Streaming and refundability of imputation credits

A government tax policy discussion document

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CHAPTER 1

Introduction

1.1 Imputation is central to New Zealand's tax system. Every resident company, independent of size, is affected by the imputation tax credit rules, and every shareholder in a New Zealand company is eligible to receive imputation credits.

1.2 Imputation is a mechanism that allows credit for income tax paid at the company level to be passed through to shareholders on dividends paid by the company. Resident shareholders may use the imputation credits attached to their dividends to reduce the amount of New Zealand tax they pay, which means that the company tax is essentially a withholding tax for New Zealand-resident taxpaying shareholders. However, because surplus imputation credits cannot be refunded to shareholders, the company tax is a final tax for shareholders who do not pay income tax in New Zealand – non-resident shareholders and New Zealand-resident shareholders that are tax-exempt, such as charities. They have no final New Zealand tax liability against which to offset the imputation credits.

Scope of discussion document

1.3 This discussion document is very much a problem definition exercise that seeks the public's views on certain features of New Zealand's imputation system concerning the question of who can use imputation credits. The government is not reviewing whether to retain an imputation system, which will remain an integral part of the New Zealand tax system.

1.4 The main areas of interest in this review are the rules relating to streaming of imputation credits, which means directing them to shareholders who can use them, and the refundability of imputation credits, an issue of particular importance to charities.

1.5 Key objectives for the government when considering the areas addressed by this review are:

- keeping the company tax system as close to a fully integrated system as possible – that is, as far as possible, taxing income derived through companies at the tax rates of the shareholders who own the company at the time the income is derived;
- ensuring that New Zealand source-basis taxation is retained – that is, taxing non-residents on the income that is derived through their investments in New Zealand;
- ensuring that the relevant rules do not stand in the way of legitimate business transactions; and

- continuing to provide a "belt and braces" approach to reducing incentives for company tax to be avoided by continuing to tax domestic shareholders on their unimputed dividends.

1.6 At times there may be conflicts between these objectives that will need to be resolved.

1.7 This discussion document is the first step in a process of consultation on possible improvements to the imputation system. The document describes the policy behind the current rules and seeks views on whether there are problems with these rules, and especially whether they impede legitimate business activity. It also seeks readers' views on whether there are better options that meet the government's objectives but work more smoothly and provide greater certainty in practice.

1.8 It is important to understand the issues before concrete proposals are developed, so the government invites submissions from interested parties on these important areas of our imputation system. Following consideration of submissions, the government may develop detailed proposals and consult further on any such proposals.

1.9 Chapter 2 considers what streaming is and why we have rules to prevent it. It covers why allowing the streaming of imputation credits to those who can use them can be contrary to the government's objectives. It invites submissions on whether not allowing streaming can stand in the way of valid business transactions.

1.10 Chapter 3 considers the current rules on streaming and seeks views on whether they create significant costs or uncertainties for business. It seeks views on possible improvements to these rules.

1.11 Chapter 4 examines the question of refunding imputation credits, which is not available under the current rules. The chapter sets out the basis for this approach and discusses the concerns raised by the possibility of allowing refunds and how that would fit with the government's objectives. The question of refunds is of particular interest to the charitable sector. At present, charities that receive imputation credits with their New Zealand dividends are not able to use them given that they are exempt from New Zealand income tax. This is likely to bias their investment decisions away from New Zealand shares.

1.12 The matters outlined in this discussion document need to be considered in their entirety, since design changes in one area of the imputation system would put pressure on other areas of the system. For example, allowing imputation credits to be refunded in some circumstances would tend to place greater pressure on measures that protect against streaming. For this reason, the government would appreciate feedback that considers coherent packages of possible reforms and clearly communicates the submitters' priorities.

1.13 There are two general issues that warrant some introductory comments: the relationship between the imputation review and the continuing review of New Zealand's international tax rules, and mutual recognition of imputation and franking credits between Australia and New Zealand.

Relation to review of international tax rules

1.14 Some commentators have argued that New Zealand's imputation system is inconsistent with the direction of the reform of our international tax rules, which has been to exempt the offshore active income of controlled foreign companies, in keeping with the practice of other OECD countries. However, that is a misunderstanding of the objectives behind the international review, the aim of which has not been to provide incentives for offshore investment ahead of investment in New Zealand. Nor is there any overarching principal that offshore income should be exempt.

1.15 Instead the exemption of offshore active income, which is the subject of legislation currently before Parliament, reflects an acceptance that if New Zealand attempts to tax the active income of its CFCs much more harshly than other countries do, New Zealand firms that want to internationalise will have incentives to migrate to countries that have more favourable tax rules. That is clearly not in New Zealand's best interest.

1.16 Without the proposed legislative changes, firms looking to expand offshore might well have found it more attractive to base their head offices in a country such as Australia, which exempts offshore active income. The aim of the reform of our international tax rules has been to remove this bias.

1.17 There is no reason, however, for this income to be exempt from tax when it is distributed to shareholders in the form of dividends.

1.18 If a company migrates from New Zealand, any New Zealand portfolio shareholders will pay tax either through the fair dividend rate system or, if the company is listed in Australia, on any dividends received from the company. Taxing unimputed dividends in New Zealand is unlikely to make it more attractive for firms to migrate offshore. Moreover, it has allowed our proposed international rules to be less onerous than would otherwise be the case.

1.19 The imputation rules offer incentives for New Zealand-owned firms to pay tax in New Zealand because they can offer imputation credits to New Zealand shareholders. That provides some safeguards against erosion of the domestic tax base.

Mutual recognition

1.20 A major issue which is outside the scope of this review is the possibility of introducing a system of mutual recognition of imputation and franking credits between Australia and New Zealand, the subject of a joint media statement from the Australian Treasurer and the New Zealand Minister of Finance in July. In the government's view, mutual recognition would increase the efficiency of trans-Tasman investment decisions and reduce incentives for the streaming of profits between the two countries. The Australian Treasurer, Mr Swan, has stated that the Australian government has an open mind on the question of whether or not to enter into a bilateral agreement on mutual recognition with New Zealand. He has invited the New Zealand Treasury to make a submission on this issue to the review known as *Australia's Future Tax*

System, which was recently established by the Federal Labor Government. Its final report is expected by the end of 2009.

1.21 The government believes that for mutual recognition to proceed, it would not be necessary to achieve complete harmonisation of our respective imputation systems. It would, however, be attractive for our systems to be aligned as much as is feasible and consistent with each country's policy goals. The possibility of introducing mutual recognition might also place constraints on policy reform options that would make Australia less comfortable with entering into such an agreement.

1.22 The question arises of why issue a discussion document on imputation at this stage when there is so much uncertainty as to future developments. On this point, the purpose of this document is to make sure that private sector concerns about the imputation system are clearly understood by the government before further work is undertaken in this area. This will be useful irrespective of the future direction on mutual recognition.

How to make a submission

1.23 The government invites submissions on the issues raised in this discussion document. Submissions should be made by 10 October 2008 and be addressed to:

Imputation review
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington

Or email policy.webmaster@ird.govt.nz with "Imputation review" in the subject line.

1.24 Submissions should include a brief summary of major points and recommendations. They should also indicated whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.

1.25 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider there is any part of it that should properly be withheld under the Act should clearly indicate this.

CHAPTER 2

What is streaming and why have rules to prevent it?

Matters for discussion

This chapter discusses imputation streaming and the reason we have rules preventing it.

Allowing streaming would conflict with a number of the key objectives of the review, including that of keeping the company tax system as close to a fully integrated tax system as possible. At the same time, preventing streaming may also stand in the way of legitimate business transactions.

The government seeks comment on the following matters:

- Do the current anti-streaming rules create particularly difficult problems for companies or shareholders?
- What are the pros and cons of allowing streaming in limited circumstances?

2.1 Under current law there are rules to prevent the streaming of imputation credits to particular shareholders, which are discussed in Chapter 3. This chapter describes the concept of streaming in the context of our current imputation system. It explains why our rules seek to prevent streaming. It also considers whether this approach is appropriate and, in particular whether there are situations where streaming should be allowed.

What is streaming?

2.2 New Zealand-resident companies earn imputation credits from the payment of their company tax and from the imputation credits attached to dividends they receive from other New Zealand-resident companies. These credits can be attached by the company to dividends paid to its shareholders.

2.3 The value of imputation credits will not be the same for all shareholders. For some shareholders imputation credits have little or no value. New Zealand-resident shareholders that pay tax can use the credits to reduce their New Zealand tax payable. However, foreign shareholders have no New Zealand income tax against which to apply imputation credits, and tax-exempt New Zealand shareholders do not benefit from imputation credits.

2.4 This creates an incentive to direct the credits to those shareholders best able to use them, a practice commonly called dividend or imputation credit "streaming". Rules preventing streaming support a number of the key objectives of the imputation system.

Why have rules preventing streaming?

2.5 Chapter 1 set out the government's objectives, which include ensuring that New Zealand's tax system remains as close to a fully integrated tax system as possible, New Zealand source-basis taxation is retained and income that has not borne company tax is subject to shareholder tax to provide a "belt and braces" approach to protecting the tax base. Abandoning any rules preventing streaming and instead allowing unlimited streaming would be inconsistent with these objectives. This is best illustrated by way of examples.

Example 1 – How unlimited streaming undermines integration principle

2.6 Consider a company owned by two shareholders, each of whom has a 50 percent shareholding. One is a domestic resident taxed at a rate of 33% and the other is a non-resident. The company earns $100 of New Zealand-source income, on which it pays $30 of tax and $100 of foreign-source income (net of any foreign taxes), on which it pays no tax in New Zealand. Any foreign tax liability for the non-resident shareholder is ignored.

2.7 Streaming is not permitted under current rules. If the company distributed all of its profits, it could pay an $85 cash dividend to both its domestic and its foreign shareholders. The New Zealand shareholder would receive $85 of dividends, together with $15 of imputation credits, and hence income of $100 on which there would be further tax of $18 to pay. This is tax of $33 minus the imputation credit of $15. The resident shareholder's after-tax income would be $67.

2.8 The non-resident shareholder receives $85 in cash dividends plus $15 of imputation credits, which implies a supplementary dividend and associated foreign investor tax credit (FITC credit) of $6.18. The cash plus the supplementary dividends lead to a gross dividend of $91.18, on which $13.68 of non-resident withholding tax (NRWT) is due. This leads to an after-tax dividend of $77.50. This is captured in Figure 1.

