Hon Barbara Edmonds, Minister of Revenue

Information Release

Deductibility of co-operative company dividends

October 2023

Availability

This information release is available on Inland Revenue's tax policy website at https://taxpolicy.ird.govt.nz/publications/2023/2023-ir-cab-dev-23-sub-0186

Documents in this information release

#	Reference	Type	Title	Date
1	DEV-23-SUB-0186	Cabinet paper	Deductibility of co-operative company dividends	23 August 2023
2	DEV-23-MIN-0186	Minute	Deductibility of co-operative company dividends	23 August 2023

Additional information

The Cabinet paper was considered by the Cabinet Economic Development Committee on 23 August 2023 and confirmed by Cabinet on 28 August 2023.

Two attachments to the Cabinet paper are not included in this information release as they are publicly available:

- Regulatory impact statement: Deductibility of co-operative company dividends[1]
- Supplementary Order Paper No 423[2]

Information withheld

No information was withheld for this information release.

Accessibility

Inland Revenue can provide an alternate MS word or HTML version of this material if requested. Please cite this document's title, website address, or PDF file name when you email a request to policy.webmaster@ird.govt.nz

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[1] https://www.taxpolicy.ird.govt.nz/publications/2023/2023-ris-deduct-coop-company-dividends
[2] https://www.legislation.govt.nz/sop/government/2023/0423/9.0/LMS898458.html

In Confidence

Office of the Minister of Revenue

Cabinet Economic Development Committee

Deductibility of co-operative company dividends

Proposal

1 This paper seeks agreement for the Minister of Revenue to release a Supplementary Order Paper to the Finance and Expenditure Committee to extend the existing treatment of deductible distributions by Fonterra to include distributions on shares that are no longer required to support supply to Fonterra. This would maintain the treatment of distributions consistent with previous years and should apply only for a transitional period while a permanent response is developed.

Relation to government priorities

2 The proposal in this paper promotes Government priorities by maintaining the integrity of the tax system. Tax legislation needs to be regularly maintained and updated in response to changing technology and business practices. It is also important that tax legislation reflects the principles of fairness and certainty.

Executive Summary

3 The Income Tax Act 2007 allows certain co-operatives to deduct distributions to their shareholders that would otherwise be a non-deductible dividend (the deductibility provision). A recent change in the constitution of Fonterra means that a majority of its distributions to shareholders will become non-deductible, even where there has been no change in the shareholding. The loss of a deduction will result in the over-taxation of the company and its shareholders and a reduction in the distribution to shareholders.

4 This paper proposes extending the deductibility provision, for the 2022–23 to 2024–25 income years only, so that distributions that would have been deductible under Fonterra's previous constitution will continue to be deductible. This will provide time for officials to work with Fonterra to develop a permanent solution.

5 Without any legislative changes, the increase in tax revenue is forecast to be $60 million over the forecast period (subject to significant uncertainty). The proposed extension to the deductibility provision to 2024-25 is forecast to cost $58 million over the forecast period. The Minister of Finance and I have agreed to manage the cost of the proposed extension against the Tax Policy Scorecard.

6 This proposal should be included in a Supplementary Order Paper to the Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters)

Bill which is currently being considered by the Finance and Expenditure Committee. Although this Bill is not expected be enacted until early 2024, the announcement of a proposed law change will support Fonterra to maintain its existing distribution policy.

7 This Supplementary Order Paper will also include an amendment that ensures the bright-line line and other time related tests in the Income Tax Act do not apply when there is a Government/local authority buy-out of a North Island flood affected property. This amendment is consistent with the policy intent of previous approvals for taxation rollover relief for flood affected assets and therefore does not require separate Cabinet consent.

Background

8 An existing deductibility provision in the Income Tax Act 2007 allows certain co-operative companies to deduct distributions to their shareholders that would otherwise be a non-deductible dividend. In most circumstances this deductibility treatment provides an equivalent outcome to a non-deductible dividend that is paid with imputation credits. It is also equivalent to deductible rebates paid by other mutuals and co-operatives.

9 This deductibility provision was designed to reflect the linkage between shareholding and products or services supplied between a co-operative and its shareholders. For example, if a shareholder supplied 5% of the total supplies to a co-operative they would be required to hold 5% of the shares and would receive 5% of the distributions of profit.

