# Regulatory Impact Statement

## Clarification of dividend definition

### Agency Disclosure Statement

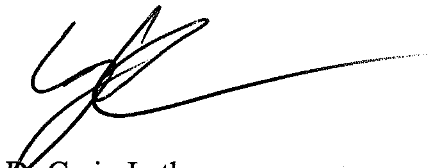
This Regulatory Impact Statement has been prepared by Inland Revenue.

The question in this RIS is how to clarify that three transactions (rights issues, premiums paid under bookbuild arrangements, and share splits) are excluded from the definition of "dividend" in the Income Tax Act 2007.

The analysis is based on the existing policy that these transactions should not constitute a dividend. There are no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties concerning the analysis.

Officials have undertaken targeted consultation on the draft legislative provisions, including consultation with representative organisations. Comments were also received on whether clarification for the tax treatment of these three transactions is required. The feedback has been taken into account and has influenced the proposed draft provisions. As a result, the proposed provisions have been amended so that they target the intended transactions more appropriately, especially to cater for transactions arising in practice.

None of the policy options considered impair private property rights, reduce the incentives for businesses to innovate and invest, impose additional compliance costs, restrict market competition, or override fundamental common law principles.



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## STATUS QUO AND PROBLEM DEFINITION

1. Under the Income Tax Act 2007, dividends are treated as income and can be subject to tax. The current definition of "dividend" was rewritten as part of the Income Tax Act 2004 rewrite project. The definition contains a general, broad definition and then excludes certain transactions that are not intended to fall within the definition. Under the general definition, three elements are required for an amount to be a dividend:

- a transfer of value;
- the transfer is from the company to the shareholder; and
- the transfer is made because of a shareholding relationship.

2. It is unclear whether three transactions (rights issues, premiums paid under bookbuild arrangements, and share splits) fall within this definition. From a policy perspective, these transactions should not be treated as dividends, since dividends are transactions between a company and a shareholder where the company generally transfers:

- retained earnings or current-year profits to the shareholder; and
- the transfer is made in recognition of the shareholder's ownership interest in the company.[1]

3. These three transactions have been targeted because they have been identified as key practical situations where the tax implications are unclear. Inland Revenue officials are aware of a number of large publicly listed companies that are undertaking these transactions. For these companies and their shareholders clarification of the tax treatment of the transactions would be beneficial.

4. If the status quo is retained, the tax treatment of the three transactions will remain uncertain. This is an undesirable outcome since it reduces incentives for businesses to innovate and invest, as companies may be deterred from undertaking the equity-raising transactions of rights issues and bookbuilds.

5. The question in this RIS is how to clarify that the three transactions (rights issues, premiums paid under bookbuild arrangements and share splits) are excluded from the definition of "dividend" in the Income Tax Act 2007. The three transactions are described below.

### Rights issues

6. A rights issue is where a company issues its shareholders with the right to buy new shares, usually at a discount to market price. The price at which the original shareholders are entitled to buy the shares is the *subscription price*. Rights issues are a form of equity finance and, in some instances, the rights can be traded or renounced so that the shareholder can sell their rights to others.

7. From a policy perspective, rights and discounted shares issued under a rights issue should not be treated as a dividend because the company does not give up anything of value

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[1] There are other provisions which extend this general policy, and these are necessary to buttress the dividend rules. However, these provisions are not relevant to the changes that are being proposed.

that represents retained earnings or current-year profits. A rights issue involves the company raising new equity where the shareholders insert new funds into the company.

**Premiums paid under a bookbuild**

8. A bookbuild is an arrangement where, after a rights issue, the rights of shareholders who did not participate are offered to other investors (the investors pay a *clearing price* for the rights). The shareholders who choose not to participate or are not entitled to participate are paid a premium for giving up their rights. This premium generally reflects all or some of the difference between the clearing price and the subscription price.

9. From a policy perspective, a bookbuild should not be treated as a dividend because, like a rights issue, the company does not give up anything of value that represents retained earnings or current-year profits. Under a bookbuild, the premium is effectively paid by the investors (who take up the right) to the non-participating shareholders, and the company simply acts as an intermediary.

**Share split**

10. A share split involves a company diluting its shareholding by issuing new shares to its shareholders, or by dividing or subdividing its shares. This is done in a way whereby the shareholding proportions are retained but the shareholding is split into a greater number of shares.

11. From a policy perspective, a share split should not be treated as a taxable dividend because the company does not give up anything of value that represents retained earnings or current-year profits. Furthermore, in a share split, the shareholder is generally not involved in a transaction with the company.

12. Under the current dividend definition, there is a strong argument that share splits are not dividends. Although this means there is some greater clarity in this area compared to the other transactions, we still recommend clarifying the rules for share splits at the same time as rights issues and premiums paid under bookbuilds to ensure that this position is beyond doubt in all relevant situations.