2.9 Total tax collected is $55.50. This appears an appropriate level of tax under current policy settings. The resident's share of the domestic-source income is $50, as is her share of the foreign-source income. On distribution, all this income ends up being taxed at the shareholder's rate of 33%, resulting in $33 of tax. The non-resident's share of domestic-source income is taxed at 30%, resulting in $15 of tax, and, on final distribution, there is an NRWT deduction of 15%, or $7.50, on his share of foreign-source income that flows through New Zealand. The total tax of $55.50 is the sum of these amounts ($33 plus $15 plus $7.50). These calculations are shown in Figure 1.

Figure 1. After-tax return for Example 1 – without streaming

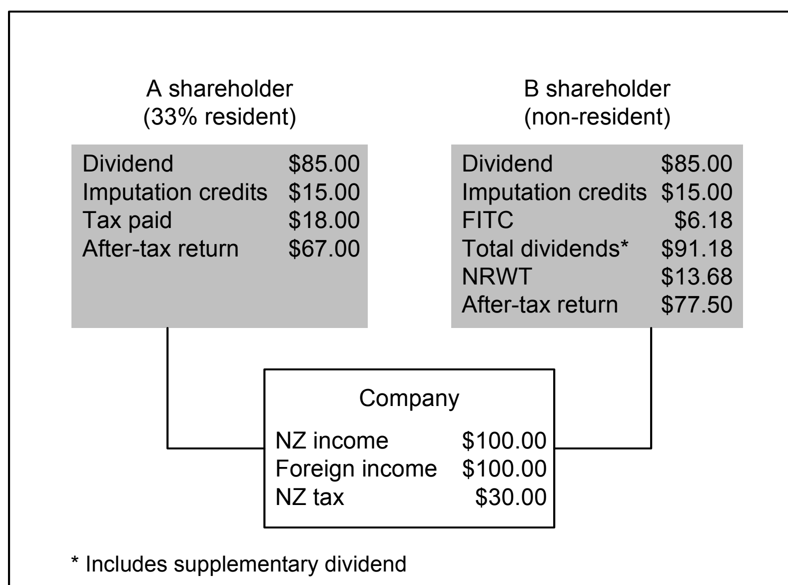
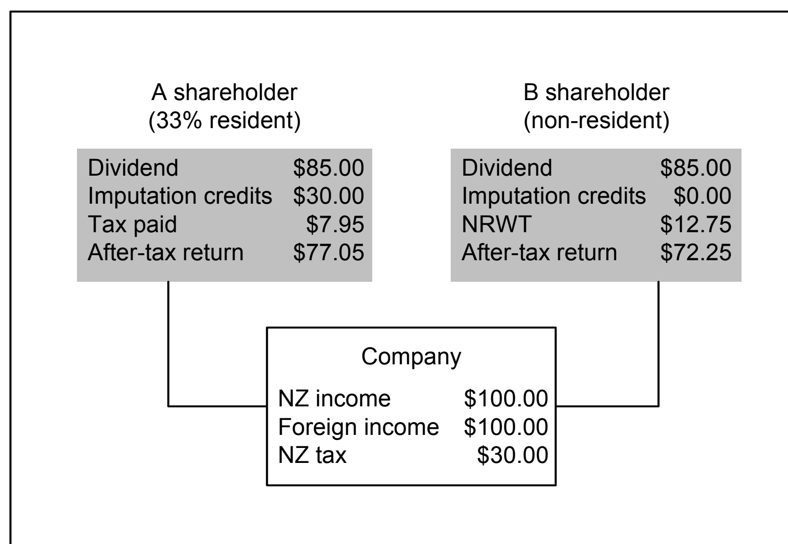


Figure 2. After-tax returns for Example 1 – with streaming



2.10 If dividend streaming were allowed it could be used to shelter the foreign income of domestic residents from tax and to shelter domestic-source income from tax, as is shown in Figure 2. Assuming that both shareholders in the figure continue to receive a cash dividend of $85, the domestic resident now has gross income of $115 ($85 plus an imputation credit of $30).[1] Extra tax on this is $7.95, leading to after-tax income of $77.05.

[1] The examples here abstract from a number of potential company and securities law issues. This particular example assumes that streaming imputation credits within a single class of shareholder is acceptable under company law as well as tax law.

2.11 The non-resident shareholder now receives a cash dividend of $85, with no imputation credits, on which 15 percent NRWT is levied, amounting to $12.75. The after-tax return is $72.25. In this example, tax paid by the resident has fallen by $10.05 ($18 minus $7.95), while taxes in respect of the non-resident's dividend have increased by $5.25 ($12.75 minus $7.50).

2.12 If streaming is allowed, New Zealand obtains less tax than would be the case if both shareholders invested in a single company with half of the foreign and half of the domestic earnings of the company that they jointly own. We end up taxing shareholders on less than their shares of the income. Thus streaming would be counter to the integration principle.[2]

2.13 The anti-streaming provisions also guard against artificial incentives for sales of shares or mergers to achieve a tax-efficient ownership structure. To illustrate this point, suppose once more that there were two companies, each with half the foreign and half the domestic income of the company described above. Assume that one company is owned by a resident and the other by a non-resident. Allowing streaming would create an artificial incentive for these firms to merge so that imputation credits could be streamed to the resident shareholder, who is best able to use them.

2.14 The rules preventing streaming also act as a barrier to the undermining of the integration principle or source-basis taxation in a number of other ways.

2.15 For example, abandoning our anti-streaming provisions (such as the share lending and imputation continuity provisions discussed in Chapter 3) could also open up scope for source-basis taxation to be undermined. This is illustrated in Example 2.

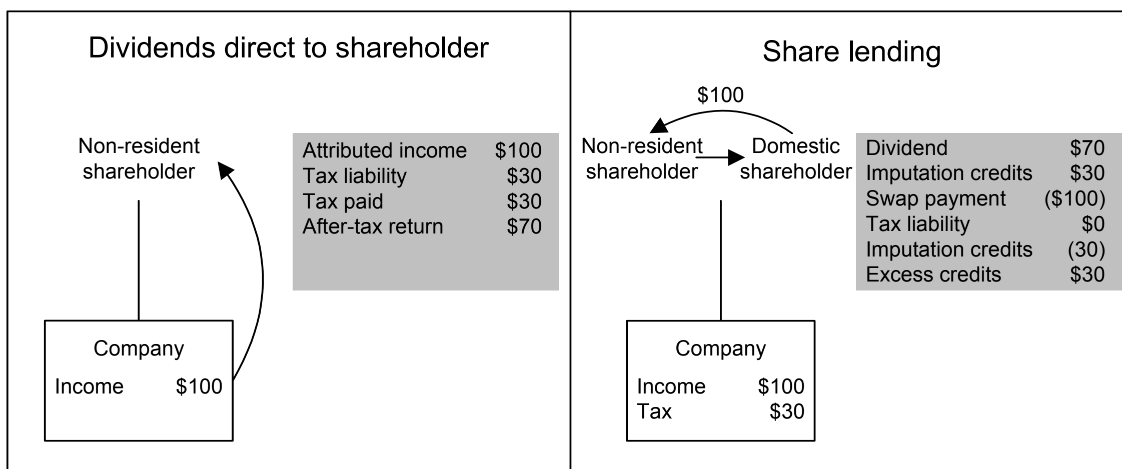
Example 2 – How unlimited streaming undermines source-basis taxation

2.16 Suppose that a company that is 100 percent owned by a non-resident shareholder earns $100 profit and pays $30 tax. If these profits are distributed to the non-resident shareholder then the shareholder will make an after-tax return of $70. New Zealand has imposed source-basis taxation, as intended.

2.17 However, to take an extreme possibility, suppose instead that before distribution the shares are sold temporarily to a 33% shareholder, with an arrangement to receive a $100 cash payment (equal to the cash dividend plus a share of the imputation credits). The non-resident would make an after-tax return of $100. In this case source-basis taxation would be completely undermined. As a tax deduction is likely to be available for making the payment, the 33% shareholder would receive excess imputation credits of $30, which could be used against its tax liability on other New Zealand income. This would equate to a $30 reduction in New Zealand tax collected. These calculations are shown in Figure 3.

[2] In this simple example, if streaming were allowed the foreign shareholder ends up being worse off. However, the company might make both shareholders better off than they are in Figure 1 by issuing two classes of shares, one of which pays a slightly higher cash dividend than the other.

Figure 3. After-tax returns for Example 2



2.18 In this extreme example, the taxpayer acquiring the shares just breaks even. The cash dividend of $70 and the $30 of excess imputation credits just compensate for the $100 cost of the swap payment. In practice, the benefits of this arrangement are likely to be shared between the two parties.

2.19 The transaction raises policy concerns because the taxation of the dividend income in the hands of the domestic shareholder is sheltered by the swap payment. Therefore the purchaser obtains access to the imputation credit without receiving any net tax liability on the underlying income.

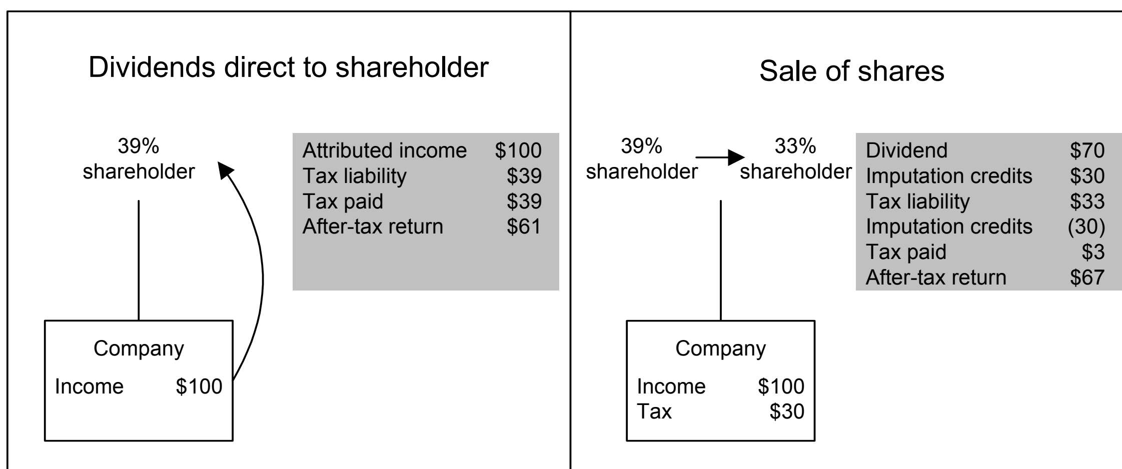
2.20 In practice, both the returning share transfer rules and the imputation continuity rules discussed in Chapter 3 guard against this possibility. They are necessary to protect source-basis taxation.