10 A recent change in the constitution of Fonterra reduced the number of shares that shareholders are required to hold while still maintaining the ability to hold shares up to (and above) the level of supplies. In other words, the link between supplies and shareholding was weakened. For purposes of this discussion, the old level can be referred to as 1 share per 1 unit of supply , or 1:1. The new level is 1:3. This was done for commercial reasons, essentially to make it more attractive for suppliers to supply Fonterra (by reducing the amount of capital they were required to invest in order to supply a certain amount of milk solids).

11 Although individual shareholders can reduce their holding, the total number of shares on issue remains relatively constant. Shareholders reduce their holdings by trading amongst other shareholders rather than redeeming their shares with Fonterra.

12 Inland Revenue has confirmed that when the existing deductibility provision is applied to this new constitution only distributions up to the (newly reduced) level of shares that shareholders are required to hold (i.e. 1:3 units of supply) will be deductible. Distributions above this level will cease to be deductible. Distributions on shares above the level of supplies (i.e. on shares in excess of 1:1) have always been non-deductible and this is unchanged.

13 Due to the interaction of existing legislation and Fonterra's constitution, it will also not be able to attach imputation credits to any dividends. The consequence of this is, without further intervention, the amount of cash distributed by Fonterra will reduce and income derived by Fonterra will be taxable at the co-operative

level and again where it is distributed to its shareholders. This is a higher level of tax than would be paid on income derived by a regular company and distributed to its shareholders.

Analysis

Link between supply and shareholding

14 Historically, a co-operative applying the relevant provision would have had an explicit link between shareholding and supply (for example, being required to hold one share per one unit supplied to the co-operative). This then provided a direct linkage between the co-operative's production, profits and proportionate shareholding.

15 Following a change in Fonterra's constitution this linkage has been partially lost. For example, a constitution could require a shareholder to hold one share per three units supplied instead of per one unit supplied while still allowing a supplier to hold three (or more) shares. The consequence of this is if two shareholders each provided 3% of a co-operative's supplies one might continue to hold 3% of its shares while the second might reduce their holding to 1%. In this example both shareholders supply the same amount but the first shareholder would hold three times as many shares and therefore receive a distribution that is three times the size. Therefore, the link between supplies and distributions received is lost.

Case for deductible distributions

16 Although a deductible distribution will, in most circumstances, provide the same final tax outcome as a non-deductible imputed dividend this will not always be the case. Examples of this are where a shareholder cannot utilise the imputation credit such as a tax-exempt charity, a non-resident or a shareholder with significant tax losses. The standard treatment of companies in New Zealand is imputed dividends and there needs to be good policy grounds for varying from this treatment. An example of where this is justified is a co-operative who can reallocate their return to shareholders between the price paid for supplies and an end of year dividend – applying a different tax treatment to these two economically equivalent payments would create a tax incentive to favour increasing the price of supplies which may not otherwise commercially exist.

17 Where the linkage between supplies and shareholding no-longer exists a co-operative cannot reallocate returns to shareholders in this manner. Increasing the price paid for supplies advantages shareholders who hold fewer shares over a shareholder who holds more shares and would therefore prefer a greater distribution. Accordingly, this ground for providing deductible distributions also no longer exists in this circumstance.

Transitional deductible period

18 Without a legislative response Fonterra will pay a smaller distribution for the 2022–23 and subsequent years. As referred to in paragraph 13, this distribution will also not be imputed. This has two consequences:

18.1 The tax imposed on earnings ultimately distributed to shareholders will be higher than on other equivalent businesses as tax will be imposed at both the co-operative and shareholder level, with no reduction for imputation credits.

18.2 Shareholders will receive a smaller distribution than they are expecting based on advice from Fonterra over both the tax treatment of distributions under its new constitution and the amount of the distribution.

19 There is insufficient time to develop and introduce a permanent solution to this issue before Fonterra confirms and pays its 2022–23 distribution. This would require consultation with affected shareholders as not all shareholders would benefit equally from a potential solution. I recommend an extension of the previous deductibility treatment on distributions on shares up to the level of supplies. This should apply for the 2022–23 to 2024–25 years only. This will provide sufficient time for officials to develop a permanent solution in conjunction with Fonterra.

