as discussed above). Officials propose the risk to the tax base could be partially mitigated by only allowing an imputation credit transfer within four years of the balance date of the return that included the loss grouping.

***How many credits should be transferred?***

3.26 Officials propose that the amount of credits which would be able to be credited (and debited) will be capped. The upper level which is proposed is:

$$\left( \begin{array}{c} \text{amount of} \\ \text{subvention payment} \end{array} + \begin{array}{c} \text{amount of loss} \\ \text{offset election} \end{array} \right) \times \text{the company tax rate}^6$$

3.27 In the example above, this means that the maximum number of imputation credits which could be transferred would be \$2,800 ((\$2,800 subvention payment + \$7,200 loss offset election) x 28%). The companies could agree to credit and debit a smaller number of imputation credits, so long as the credit and debit amounts were equal.

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<sup>6</sup> The company tax rate for the return that included the loss offset.

## *Process*

3.28 Officials propose that both companies would need to inform the Commissioner of their election to engage in the imputation credit transfer as part of filing the imputation credit account return that included that transfer. Similar to the current loss grouping notification requirements, the prescribed form will require:

- the names and IRD numbers of both parties to the imputation credit transfer;
- the quantum of imputation credits debited and credited from and to each account;
- identification of the return that included the original loss grouping transaction;
- the quantum of losses grouped and the respective amounts of subvention payments/loss offset elections; and
- the date of the imputation credit transfer that the dividend was declared by the profit company.

3.29 Both companies would already be filing imputation returns (the IR 4J) and therefore, in addition to the notification to the Commissioner, they would need to include the amount of the transfer in the IR 4J. The two companies would simply be required to include the amount of the imputation credit transfer in the boxes labelled “other” for their relevant debit and credit.

## *Amended assessments*

3.30 If a loss company which has undertaken a loss offset has an amended assessment and its loss is consequently reduced below the level of the amount which was eligible to be offset, the Commissioner may amend the assessment of the profit company. Similarly, if a profit company which has undertaken a loss offset has an amended assessment and has reduced profits, the offset is only valid up to the amount of the reduced profits.

3.31 In these cases, corresponding adjustments may need to be made to the imputation credit accounts and other returns of the affected companies.

3.32 Officials are interested to hear whether such adjustments are likely to give rise to problems in practice and, if so, how these problems could be mitigated.