2.21 Example 3 provides a further illustration of the way in which eliminating anti-streaming provisions would be inconsistent with the objective of keeping the tax system as close to a fully integrated tax system as possible.

Example 3 – How unlimited streaming undermines integration objective

2.22 Suppose that a company were owned by an individual taxed at a 39% marginal rate. The company earns $100 and pays tax of $30. If the dividend were distributed to its shareholder, there would be a further $9 of tax to pay, leaving an after-tax dividend of $61. This is illustrated in the left-hand panel of Figure 4.

Figure 4. After-tax returns for Example 3



2.23 However, if there were no continuity provisions or other safeguards, the company might be sold to a shareholder on a 33% tax rate (possibly a trust). In this case, the dividends could be distributed to the new shareholder and taxed at 33%, which is less than the tax rate of the shareholder who owned the company at the time the profit was earned. This would be inconsistent with the integration objective of ensuring that, as far as possible, income is taxed as income of the shareholders who own the company at the time the profits are being earned.

2.24 New Zealand's continuity provisions, which are described in Chapter 3, may guard against this sort of possibility. They generally ensure that before any such sale takes place, profits are distributed to the original shareholder, either as a dividend or through a bonus issue, so that the profits end up being taxed at the marginal rate of the original owner (although not, of course, necessarily at the marginal rate that applied in the year the income was earned).

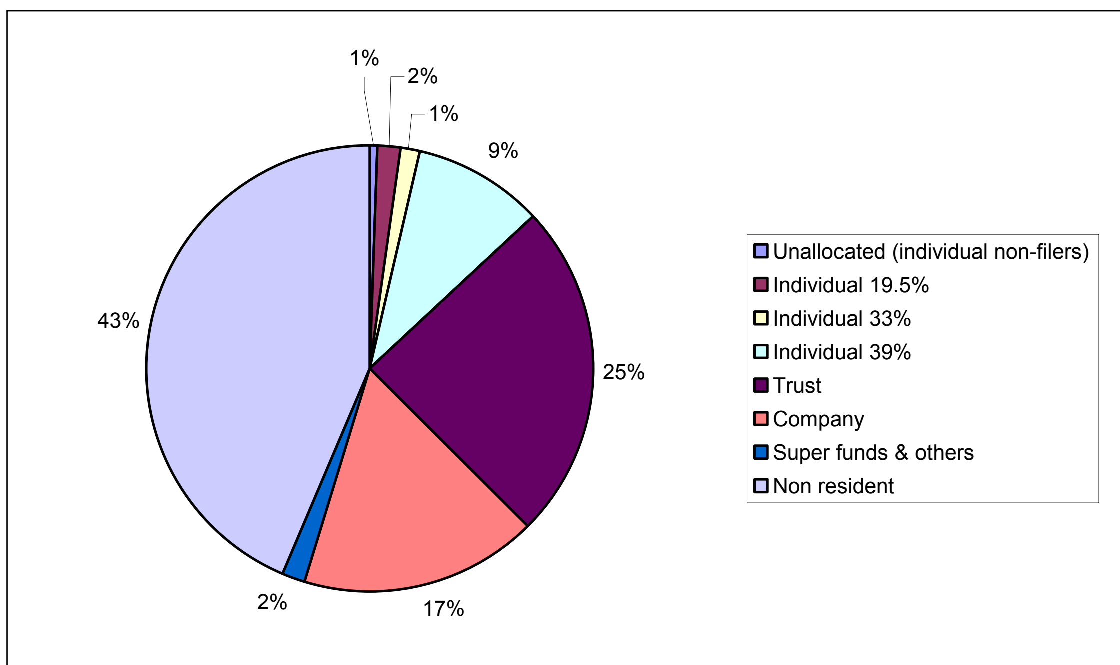
2.25 It is an open question, however, as to how concerned we should be if shares are sold to one person to another on a different tax rate when there is only a minor difference in their rates. These concerns obviously become larger the greater the difference in tax rates or, as discussed in Chapter 4, if imputation credits can be refunded.

What would the cost be if there were no anti-streaming provisions?

2.26 First, consider the potential costs arising from undermining source-basis taxation, as shown in Example 1.

2.27 Figure 5 shows imputation credits claimed in 2006. Approximately 43 percent of these were claimed by non-resident shareholders.

Figure 5. Imputation credits claimed in 2006 income year



2.28 It is clear that if unlimited streaming were allowed and this effectively allowed domestic company tax to be refunded to non-resident shareholders, the cost could be very substantial indeed. Company tax for 2008-09 is forecast to be $7.5 billion, and 43 percent of this would be of the order of $3.2 billion.

2.29 This is a very rough costing. The 43 percent figure does not necessarily reflect the proportion of foreign ownership of New Zealand companies because different companies will have different distribution rates. Also, there is the possibility for double counting as dividends are passed between related companies. Finally, there is considerable volatility in this ratio. For example, in 2005 only 36 percent of imputation credits were claimed by non-residents.

2.30 Whether or not all of this would be at risk is an open question. However, loss of any significant part of $3.2 billion could not be contemplated by the government.

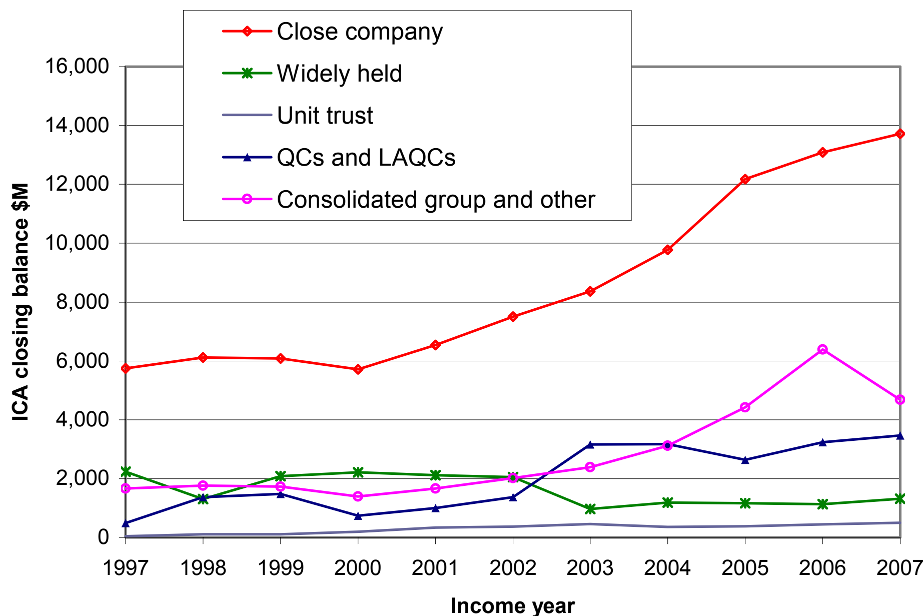
2.31 Costs of allowing streaming could also arise in the case of a company owned by a New Zealand resident. Suppose, for example, that our imputation continuity provisions (discussed in Chapter 3) were repealed and there were no replacement safeguards. That would allow the type of arrangement considered in Example 3. While there is a theoretical risk of income that should be taxed at a marginal rate of 39% being diverted to companies owned by those on a marginal rate of 12.5%, it is unlikely to be a major problem in practice. The larger concern could be diversion of income from those on a marginal rate of 39% to those, including trusts, taxed at a marginal rate of 33% percent or perhaps to widely held savings vehicles taxed at 30%.

2.32 At present, those on the top marginal tax rate are declaring $1,872 million in imputed dividends. If all of these were diverted to taxpayers on a 33% rate, the cost would be $112 million. It is also possible that income would be diverted to taxpayers on lower rates. If instead the income were all diverted to taxpayers on a 30% rate, the cost would be $169 million.

2.33 In practice, only a fraction of this amount is likely to be at risk because the kind of diversion shown in Example 3 would apply only to companies owned and controlled by a small group of shareholders. It would seem to be much more difficult to achieve diversion in the case of a more widely held company, although individual shareholders in the company could sell their shares before receiving a dividend without the company losing credits.

2.34 As well as any ongoing costs, there could potentially be an important one-off cost from allowing unlimited streaming. Figure 6 shows imputation credit account balances for various types of companies in New Zealand. By far the largest number of excess credits are held by close companies. These are companies with five or fewer shareholders, which can of course include very large private companies. The explanation for this is likely to relate in part to the fact that if dividends are distributed to shareholders rather than being retained in the company, they will be taxed in the shareholders' hands at 39%. Removing anti-streaming provisions would create opportunities for this income to be passed to new shareholders on lower tax rates.

Figure 6. Who has excess imputation credits?



Do current rules preventing streaming get in the way of valid commercial transactions?

2.35 Chapter 3 discusses a number of rules that are aimed at preventing dividend streaming. An important question is whether or not these anti-streaming rules get in the way of valid commercial transactions.

2.36 Before examining the question, it is worth briefly discussing the imputation system itself. Some have argued that imputation can stand in the way of firms expanding overseas. This is because domestic profits are taxed once, whereas foreign profits may be taxed twice: first when earned abroad by a foreign tax authority, and second when distributed as non-imputed dividends to domestic shareholders. Foreign profits would be double taxed under some other tax systems as well, including New Zealand's former classical company tax system.

2.37 It is clear that relative to New Zealand's former classical company tax system, there is a greater incentive to earn taxable domestic income under full imputation. Incentives to earn income in forms that are taxable in New Zealand help to make our company tax base more robust. They also tend to boost New Zealand's capital stock, which will add to growth and productivity.

2.38 However, the fact that the full imputation system increases incentives for domestic investment does not mean that it discourages offshore investment more than a classical company tax system does (for a given company tax rate). Shareholders will invest in companies that invest abroad if the after-tax returns are likely to exceed the opportunity cost of capital. Under both a classical company tax system and New Zealand's full imputation system, foreign-source income can be taxed both by the foreign revenue authority when the income is earned and in New Zealand when ultimately distributed to shareholders.

2.39 There may, however, be some more complex instances where the imputation system could be argued to impede internationalisation. This leads to a difficult conundrum for the government because addressing this issue would open up the concerns with streaming that were discussed earlier.

Example 4 – Bias against domestic company taking on foreign equity to invest abroad

2.40 Consider, for example, Company 1, which is owned solely by residents and is earning domestic-source income. Also suppose that this company is currently fully distributing its profits as dividends and that it wishes to continue to do so. Such a company can be discouraged from issuing shares to foreigners to invest abroad in ways that would not happen if the investment took place through a separate company. This is illustrated in Example 4.