Implementation

20 The proposal will have no systems implications for Inland Revenue, and other administrative implications (such as guidance) will fall within Inland Revenue's existing change capacity.

Cost-of-living Implications

21 This proposal will retain the distributions that shareholders would be expecting to receive for these years. Officials estimate that, based on the level of distributions for the 2021–22 year, if this proposal is not introduced the effect on an average shareholder may be a reduction in pre-tax distributions of approximately $3,000 per year.

Financial Implications

22 Current baseline forecasts do not include any additional tax revenue from the impact of the change to Fonterra's constitution. However, now Inland Revenue has come to a position on the correct tax treatment, any future forecasts would need to include an estimate of the increased tax revenue (in the absence of any law change but assuming Fonterra changes its constitution). Inland Revenue has estimated the increase in tax revenue as follows (subject to considerable uncertainty):

	$ m – increase / (decrease)			
Vote Revenue Minister of Revenue	**2023/24**	**2024/25**	**2025/26**	**2026/27 and outyears**
Crown Revenue and Receipts: Tax Revenue	54.000	2.000	2.000	2.000

23 Introducing the proposed extension would have the following fiscal implications:

	$ m – increase / (decrease)			
Vote Revenue Minister of Revenue	**2023/24**	**2024/25**	**2025/26**	**2026/27 and outyears**
Crown Revenue and Receipts: Tax Revenue	(54.000)	(2.000)	(2.000)	0.000
Total Operating	**54.000**	**2.000**	**2.000**	**0.000**

24 Without any legislative changes, the increase in tax revenue is forecast to be $60 million over the forecast period (subject to significant uncertainty). The proposed extension to the deductibility provision to 2024-25 is forecast to cost $58 million over the forecast period. The Minister of Finance and I have agreed to manage the cost of the proposed extension against the Tax Policy Scorecard.

Legislative Implications

25 This proposal will require an amendment to the Income Tax Act 2007. I propose to include the necessary legislative changes in a Supplementary Order Paper to the Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters) Bill which is currently being considered by the Finance and Expenditure Committee. This Supplementary Order Paper will also include a remedial amendment to the bright line rollover relief rules that is consistent with the policy intent.

26 I will release this Supplementary Order Paper before Parliament is dissolved on 8 September. This timing will support the announcement of Fonterra’s 2022–23 distribution shortly after this.

Impact Analysis

Regulatory Impact Statement

27 The Quality Assurance reviewer at Inland Revenue has reviewed the regulatory impact assessment prepared by Inland Revenue. The reviewer considers that information and analysis summarised in the regulatory impact statement partially meets the quality assurance criteria. Due to time limitations, it has not been possible to consult with Fonterra’s shareholders and as a result some potential policy options have been ruled out of consideration at this time.

Climate Implications of Policy Assessment

28 The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that CIPA requirements do not apply to this proposal as it not expected to result in any significant, direct emissions impacts.

Population Implications

29 The proposal will prevent a reduction in the distribution received by all shareholders of Fonterra. Fonterra has not supplied a breakdown of the population groups that make up its shareholders.

30 The mixture of groups that are shareholders that will include corporates, individuals, charities and Maori authorities. As this proposal will affect the level of cash distributions all shareholders will receive an equal reduction in their distribution in proportion to their shareholding.

Human Rights

31 The proposal is consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Use of external Resources

32 No external resources have been engaged in the preparation of this proposal.

Consultation

33 Inland Revenue has consulted with the Treasury, the Ministry for Primary Industries and the Department of the Prime Minister and Cabinet in the preparation of this proposal.

34 Fonterra has been consulted throughout the development of this proposal.

Communications

35 I will release this Supplementary Order Paper before Parliament is dissolved on 8 September. It will also be published on Inland Revenue's policy website. This timing will support the announcement of Fonterra's 2022–23 distribution shortly after this.

Proactive Release

36 I propose to proactively release this Cabinet paper and associated Cabinet minute shortly after the proposed release of the Supplementary Order Paper.

Recommendations

The Minister of Revenue recommends that the Cabinet Economic Development Committee:

1 **note** that the Income Tax Act 2007 allows certain co-operatives to deduct distributions to their shareholders.