## OBJECTIVE

13. The objective is to assist taxpayers by ensuring that there is tax certainty for the three transactions described above.

## REGULATORY IMPACT ANALYSIS

14. There are two main options for clarifying the dividend definition. The options are:

- **Option 1:** amend the law so that the three transactions are not dividends *(preferred option)*, or
- **Option 2:** carry out a broad review of transactions that may constitute a dividend, including the tax treatment of various types of securities.

15. Option two arose out of consultation. This option is not recommended because it would involve an investment of resources that is not justified, as officials are not aware of any tax uncertainty for other similar transactions.

16. As option one is in line with the current policy rationale of what should constitute a dividend, officials have focused on this option. Within option one there are three main sub-options, all of which achieve the objective of tax certainty.

17. Sub-option 1A involves amending the Income Tax Act 2007 by inserting specific exclusions to the general definition of "dividend". This is the recommended option.

18. Sub-option 1B involves amending the general definition of "dividend" itself.

19. Sub-option 1C involves retaining the status quo and issuing an Inland Revenue publication (such as an interpretation statement) stating how the current legislation is intended to apply to the three transactions.

20. The three sub-options are summarised in the following table:

| Sub-option | Advantages | Disadvantages |
|---|---|---|
| **1A:** Insert specific exclusions to the general definition | - Results in tax certainty<br>- Unlikely to result in unintended effects<br>- Any amendment would fit within the existing legislative structure of the dividend definition | - Clarification is strictly limited to the three transactions (if similar transactions arise in the future, further legislative changes would need to be made) |
| **1B:** Amend the general definition | - Results in tax certainty<br>- Targets the source of the problem | - May result in unintended effects (for unanticipated transactions) |
| **1C:** Retain status quo for legislation and publish Inland Revenue interpretation guidance | - Provides some degree of tax certainty | - Legislative uncertainty remains which may impose additional compliance costs |

21. The implications of sub-options 1A, 1B and 1C are outlined in the table above. Apart from increased tax certainty that facilitates investment, none of these three options have economic, compliance, environmental, social or cultural impacts.

22. Sub-options 1A, 1B and 1C do not result in fiscal implications (on the basis that any changes simply align with existing policy). It should be noted that option 1B could introduce a revenue-negative risk if the amended definition inadvertently grants non-taxable status to unanticipated transactions.

23. We understand that companies currently treat these three transactions as falling outside the dividend definition. Therefore, any amendment which clarifies that these transactions are not dividends would not have a fiscal impact when compared to the status quo. Although, in practice, companies have not treated these three transactions as dividends, it would still be beneficial to clarify their tax treatment as it would ensure that there is tax certainty.

24. Option 2 may result in fiscal implications, depending on the decisions that are made following any such review. However, this option is not recommended. As noted above, Inland Revenue is not aware of the legislation resulting in interpretation issues for other arrangements, and for this reason do not consider the additional investment in time and resource for a broader review to be justified. If officials are made aware of unclear tax treatment of other arrangements, a review of the tax treatment of these arrangements may be considered.

## CONSULTATION

25. In April 2012, officials undertook targeted consultation on the draft legislative provisions (drafted in line with sub-option 1A), including consultation with representative organisations. The consultation focused on groups that have a strong interest in general tax policy amendments, or expressed an interest in the particular issue.

26. Submitters commented on technical issues regarding the drafting, and questioned or provided their views on whether the proposed changes should extend to other similar transactions. All submitters' comments have been taken into account in the design of the options.

27. In addition, one submitter considered that the tax treatment of these transactions would be best reviewed as part of a broader review, rather than focusing on only these three transactions. They also considered that the change to share splits should not proceed because, in the submitter's view, the current provisions already achieve the intended result. We agree that, in practice, it is highly unlikely that taxpayers will interpret the legislation as giving rise to a dividend when a share split is carried out. However, we still consider that it is worthwhile to carry out legislative clarification for share splits because, depending on the form of the share split (whether the shares are divided or new shares are issued), the legislation may be able to be interpreted in a way that results in a dividend.

28. The Treasury was also consulted and agrees with the recommended solution.

## RECOMMENDATION

29. The recommended option is to amend the Income Tax Act 2007 by inserting specific exclusions to the general definition (option 1A).

## IMPLEMENTATION

30. The legislative change would be included in the tax bill scheduled to be introduced in July 2012.

31. No implementation risks have been identified. Implementation can be managed within existing systems.

## MONITORING, EVALUATION AND REVIEW

32. There are no plans to monitor, evaluate and review the changes under the Income Tax Act 2007 following this amendment. This is because the reforms align the legislation with existing policy and the approach generally adopted in practice. If any specific concerns are

raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process. Also, the Income Tax Act 2007 is subject to regular review by officials.