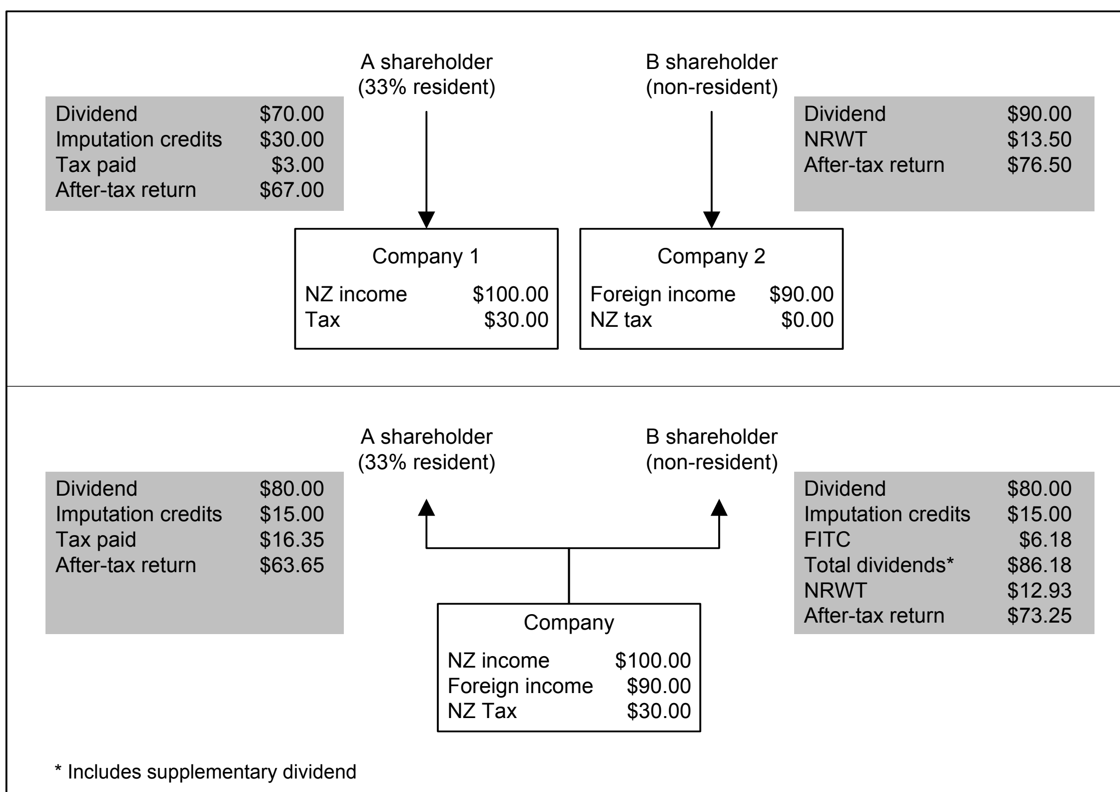
2.41 Suppose that Company 1 is initially owned by a New Zealand-resident shareholder taxed at a rate of 33%. It earns $100 of income on which it pays $30 of tax. It has a 100 percent distribution policy so it distributes its $70 of after-tax income as a dividend. The shareholder pays further tax of $3 and receives after-tax income of $67. This is illustrated in the left-hand side of the top panel of Figure 7.

2.42 Also suppose that a non-resident is willing to invest an amount, say $1,000, to a New Zealand firm (Company 2) with a technological innovation that allows the company to earn $90 abroad net of any foreign taxes. This income can then be paid as a dividend to the foreign shareholder. Under the proposed active income exemption that is currently before Parliament, Company 2 would pay no further tax in New Zealand, assuming the income is "active". This income can then be distributed as a dividend on which $13.50 of NRWT is paid, leaving the non-residents with $76.50 net of New Zealand taxes. For simplicity, we assume that the non-resident is not taxed on this income and cares only about the return net of New Zealand tax.

2.43 The imputation system can disadvantage the New Zealand company drawing on foreign capital to expand into offshore markets. Suppose, for example, that rather than these investments being undertaken by two separate companies, Company 1 acquires the foreign capital and starts earning both domestic and foreign-source income. Also suppose that it continues to want to fully distribute its profits. This case is illustrated in the bottom panel of Figure 7. The company is now earning $100 of domestic income, on which it pays $30 of tax and $90 of foreign-source income net of any foreign taxes. It pays no New Zealand tax on its foreign-source income. It could now pay a dividend of $80 to both its domestic shareholder and its foreign shareholder, assuming equal numbers of shares are held by both parties. However, this will be less attractive to both shareholders than if the investment were to be undertaken by separate companies.

2.44 Under the single company scenario, the domestic shareholder would receive an $80 dividend together with $15 of imputation credits, on which it would need to pay $16.35 in further tax. This would leave it with an after-tax return of $63.65, which is less than the initial after-tax return of $67. At the same time, the foreign shareholder would receive $80 of dividends and $15 of imputation credits, leading to a FITC credit of $6.18 and a gross dividend of $86.18. NRWT of $12.93 would be payable, leaving an after-tax return of $73.25, which would be unattractive from the foreign shareholder's point of view as well. Thus an investment that would be attractive if taken through separate companies can become unattractive if undertaken through a single firm. Figure 7 shows the after-tax return under both scenarios.

Figure 7. After-tax returns for Example 4



2.45 There are clearly some margins of adjustment that this example has ignored. For instance, one possibility might be for Company 1 to reduce its dividend yield when it takes on foreign shareholders to invest abroad.

2.46 Clearly, one possible way of removing this bias would be to allow foreign-source income to be streamed to foreign shareholders and domestic-source income to domestic shareholders. In this case, Company 1 could take on additional foreign capital to invest abroad without this diminishing its ability to pay fully imputed dividends to its domestic residents. It is very easy for taxpayers to convert domestic passive income into foreign passive income, and there may be concerns about biases discouraging firms from acquiring foreign equity to earn passive income abroad. This might possibly provide grounds for allowing only foreign active income to be streamed to foreign residents. At least in principle, however, a case could be made for allowing domestic income to be streamed to domestic residents and, perhaps, foreign active income to be streamed to foreign residents.

2.47 There are, however, a number of balancing considerations.

2.48 First, it is clear that there is a conflict between allowing such streaming and the government's objective of keeping the imputation system as close to a fully integrated system as possible.

2.49 In principle, all shareholders own a fraction of a company's underlying assets and have, in effect, borne a share of the corporate tax. Integration would mean that credits should, in principle, be distributed to all shareholders on a pro rata basis. This is not compatible with streaming, as was illustrated in Example 1.

2.50 Second, as noted, an important constraint on considering any possible streaming options is that the options should not create scope for source-basis taxation to be undermined. Before the government could contemplate allowing this form of dividend streaming it would need to be assured that it could do so without undermining source-basis taxation.

2.51 Third, allowing streaming would also create other biases. As was examined when discussing Example 1, allowing streaming would provide artificial incentives for mergers or sales of shares to create a tax-efficient ownership structure. Would these efficiency costs be greater than any efficiency benefits from allowing such streaming?

2.52 Fourth, an important feature of the New Zealand imputation scheme is the way in which it taxes dividends to domestic taxpaying shareholders when these dividends are not out of profits that have borne domestic tax. This creates incentives, all else equal, for firms to pay tax in New Zealand. This helps ensure the integrity of the New Zealand company tax system. A potential concern with any system of dividend streaming is that it may weaken these incentives.

2.53 Working through the pros and cons of allowing this form of dividend streaming is a complex issue. The government has yet to make a firm decision on this issue but there is clearly a big hurdle that needs to be overcome before contemplating any change in this area. The government would need to be convinced that the current rules were causing particularly difficult problems and that any rule change could be reasonably contained to the identified problem. It would also need to be convinced that the benefits of allowing streaming would outweigh the costs. It is interested, however, in receiving submissions on this issue and especially on whether or not it would be possible to introduce some form of dividend streaming without compromising the government's other objectives.

Impact on capital markets

2.54 A number of other, more limited dividend streaming proposals have been made for certain foreign-owned companies operating in New Zealand as ways of developing capital markets.

2.55 Market participants have raised concerns about the lack of depth in the New Zealand market. In particular, it has been argued that the acquisition of New Zealand companies by foreign investors means that New Zealand investors can now access only certain key sectors of the market by investing through foreign (mainly Australian) companies. It is clear that New Zealand's imputation system does provide incentives for New Zealand residents to invest at home, since imputation credits are provided for domestic but not foreign taxes. However, that is arguably attractive from a national welfare perspective because domestic taxes form part of the national return on the investment as they contribute to the government's ability to finance a wide range of public services. Capital invested in New Zealand will add to labour productivity and growth.

2.56 Limited dividend streaming might be one way of increasing the attractiveness of investment in foreign companies, but a case would need to be made as to why this would be in the best interest of New Zealand as a whole. A more attractive option still would be to allow mutual recognition of imputation credits between Australia and New Zealand. This option is being explored with Australia. It would appear to be an attractive way of expanding the set of companies that New Zealanders can invest in and receive imputation credits.

2.57 A number of parties have expressed concerns about the size of New Zealand's share market. On the surface, New Zealand's full imputation system, by making it more attractive for New Zealanders to invest at home, would appear likely to increase the size of the New Zealand share market. Even so, the government is particularly interested to hear of any features of the imputation system that might be inefficiently restricting the development of New Zealand's capital markets. This is an issue that might be considered by the government's recently announced Capital Market Development Task Force.

2.58 The government is not closing the door on limited dividend streaming proposals and is interested in receiving submissions on the issue. Before any moves in this direction were contemplated, however, it would be necessary to ensure that any such changes would not advantage foreign-owned firms relative to domestic-owned firms. To do so could create incentives for New Zealand companies to move their head offices overseas and then conduct their domestic operations through a subsidiary of the foreign parent.

2.59 It is also recognised that allowing any form of dividend streaming may or may not be acceptable to Australia if the two countries were to agree on a system of mutual recognition of imputation credits. Therefore it may not be possible to decide if this sort of reform is feasible until we decide on whether or not to pursue mutual recognition. Even if mutual recognition were not to proceed, any move to allow limited streaming would need to be discussed with Australia under the existing trans-Tasman imputation arrangements.

CHAPTER 3

Options for improving the current anti-streaming rules

Matters for discussion

Chapter 2 discussed the grounds for the government continuing to enforce some form of anti-streaming and credit allocation rules.