2 **note** that Fonterra has adopted a new constitution that has the following tax implications for the 2022–23 and subsequent tax years (absent any legislative change).

3 **note** the forecasted increase in revenue following the adoption of the new constitution (in the absence of any legislative change) is as follows (subject to significant uncertainty):

	$ m – increase / (decrease)			
Vote Revenue Minister of Revenue	**2023/24**	**2024/25**	**2025/26**	**2026/27 and outyears**
Crown Revenue and Receipts: Tax Revenue	54.000	2.000	2.000	2.000

4 **agree** to allow Fonterra to deduct distributions on shares up to their 1:1 share standard (the treatment that applied before the change to the constitution.

5 **agree** that recommendation 4 apply to the 2022–23 to 2024–25 years only.

6 **note** the following changes as a result of the decision in recommendations 4 and 5 above, with a corresponding impact on the operating balance and/or net debt.

	$ m – increase / (decrease)			
Vote Revenue Minister of Revenue	**2023/24**	**2024/25**	**2025/26**	**2026/27 and outyears**
Crown Revenue and Receipts: Tax Revenue	(54.000)	(2.000)	(2.000)	0.000
Total Operating	**54.000**	**2.000**	**2.000**	**0.000**

7 **note** that the Minister of Finance and the Minister of Revenue have agreed to manage the cost of the proposed extension against the Tax Policy Scorecard.

8 **note** that officials will consider what the appropriate tax treatment should be for the period from 2025–26 onwards.

9 **agree** to authorise the Minister of Revenue to release a Supplementary Order Paper to the Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters) Bill, containing the measure referred to in recommendations 4 and 5.

Authorised for lodgement

Hon Barbara Edmonds

Minister of Revenue

Cabinet Economic Development Committee

Minute of Decision

Deductibility of Co-operative Company Dividends

Portfolio Revenue

On 23 August 2023, the Cabinet Economic Development Committee:

1 **noted** that the Income Tax Act 2007 allows certain co-operatives to deduct distributions to their shareholders;

2 **noted** that Fonterra has adopted a new constitution that has tax implications for the 2022/23 and subsequent tax years (absent any legislative change);

3 **noted** that the forecasted increase in revenue following the adoption of the new constitution (in the absence of any legislative change) is as follows (subject to significant uncertainty):

	$ m – increase / (decrease)			
Vote Revenue Minister of Revenue	**2023/24**	**2024/25**	**2025/26**	**2026/27 and outyears**
Crown Revenue and Receipts: Tax Revenue	54.000	2.000	2.000	2.000

4 **agreed** to allow Fonterra to deduct distributions on shares up to their 1:1 share standard (the treatment that applied before the change to the constitution);

5 **agreed** that the decision in paragraph 4 above apply to the 2022/23 to 2024/25 financial years only;

6 **noted** the following changes as a result of the decision in paragraphs 4 and 5 above, with a corresponding impact on the operating balance and/or net debt:

	$ m – increase / (decrease)			
Vote Revenue Minister of Revenue	**2023/24**	**2024/25**	**2025/26**	**2026/27 and outyears**
Crown Revenue and Receipts: Tax Revenue	(54.000)	(2.000)	(2.000)	-
Total Operating	**54.000**	**2.000**	**2.000**	**-**

7 **noted** that the Minister of Finance and the Minister of Revenue have agreed to manage the cost of the proposed extension against the Tax Policy Scorecard;

8 **noted** that officials will consider what the appropriate tax treatment should be for the period from 2025/26 onwards;

9 **authorised** the Minister of Revenue to release the Supplementary Order Paper [IRD 23491-1/5.0] to the Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters) Bill, containing the measure referred to in paragraphs 4 and 5 above.

Janine Harvey
Committee Secretary

Present:
Hon Grant Robertson (Chair)
Hon Dr Ayesha Verrall
Hon Damien O'Connor
Hon Andrew Little
Hon David Parker
Hon Peeni Henare
Hon Priyanca Radhakrishnan
Hon Kieran McAnulty
Hon Ginny Andersen
Hon Dr Duncan Webb
Hon Dr Deborah Russell
Hon Rachel Brooking

Officials present from:
Office of the Prime Minister
Officials Committee for DEV