This chapter seeks feed-back on the current anti-streaming rules as follows:

- The extent to which the rules:
  - interfere with normal commercial transactions;
  - impose unnecessary compliance costs; or
  - lack certainty.
- Suggestions for changes to any or all of the current anti-streaming rules. Would adoption of some Australian anti-streaming concepts enhance our rules?

3.1 Chapter 2 discussed why New Zealand's current imputation rules are aimed at preventing dividend streaming and the reasons for the government continuing to enforce some form of anti-streaming rules.

3.2 That means, regardless of the eventual decision on whether or not there may be limited circumstances when streaming should be allowable, that a review of the current anti-streaming rules is timely. It would be of particular importance if the government were to support some form of limited streaming as that would introduce a new boundary into the tax system. Limited streaming would inevitably place more pressure on the existing rules.

How will the government judge suggestions for change?

3.3 Some of the current anti-streaming rules target specific transactions, while others are of a general anti-avoidance nature. The rules are intended to be interdependent. When considering whether any or all of the rules can be enhanced, the government seeks comment on three broad questions.

3.4 The first question, taking into account the government's objectives for this review, as set out in Chapter 1, is whether the rules inhibit normal commercial transactions. The government is especially keen to hear how the rules impact on arrangements using hybrid instruments (mixtures of debt and equity) such as redeemable preference shares, or the use of special purpose vehicles, as these type of arrangements are becoming increasingly common.

3.5 The second question is whether the rules impose an unnecessary compliance burden. As was pointed out in Example 3 of Chapter 1, the rules provide some protection for keeping the tax system as close as possible to an integrated tax system when the original and new shareholders are on different rates. The weight that is given to this concern when the rate differential is small is an open question. Take, for example, a share sale (including sale of an imputation credit balance) where the vendor shareholder is on a 39% percent tax rate and the purchaser on a 33% rate. In that case, the current rules would protect against a small loss of revenue ($6). It is clear, however, that concerns about this sort of arbitrage would be much larger if there were much bigger differences in tax rates.

3.6 The third potential question is whether the rules provide sufficient certainty for taxpayers to undertake commercial transactions with a clear understanding of the boundaries between what is legally acceptable and unacceptable.

3.7 The rules need to be considered in their entirety. Design change in one area of the rules puts pressure on other areas. The ease of administering any rule changes would also need to be considered.

3.8 This chapter outlines the current rules and suggests some possible areas where the anti-streaming provisions might be amended, particularly in light of the possibility of some movement in the direction of Australia's anti-streaming rules.

Relationship with Australian rules

3.9 Contemplating rules that are more consistent with those in Australia may be helpful when negotiating whether to have a system of mutual recognition of imputation credits and in implementing such a system. Australian rulings issued under the rules, as well as relevant case law, may also help provide taxpayers and administrators with a greater degree of certainty.

3.10 Any consideration of moving towards the Australian rules, however, should recognise New Zealand's different tax environment. Share sales in Australia are subject to a capital gains tax, which also has the effect of inhibiting short-term transactions. The absence of such a tax in New Zealand means that it is more likely that shareholder integrity measures have to be comprehensive, to avoid unintended manipulation of the rules. This means that, other things being equal, New Zealand may need tighter anti-streaming provisions than Australia does.

New Zealand's current anti-streaming rules

Shareholder continuity rule (sections OA 8, OB 41, OZ 4)[3]

3.11 The shareholder continuity rule helps to protect both source-basis taxation and the objective of keeping that tax system as close to a fully integrated system as possible, by preventing the type of streaming discussed in Examples 2 and 3 of the preceding chapter. This rule attempts to prohibit a company from carrying forward imputation credits unless a substantial percentage of those people who benefit from imputation credits were shareholders when the income was derived. It works by cancelling imputation credits in the event of a change of ownership greater than 34 percent from the time when those credits were generated

Same credit ratio (sections OA 18, OB 60-63, OZ 7, OZ 8, OZ 9)

3.12 A company can attach imputation credits to its dividends from a minimum of nil to a maximum ratio of:

$$\frac{\textit{Company Tax Rate}^{4}}{1 - \textit{Company Tax Rate}}$$

3.13 Companies are required either to maintain the same ratio of credit to net dividend distributions for all distributions during any income year as the credit ratio on the first (or benchmark) dividend, or make a ratio change declaration to the effect that the variation of credit ratio is not a streaming arrangement. Individual shareholders are therefore not able to gain a tax credit for a greater amount of tax than others who may have paid it on distributions within the current imputation year.

Trusts and partnerships (sections LE 1-6, LF 2-4)

3.14 Imputation credits on dividends distributed to trust beneficiaries are allocated according to the proportion of aggregate distributions (whether capital or income) made to each beneficiary from the trust in that year. The allocation rules for partnerships mirror those of trusts.

Imputation credit shopping (section OB 71, OB 72)

3.15 These rules are intended to prevent imputation credits earned by one group of companies being paid to the shareholders of a different group of companies. In broad terms, a company that has an imputation credit account debit balance when it leaves or joins a wholly owned group must pay an amount of tax equal to the debit. When there is no change in the ultimate owners of the group the leaving company can elect to have the debit balance debited to the imputation credit account of another company in the group. The shareholder continuity rule is also intended to prevent imputation credit shopping.

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[3] All statutory references are to the Income Tax Act 2007.

[4] Following the change in the company tax rate to 30% from the start of the 2008-09 income year, a transitional rule allows existing credits to be passed through at the 33/67 ratio until 1 April 2010.

Share lending (section GB 49)

3.16 Share lending rules allow qualifying transactions to be taxed on the substance of the transaction, which is a loan of shares, rather than the legal form, which is a sale of shares. Therefore, for imputation purposes, the imputation credits remain with the economic owner of the shares (the share supplier), who is the person who originally transferred the shares to another person (the share user). This is achieved by transferring the imputation credits to the share supplier and denying the tax credit to the share user. A specific anti-avoidance provision ensures that taxpayers do not attempt to structure arrangements to fall outside of the Income Tax Act (not merely the share lending rules). In that situation, Inland Revenue may treat the arrangement as a returning share transfer, with the person affected by the arrangement treated as a share supplier or share user. These rules guard against the type of arrangements illustrated in Example 2 of Chapter 2.

General anti-avoidance rules

Arrangements to defeat continuity rule (section GB 34)

3.17 When shares have been subject to an arrangement intended to defeat the intent and application of the shareholder continuity rule, under this rule the company is deemed not to have met the continuity requirements in respect of those shares.

Stapled stock (section GB 37)

3.18 This rule is aimed at arrangements in which a taxpayer is a shareholder of, say, a non-resident company but the rights of shareholding include allowing the shareholder to receive dividends from an associated company resident in New Zealand. (This kind of arrangement is not to be confused with arrangements that involve equity stapled to debt instruments. These are being addressed separately.)

3.19 If an arrangement is entered into for a purpose of having another company pay a dividend to the shareholder, a dividend is deemed to be paid by the company that entered into the arrangement. Also, the imputation credits attached to the dividend are deemed to be a debit to that company's imputation credit account.

3.20 Any imputation credit subject to this provision is neither eligible as a credit of tax against the recipient's income tax liability nor is it eligible for conversion and carry-forward as a net loss or tax credit.

Arrangements to obtain a tax advantage from imputation credits (section GB 35)

3.21 The imputation rules have a general anti-avoidance provision directed at counteracting trading in or recycling of credits and temporary transfers of interests in companies in order to obtain a tax advantage.

3.22 An arrangement to obtain a tax advantage includes streaming arrangements in which the streaming will give a higher credit value to a person receiving the credit than would have been case for the person who would have otherwise received the credit. A dividend has a higher credit value if it has an attached imputation credit and it replaces a dividend that does not, or if the imputation ratio of the dividend is higher than that of the other dividend.

3.23 When an arrangement is subject to this provision, the person who would get a tax credit advantage is denied it, and the company that would get an account advantage (a credit to its imputation credit account) has a debit to its imputation credit account equal to the imputation credit.

What are the private sector's concerns about the current rules?

3.24 The government is uncertain about the overall depth of private sector concern about the current anti-streaming rules, and therefore seeks comment about whether they need change and, if so, the form that change should take.

General anti-avoidance rules

3.25 Most comment to date has been that the general anti-avoidance rules present a number of difficulties of interpretation for both taxpayers and Inland Revenue, particularly when taxpayers contend the arrangements in question have legitimate commercial purposes. Existing rules have been criticised as being unclear on complex arrangements. Also, they should be flexible enough to allow arrangements that are commercially desirable.

3.26 One alternative would be to replace the general rule with rules that target particular types of transactions (as is done with imputation selling transactions, referred to earlier). If we move in the direction of closer alignment between the Australian and New Zealand imputation provisions, another possibility would be to adopt some of the Australian provisions.

3.27 Australia has four basic anti-avoidance rules (see Appendix) and while one rule is similar to New Zealand's current stapled stock provisions, referred to earlier, and another is purely of an administrative nature, the others attack arrangements that might otherwise be allowable in New Zealand under the current rules.

Continuity rules

3.28 If there was no continuity test or it was set at a lower threshold than the present 66 percent, a credit that had been earned in the past could be transferred to a new owner (say, a taxable resident) who might be in a very different tax position from that of the original owner (say, a tax-exempt entity). The continuity test also helps prevent sales of companies with imputation credit balances to companies who can more benefit from them.

3.29 Generally, when a continuity breach is imminent, a company may take action to prevent the loss of the imputation credits to shareholders by paying a dividend (often by way of a bonus issue) to reduce the imputation credit account to zero. Therefore the continuity rule can fill a useful function in that it can prevent the build up of unusable credit balances.

3.30 Some companies, however, lose their imputation credit balances because of errors in calculating shareholding changes. Moreover, the rules sometimes require companies to pay dividends or bonus shares, which may be costly for those companies, when there are no policy concerns with the shareholding change.

3.31 For example, suppose a company that is 100 percent owned by a shareholder on capital account on the 33% tax rate earns $100 profit and pays $30 tax. Under our current continuity rules, if these profits and imputation credits are not distributed before a sale of more than 66 percent of the shares of the company, the credits are cancelled in full. However, assuming the purchaser is able to make use of the imputation credits, if there were no continuity rules the value of the credits would be factored into the sale price for the shares. If the purchaser is also on capital account and on a 33% tax rate the vendor would receive a $67 after-tax return. Although this is, on the face of it, inconsistent with the integration principle, it is of no practical effect as the aggregate tax liabilities are unchanged.

3.32 The share sale in these circumstances, therefore, does not appear to create concerns as the transfer of a credit is accompanied by an offsetting obligation to pay tax on the underlying income. On the other hand, Examples 2 and 3 in Chapter 2 show that the risks of removing the rule in its entirety could be significant, especially if at some point in the future imputation credits could be refunded to some non-taxpayers, such as charities, as discussed in Chapter 4.

3.33 In the light of these policy concerns, the government seeks comment on whether the continuity rules have practical compliance consequences or if they constrain commercial activity, and if so, how these problems can be addressed without opening up arbitrage opportunities. For example, if a continuity rule is retained, is the 66 percent continuity threshold still appropriate, or should the ratio go up or down? What are the costs and practical implications of complying with the current rules, including taking action such as making bonus issues before a major shareholding change occurs? Alternatively, are there better ways of targeting arrangements, such as those described in Examples 2 and 3 in Chapter 2?

Exempting credit rule

3.34 Australia does not have quantitative tests for shareholding continuity. Instead it protects its source-basis taxation by an exempting credit rule that is designed to prevent the trading of imputation credits when foreign-owned companies or companies owned by tax-exempt entities are sold to residents. This rule is described in the Appendix.

3.35 A question for New Zealand is whether any such rules should be considered as a replacement for continuity provisions or in addition to continuity. If refunds are provided to charities and/or other non-taxpayers, transfers of imputation credits from non-resident shareholders to domestic taxpaying shareholders will not be the only issue of policy concern. Similar concerns would arise with transfers between domestic taxpayers on different rates. New Zealand may be subject to much greater pressures here than Australia would be because of the absence of a capital gains tax.

3.36 There is also an element of arbitrariness in the Australian rules. Should there, for example be a foreign/tax-exempt ownership threshold before the rules kick-in (in Australia it is 95 percent) and if so what is an appropriate ratio?

Holding period rule

3.37 While some of the impact of the exempting credit rules can be avoided by a temporary transfer of shares, the Australian franking credit holding rule, which generally allows only shareholders to benefit from imputation credits if shares are held for a minimum period (45 days, as discussed in the Appendix) provide some barriers to such arrangements. Would a similar rule be sensible for New Zealand and, if so, is 45 days a reasonable period? If such a rule were introduced, how should we best assess when a substantial part of the risks of ownership of shares is subject to an arrangement to defeat their application.

3.38 Finally, would compliance costs be eased by repealing our continuity rule and adopting the Australian holding period rule, together with the exempting credit rule?

Same credit ratios

3.39 The benchmark dividend rule is intended to ensure that imputation credits are evenly spread across all shareholders and not directed at those best able to use the credits. However, the current rule does not prevent the unequal distribution of imputation credits. This is because it looks only at actual distributions within the current year. Therefore it is possible to stream imputation credits by paying dividends only on one class of share, or using a special purpose vehicle with a different payout ratio to the head company or by paying dividends in alternate years. The question is whether, in practice, this causes major concerns.

3.40 The rules could be changed to measure imputation credit ratios across a two-year period and require them to be maintained. Moreover, to target transactions that consistently pay dividends only on certain classes of share or from special purpose vehicles, the benchmark rules could be extended to all shares from all entities within a group of companies. Would such a change have a substantial effect on compliance costs or hinder valid commercial transactions?

Trusts

3.41 The rule preventing streaming of credits to beneficiaries applies even if, for example, one beneficiary receives all dividend income and another receives non-dividend or capital payments only. This can lead to capital beneficiaries losing all of their allocation of imputation credits, as illustrated in Example 5.

Example 5. How beneficiaries can lose imputation credits

An estate has a number of beneficiaries. Beneficiary A has a lifetime interest in the income from half the original capital. The other half of the capital plus accrued income is to be paid to the deceased's children (Beneficiaries B and C) when they turn 25.

The income of the estate includes dividends that carry imputation credits.

In a particular year, Beneficiary A is paid out her share of the estate's income, being $4,000 of dividends. Beneficiary B turns 25 and is paid out her capital of $36,000. Therefore the total distribution is $40,000. $500 of imputation credits were attached to the dividend income distributed.

Based on her share of total distributions, Beneficiary A is entitled to 10 percent of the $500 of imputation credits, being $50. The remaining imputation credits are forgone as Beneficiary B is not entitled to an allocation of imputation credits because she is a capital beneficiary only.

3.42 The current requirement to pro-rate the imputation credits in the circumstances described in Example 5 produces results that are not equitable to the beneficiaries when there is no avoidance concern. Therefore some have argued that the scope of the rule is too wide.

3.43 One option would be to remove the current rule and instead rely on the general anti-avoidance rule. Alternatively, a formulaic approach could be used, although in the past this has been rejected as unworkable and not sufficiently robust.

3.44 The government is not considering a change to the rule requiring pro rata allocation of imputation credits to partners in a partnership as it was decided during the review of partnership taxation that all tax attributes associated with partnership income must be allocated pro rata, in proportion to partnership income. This is to prevent partnerships from using special allocations as a way of streaming tax benefits to partners who can best use them.

Imputation credit shopping

3.45 The imputation credit shopping rules preserve the integration principle, and the government would be reluctant to narrow it unless there was evidence of legitimate commercial transactions being prevented. If the continuity rule is relaxed, however, there may be a case for its extension to deal with situations involving change of ownership of group companies with credit balances to prevent inappropriate access to tax refunds by corporate purchasers.

Share lending

3.46 The specific anti-avoidance rule in the share lending provisions targets the streaming possibility outlined in Example 2, so the government would also be reluctant to change it without providing some clear substitute preventing temporary share transfers

CHAPTER 4

Rethinking the refund rules

Matters for discussion

The current imputation rules do not provide refunds for imputation credits that cannot be used. This chapter discusses the case for providing refunds for imputation credits in some cases – such as for tax-exempt organisations such as charities – and seeks comment on the following matters:

- Does the absence of a rule allowing a refund for imputation credits affect the type of investments a tax-exempt organisation makes?
- If rules were introduced to allow imputation credits to be refunded, it would be necessary to ensure they did not undermine the objectives of the imputation system. What checks and balances would a responsible refund mechanism have?
- Do other options exist to deal with concerns identified in this chapter?

4.1 New Zealand company tax is paid on income earned by New Zealand companies. This company tax paid can then be attached in the form of imputation credits to dividends paid to shareholders, so that, effectively, the company tax is seen as a withholding tax for the shareholder. If shareholders are subject to New Zealand tax they will have tax to pay on the dividend they receive and can use the imputation credits to pay all or part of that tax.

4.2 If, however, the shareholder does not have to pay tax on the dividend – for example, if the shareholder is a tax-exempt charity – the imputation credits cannot be used and cannot be refunded. The benefit of the imputation credits is lost to the shareholder. Moreover, the dividend income earned by the tax-exempt shareholder has effectively been taxed at the company rate rather than at the shareholder's effective rate of zero percent.

4.3 One of the effects of this treatment is that tax-exempt organisations may choose investments that pay them a before-tax return (referred to as non-imputed income, such as interest) over those New Zealand shares that provide an after-tax return, such as imputed dividends.

4.4 This outcome is a concern for shareholders in New Zealand companies when those shareholders have a specific exemption from New Zealand income tax and consequently are not subject to tax on the dividends they receive. Registered charities are one example of a group that currently has a specific income tax exemption.

4.5 Similar concerns arise for shareholders who have tax losses or who are on marginal tax rates that are lower than the company tax rate. In these cases, however, the imputation credits that are not needed to satisfy the current year's tax obligation on the dividend can be carried forward by the shareholder and used to meet future tax obligations on other income.

4.6 This chapter covers the current policy reasons for not allowing the refunding of imputation credits. It then considers the case for refunding imputation credits to organisations that have specific exemption from New Zealand income tax – for example, registered charities – and taxpayers with losses or tax rates that are lower than the company tax rate.

Current policy on refunding imputation credits

4.7 For reasons discussed in Chapter 2, New Zealand tax will continue to apply to foreign shareholders on the income they earn indirectly through their investments in New Zealand companies. This means that foreign shareholders should not receive refunds for imputation credits. Providing a refund to these shareholders would mean that any company tax paid in New Zealand would be effectively refunded.

4.8 In the case of New Zealand organisations that are not subject to tax on their income the issue is more complex, however. The concern is that these organisations are not able to benefit from the imputation system. This is contrary to one of the principles underpinning the imputation system, which is that shareholders should, as far as possible, be treated as if the income earned by the company were earned by them directly.

4.9 This concern with the current policy is frequently raised by the charitable sector as a reason for rethinking the rules that apply to refund of imputation credits.[5] The government is very aware of these concerns. In designing the imputation system, however, policy decisions were made that imputation credits should not be refunded, meaning that tax-exempt organisations and non-resident shareholders continued to be taxed at the company level on dividends received. Tax-exempt organisations are, in principle, no worse off under this decision than they were under the dividend system that applied till 1988.

4.10 The concern that has always existed when considering the case for refunding imputation credits is the pressure that could be placed on the company tax base by allowing refunds. Refunding tax credits could also create greater incentives for charities to be used in "tax planning" arrangements, contrary to policy.

4.11 Given the objective of taxing non-residents on the income they earn in New Zealand and that shareholders should, as far as possible, be treated as if the income earned by the company were earned by them directly, we now consider the case for refunding imputation credits.

[5] As noted in the October 2006 discussion document *Tax incentives for giving to charities and other non-profit organisations*.

The case for refunding imputation credits to tax-exempt organisations

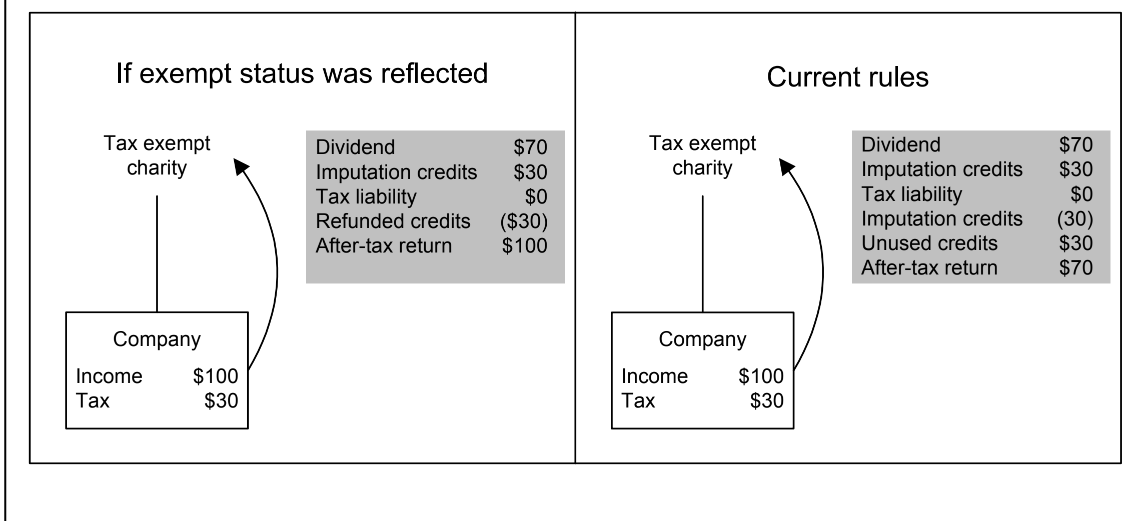
4.12 Tax-exempt organisations are concerned that they cannot use imputation credits. They are effectively subject to tax at the company rate, 30%, on the income that is taxed within any companies they invest in. Example 6 shows the after-tax return a tax-exempt organisation receives from an investment in New Zealand shares, compared to what it would get if the taxation of the company income reflected its tax-exempt status.

4.13 As a result of the effects illustrated in Example 6, tax-exempt organisations are likely to prefer investing in products such as loans, bank deposits or shares that do not pay imputed dividends. Investment in New Zealand company shares, on the other hand, offers an after-tax return in the form of imputed dividends. Example 7 illustrates this point.

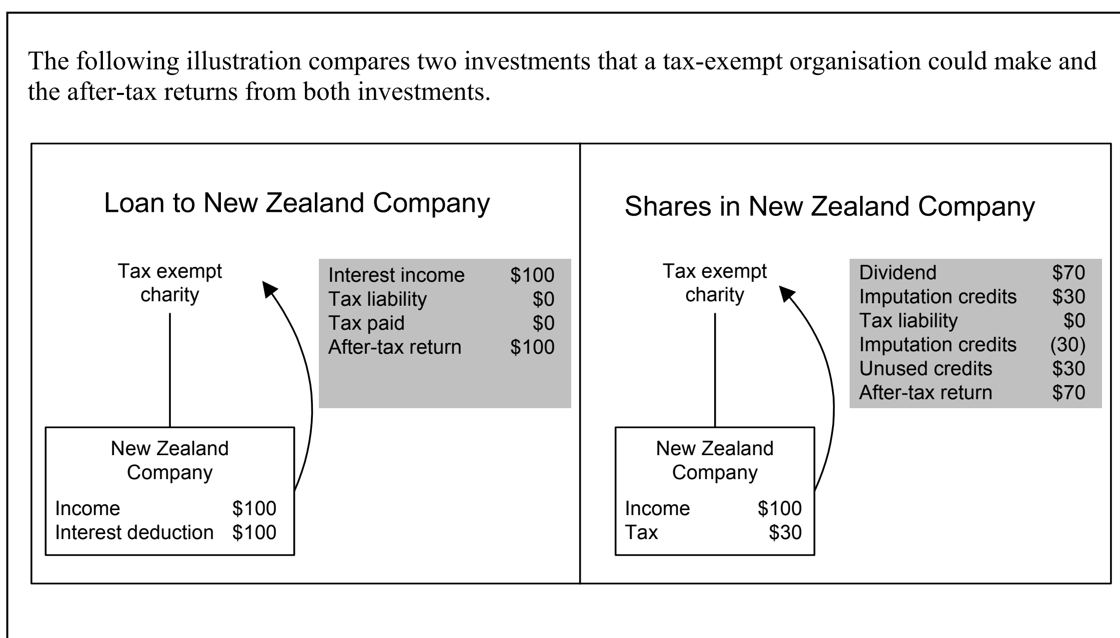
Example 6. How the imputation rules do not reflect tax-exempt status

A tax-exempt charity invests in a company that earns $100 profit and pays $30 tax at the company level. The profit is distributed to the charity. If the imputation system recognised the charity's tax-exempt status the after-tax return would be $100.

Under the current imputation system, however, when the profit is distributed to the charity, there is an after-tax return of $70. The imputation credits of $30 are lost.



Example 7. How the imputation rules can affect the after-tax return on investments



The case for refunding imputation credits to taxpayers with lower marginal tax rates or those with losses

4.14 Taxpayers with marginal tax rates that are lower than the company rate or taxpayers with losses may also have an interest in receiving refunds of imputation credits. They are unable to receive the full benefit of the imputation credits attached to the dividends they receive unless they have enough other taxable income. Imputation credits that cannot be used must be carried forward against future taxable income.

4.15 One important distinction between this group of taxpayers and tax-exempt organisations is that taxpayers in loss or on lower marginal tax rates may benefit from using the imputation credits in future income years.

4.16 While there is a cost to this deferral, the tax benefit of the imputation credits is not lost and, for financial reporting purposes, the value of these credits may be recorded as a tax asset. Therefore the concern is a matter of timing because tax is collected on taxable income at an earlier point in time than it would be otherwise.

4.17 The fact that the benefit of the imputation credits is not lost raises questions about whether it is necessary to refund to this group of taxpayers any imputation credits that remain unused in a current tax year.

Important considerations for refunding imputation credits

Scope

4.18 Consideration could be given to allowing imputation credits to be refunded to some or all of the groups that have an interest in allowing imputation credits to be refundable – including registered charities, other entities with specific statutory tax exemptions, taxpayers whose marginal tax rates are lower than the company rate, and taxpayers in loss.

4.19 Australia, for example, has taken the approach of limiting access to refunds to certain groups, including individuals who are Australian residents, superannuation funds and certain tax-exempt organisations.

4.20 To qualify for a refund under the Australian rules, tax-exempt organisations must have a physical presence in Australia, incur expenditure in Australia, pursue their objectives principally in Australia during the income year in which the distribution is made.

4.21 The Australian refund rules are supported by a range of anti-avoidance rules designed to ensure that the franking credits (Australia's equivalent to our imputation credits) are not streamed to those that can seek refunds of the credits. If New Zealand provided for refunds, consideration would need to be given to these sorts of rules. It is obviously necessary to balance the complexity of the rules against concerns about the potential for tax planning opportunities. The rules in this area are also relevant in the context of streaming generally, as discussed in Chapter 3.

4.22 In considering the scope of introducing a refund mechanism it is relevant to consider whether such a move could be viewed as discriminatory. In other words, would it be acceptable to discriminate against non-resident shareholders over resident shareholders and between domestic shareholders in different tax paying situations?

"Tax planning"

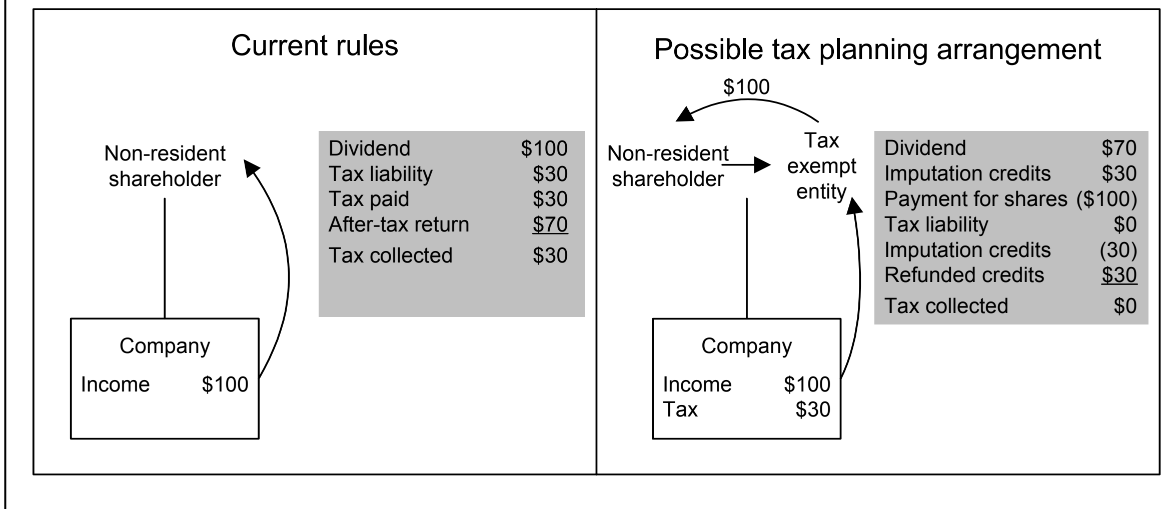
4.23 Refunding imputation credits could lead to an increase in incentives for companies and shareholders to allocate imputation credits to shareholders that could access refunds. A concern with refunding imputation credits is that it would place additional pressure on the rules that ensure taxpaying shareholders in New Zealand companies continue to pay the correct amount tax on the income they earn in New Zealand.

4.24 For example, allowing imputation credits to be refunded to tax-exempt organisations could increase the incentive for certain taxpayers to temporarily transfer shares to tax-exempt organisations and then extract the refund, to the benefit of both parties – as illustrated in Example 8. If the type of arrangement described in the example resulted in less tax being paid by non-resident shareholders or higher marginal tax rate taxpayers (those that are required to pay tax at 33% or 39%), that would pose a risk to the tax base. The risk would apply equally to shareholders with losses.

4.25 The need for robust, potentially complex, rules to guard against tax planning opportunities must be balanced against the need to have legislation that is easy to understand and comply with.

Example 8. Base maintenance problem with refunding imputation credits

A company that is 100 percent owned by a non-resident shareholder earns $100 profit and pays $30 tax. If these profits are distributed to the non-resident shareholder, there will be an after-tax return to the shareholder of $70. However, if the shares were sold to a tax-exempt entity before distribution, in the absence of suitable anti-avoidance rules the tax-exempt entity would be entitled to a $30 refund of tax (assuming a refund is available for the imputation credits). This tax refund is likely to be shared between the vendor and purchaser through the sale price of the shares. If the shares were sold for $100, the vendor would receive a $100 after-tax return. This result is inconsistent with the objectives of the imputation system, and the $30 reduction in tax paid would also be a fiscal cost.



Fiscal cost

4.26 It is difficult to determine the fiscal cost of providing refunds to the various groups identified in this chapter.

4.27 Refunding imputation credits to tax-paying resident shareholders that cannot use the credits against a current year's tax liability (for example, if the taxpayer is in a tax loss position or has insufficient current year's taxable income to use the credit against) is estimated to have a fiscal cost of $400 million. This estimate is based on data available for the 2006 and 2007 income years. This fiscal cost is likely to make it difficult for the government to extend refundability to this group. It should be noted, however, that these taxpayers can use the imputation credits against future years income tax liabilities.

4.28 Information about the value of imputation credit balances held by tax-exempt organisations is limited because they are not required to file tax returns. Allowing refunds for imputation credits, though, is likely to come with significant cost to New Zealand, without taking into account any changes in investment behaviour that may result.

4.29 There is also the question of the value of existing imputation credit balances and whether refunds should be limited to imputation credits generated by companies after the introduction of any refunds. The cost of not doing so is expected to be prohibitively expensive.

Fairness

4.30 If, because of concerns about tax planning or fiscal cost, decisions are made to exclude certain persons or organisations from any refund mechanism, that will add to the complexity of any rules and raise questions about discrimination. For example, refunds could be selectively made to organisations such as registered charities or charities that qualify for income tax exemptions. That, however, would discriminate against other tax-exempt taxpayers such as local authorities, qualifying friendly societies and amateur sports clubs.

Discrimination and non-residents

4.31 Similarly, establishing the grounds for refunding imputation credits is also important if New Zealand continues to tax income earned in New Zealand by non-residents. For example, consideration needs to be given to whether or not the extension of refunds to some or all New Zealand residents could violate discrimination prohibitions, either in domestic law or in international agreements (such as double tax treaties).

Matters for consultation

4.32 The question of refunding imputation credits to charities or other groups poses a number of complex questions and is not without its risks. Readers' views about whether a refund mechanism for imputation credits would be suitable for New Zealand, in light of the issues outlined in this chapter, are welcome.

APPENDIX

Australian anti-streaming rules

Australia has four anti-streaming rules contained in the Income Tax Assessment Act 1997. The rules are:

1. A franking debit is generated if the exercise or non-exercise of a choice by a member (in broad terms, a shareholder) of one corporate entity results in a linked distribution being made by another corporate entity in substitution for a distribution by the first entity.

2. A franking debit is generated if the exercise or non-exercise of a choice by a member of the entity determines (to any extent) that the entity issues tax exempt bonus issues (as defined) to the member or another member in substitution for imputed dividends.

3. A rule that applies where a member who is better able to benefit from imputation credits receives one or more imputation benefits. An ***imputation benefit*** is:

   - an entitlement to a tax offset or, if the member is a corporate tax entity, a franking credit;
   - an amount that would be included in the member's assessable income as a result of the distribution; or
   - an exemption from withholding tax (relevant if the member is a non-resident).

   The recipient must derive a greater benefit from imputation credits than another member who misses out on an imputation benefit. Relevant factors in determining whether the recipient derives a greater benefit from imputation credits than another member includes, amongst a number of factors, the residency of the members. A difference in shareholders' marginal tax rates does not, by itself, indicate that some members derive a greater benefit from imputation credits than others.

   If the elements of this streaming rule are present, the Commissioner may make a determination that:

   - the streaming entity will incur an additional franking debit in respect of each distribution made or other benefit received by a member; and/or
   - no imputation benefit is to arise in respect of any streamed distributions paid to a member.

   The following examples are adapted from the explanatory memorandum that accompanied the legislation in order to illustrate the type of arrangements that this rule intends to target:

Single distribution streaming by a non-resident controlled company

A non-resident controlled company with resident minority shareholders adopts a strategy of distributing all its franking credits to the minority shareholders while retaining the share of profits belonging to the controlling shareholder in the company. It does this with a view to ultimately paying an unfranked dividend, or paying some other benefit to the majority shareholder, or someone else, in lieu of a dividend (which would include realising accumulated profits as a capital amount on the sale of shares).

Share buy-back – limited imputation credit surplus

A company has members with differing abilities to benefit from franking credits and a limited supply of credits. It makes a fully franked distribution by buying back off-market the shares owned by taxable residents to stream the limited credits available to those who can most benefit from them.

Share buy-back – excess credits

A company has more franking credits than it is reasonably likely to use to frank its ordinary distributions. It buys back shares off-market predominantly from members most able to benefit from franking credits because the terms of the buy-back are not attractive to the other members. As a result of the buy-back it uses profits it would not normally distribute, thereby directing a large franked distribution predominantly to those who benefit most from franking credits.

Dividend access share

A company group contains an operating subsidiary which is owned by a company that has tax losses. The members of the loss company can, because they are not in tax loss, derive a greater benefit from franking credits than the loss company. The members are issued with a dividend access share to stream dividends directly to them. (Broadly speaking, a dividend access share is one that confers no rights and is issued only to enable a shareholder to get a distribution from the company.)

4. A rule requiring disclosure to the Commissioner where an entity's benchmark ratio varies significantly between imputation periods.

Exempting credit rules

The exempting credit rules are designed to prevent imputation streaming by companies that are effectively owned (up to 95%) by non-residents or tax-exempt entities. Franking credits held by companies subject to these rules can only be used to relieve dividend payments to non-residents from NRWT.

These rules apply to an Australian resident company (the exempting entity) that is effectively owned (directly or indirectly) by a tax exempt or non-resident shareholder (though there is an exception to the rules where the company has New Zealand owners). The exempting entity would be subject to the ordinary imputation rules except that franking credits attached to dividends paid by it would be restricted solely to providing an exemption for NRWT on dividends to non-resident members. None of the franking credits would be attached to dividends paid to resident shareholders, with the credits being cancelled.

If all the shares in the exempting entity were sold to Australian residents, its franking credit account would be converted to an "exempting account". The exempting credits attached to these dividends would continue only to be eligible to reduce non-resident withholding tax where relevant. They otherwise would have no value.

Holding period rule

This rule requires resident taxpayers to hold shares for a minimum period of at least 45 days to be eligible to use franking credits from dividends paid on those shares as a credit against their tax liability. There are several exceptions to the rule, including an exemption threshold for certain small shareholders.

Furthermore, even if the shares are held for the minimum period, the franking credit is denied if the resident taxpayer has eliminated a substantial part of the risks of their ownership in the shares by other financial transactions during that period. Hence the rule also specifies a 30 percent minimum level of ownership risk.

GLOSSARY

Active income. Income of a controlled foreign company which is not passive income. It could include, for example, income from the sale of goods manufactured or purchased by the company.

Benchmark dividend. The first dividend paid by a company required to maintain an imputation credit account the imputation year (defined below). All subsequent dividends paid during the imputation year must carry imputation credits at the same ratio (unless the Commissioner of Inland Revenue is furnished with a ratio change declaration).

Classical system. The classical tax system levies income tax on company profits as they are earned and on dividends distributed to shareholders from those profits without providing any relief for what is essentially double taxation. This is the system that existed in New Zealand immediately prior to the introduction of imputation in 1988.

Controlled foreign company (CFC). A foreign company controlled by a small number of resident shareholders.

Double tax agreement. A bilateral treaty between countries designed to avoid, or provide relief from, double taxation and to prevent fiscal evasion.

Exempting credit rules. Australian anti-avoidance measures designed to prevent imputation "streaming" by targeting companies that are effectively owned by non-residents or exempt entities. Discussed in the Appendix.

Fair dividend rate. The method of calculating income from international share investments applying from 1 April 2007.

Foreign investor tax credit. The foreign investor tax credit rules reduce the combined income tax and non-resident withholding tax imposed on foreign investors with interests in a New Zealand company to 30%. A company is entitled to a foreign investor tax credit when it pays a supplementary dividend (also defined) of the same amount to its non-resident shareholders. The foreign investor tax credit can then be offset against the company's income tax liability.

Franking. The Australian equivalent of New Zealand's imputation system**.** The terms "franking" and "imputation" are often used interchangeably.

Holding period rules. Australian anti-avoidance rules to prevent the short-term transfer of shares over dividend payment dates. Discussed in the Appendix.

Hybrid instrument. Securities that combine elements of both equity and debt.

Imputation. A tax system whereby credit for all or part of the income tax paid at the company level is passed through to shareholders when dividends are paid.

Imputation year. The period 1 April to 31 March, irrespective of the company's balance date.

Imputation credit shopping. Describes an arrangement in which imputation credits earned by one group of companies are sold to the shareholders of a different group of companies.

Imputation streaming. When companies direct imputation credits to shareholders who can use them, while providing some other benefit to shareholders, such as non-residents, exempt or tax loss shareholders, who cannot fully use the credits.

Integration principle. The principle that income earned at the company level is attributed to the shareholder and taxed at the shareholder's personal tax rate.

Mutual recognition. A system under which Australia and New Zealand each provide tax credits to their resident individuals who receive company distributions from across the Tasman, to compensate for tax paid in the other country.

Non-resident withholding tax (NRWT). An amount withheld by the party making payment to a non-resident (payee) of non-resident withholding income and paid to Inland Revenue. Non-resident withholding income comprises income derived from New Zealand consisting of dividends (other than investment society dividends and, from 1 October 2007, dividends from portfolio listed companies), royalties derived by a non-resident, or interest and investment society dividends derived by a non-resident (except those carrying on business through a fixed establishment). The NRWT rate for dividends is ordinarily 30% of the non-imputed amount, though this can be reduced to 15 percent under an applicable double tax agreement.

Passive income. Income of a controlled foreign company that, in general, is very mobile and may easily be shifted between jurisdictions.

Redeemable preference shares. Shares which, on a stated date, the issuing company will buy back for face value plus dividend. Being preference shares, they rank ahead of ordinary shares, but behind debentures, in any claim on the assets of the company. They usually also give their holder priority in relation to the payment of dividends and often carry the right to a fixed dividend each year. Finally, they may be non-voting, or may only have the right to vote if the payment of their preference dividend is in arrears or in relation to certain key issues which may affect the preference shares.

Share lending. An agreement under which securities are lent in consideration for the return of equivalent securities at a later date (plus payment of a fee). New rules were enacted to ensure that imputation credits remain with the economic owner of the shares were enacted in 2006.

Source-basis taxation. The principle that all income which originates in a country is subject to tax in that country, whether the person or entity to which the income accrues is resident or non-resident.

Special purpose vehicle. A body corporate (usually a limited company or, sometimes, a limited partnership) created to fulfil narrow, specific or temporary objectives, primarily to isolate financial risk.

Stapled stock. A security which is comprised of two parts that cannot be separated from one another – for example, a unit of a unit trust and a share of a company. The resulting security is influenced by both parts and must be treated as one unit at all times for tax purposes.

Supplementary dividend. A dividend paid to non-resident portfolio investors during the year which is in addition to another dividend paid in the same income year. The amount of the supplementary dividend is calculated on the basis of the imputation credits (net of the non-resident portfolio investor tax credit) allocated to the first dividend.