



CONSULTATIVE DOCUMENT
ON
FULL IMPUTATION

DECEMBER 1987

PREFACE BY THE MINISTER OF FINANCE**Introduction**

In my Budget of 18 June 1987, I announced that the Government would proceed with the introduction of a full imputation system of company taxation in 1988/89. I first announced the Government's intention to introduce such a system in that year in my 1985 Statement on Taxation and Benefit Reform of 20 August 1985. Since that time, the Government has introduced other major business tax reforms. The most important have been reforms to the tax treatment of livestock and primary sector capital expenditure and a comprehensive accrual regime for all forms of expenditure and for income derived from financial arrangements. In addition, the Government proposes substantial reform for New Zealand's international tax regime and measures to this effect are outlined in an accompanying consultative document.

Objectives of Business Tax Reform

The main theme of all of these measures is to broaden the business tax base by removing special concessions and loopholes which allow certain types of investment to be more favourably taxed than others. This will reduce the extent to which the tax system influences business decisions. Since taxpayers naturally wish to minimise the tax they pay, tax incentives and loopholes have powerful effects on the direction of investment and the way in which it is organised. As the Government's programme of tax reform progresses, these decisions should be based increasingly on commercial rather than tax considerations.

A further important objective of broadening the tax base is to facilitate a reduction in tax rates. The Government believes that the best way to minimise the undesirable economic effects of the tax system is to levy relatively low rates of tax over as wide a tax base as possible.

The tax base, or the way in which taxable income is defined, is one of the two main structural features of an income tax system. It consists essentially of two types of income. The first is labour or wage and salary income. The second is income produced by the employment of capital. This is referred to as capital, or as investment or business income.

The second main structural feature is the way in which taxes are levied on that base - that is, the tax rate structure. The main economic objective of reform of the rate structure is to ensure that as far as possible both labour and capital income are taxed at the marginal tax rates of the persons who earn the income. Reform of this feature of the tax system is important for the same reasons that reform of the tax base is important - namely, to minimise the extent to which a person's tax liability depends on the precise form in which his or her income is earned.

The introduction of full imputation is directed at this objective. Under the present company tax system, the tax rate structure applying to income earned through companies is decidedly different from that applying to unincorporated business income and to wage and salary income. The imputation scheme outlined in this document will go a long way towards ensuring that the effective tax rate on income earned through a company is much closer to the marginal tax rates of the owners of the company.

As with previous tax reforms, the Government has taken a comprehensive approach to reform of the taxation of capital income. The same principles which are applied in this document will be applied to the taxation of income earned through superannuation funds and life offices. In both instances, the objective is to tax such income at the marginal tax rates of the persons who earn it. Companies, superannuation funds and life offices are financial intermediaries which specialise in investing various forms of capital ultimately contributed by individuals. These intermediaries can, and indeed should, compete on their merits. The tax system should neither subsidise nor discriminate against them.

Full Imputation

Under the full imputation system outlined in this document, company tax will continue to be levied but the tax paid by a company will be creditable to its shareholders. In effect, the taxable income of a company will be taxed in its shareholders' hands. This system will ensure that the effective tax rate on a company's income is largely independent of the way in which its investment is financed. Shareholders will focus increasingly on a company's pre-tax rather than its post-tax returns.

A consequential change will be made to the taxation of bonus issues. Bonus issues declared after the time of release of this document on 17 December 1987, will be assessable in shareholders' hands. An exception will apply to bonus issues from share premiums which will be exempt. Changes will also be made to the taxation of distributions on liquidation of a company. Details of all of these reforms are set out in this document.

Consultation

A consultative committee has been formed to consider submissions on the imputation scheme. A consultative process for major tax reforms is now well established. The Government is appreciative of the input of the business community and members of the public who have materially assisted in improving the design and implementation of previous reforms. The timetable for consultation must take account, on the one hand, of the need to allow sufficient time for the preparation and consideration of submissions and, on the other hand, of the need to expedite implementation of the reforms in order to reduce uncertainty.

Conclusion

The full imputation scheme set out in this document represents a substantial improvement over the present company tax system. It is another significant step in the Government's tax reform programme and complements other reforms aimed at extending the business tax base across a more comprehensive definition of income. Together, these reforms will substantially reduce the extent to which taxes are an important factor in business decisions.

The Government invites public comment on ways that will improve the effectiveness of the imputation regime and on its implementation and administration by taxpayers and the Inland Revenue Department.

Roger Douglas
Minister of Finance

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CHAPTER 1 : INTRODUCTION

1.1 Purpose of the Consultative Document

The Minister of Finance, the Hon R O Douglas, confirmed in his Budget Statement of 18 June 1987 that the Government will proceed with the introduction of a full imputation system in 1988/89. The Minister first announced the Government's intention to introduce a full imputation scheme in that year in his Statement on Taxation and Benefit Reform of 20 August 1985.

The purpose of this document is to set out fully the details of the full imputation scheme so that interested parties have an opportunity to present their views on the scheme before final decisions are made.

1.2 Objectives of the Reforms

The objectives of the imputation system outlined in this document are:

- a to ensure that, as far as possible, income earned through a company is taxed at the marginal tax rates of the shareholders of the company in accordance with the economic objective of taxing capital income at the tax rates of the owners of the capital; and
- b to minimise the additional administrative and compliance costs of the new provisions.

1.3 Consultative Committee

The Government invites the public to make submissions on the matters set out in this document. A Consultative Committee has been appointed to receive and consider submissions on full imputation and the international tax reforms. The Committee comprises:

Mr Arthur Valabh (Chairman), a tax partner and partner in charge of Deloitte, Haskins and Sells, Auckland;

Dr Robin Congreve, a tax consultant with Russell, McVeagh, McKenzie Bartleet and Company, Auckland;

Mr Stuart Hutchinson, a tax partner with Simpson Grierson Butler White, Auckland;

Dr Susan Lojkine, a tax partner of McLeod Lojkine Associates, Auckland;

Professor John Prebble, a Wellington tax barrister and Dean of the Law Faculty at the Victoria University of Wellington; and

Mr Tim Robinson, an economist with Jarden and Company Limited, Wellington.

The Committee's terms of reference are:

- a to receive public submissions on matters affecting the implementation and efficient operation of the full imputation system of company taxation set out in this consultative document;
- b to report to the Minister of Finance making recommendations on:
 - i matters covered in the consultative document or raised in submissions concerning the implementation and administration of the full imputation system; and
 - ii possible amendments to the treatment set out in this document which, while consistent with the objectives of the new scheme, would assist its smooth introduction and administration;
- c to prepare draft legislation for implementing the full imputation system and the associated measures referred to in this document.

The Committee is to report to the Minister of Finance by 31 March 1988. The Committee will have authority to engage legal draftsmen to assist in the preparation of draft legislation.

1.4 Submissions

Submissions should be lodged by Friday, 12 February 1988. They should be on A4-sized paper, typed in double space on one side of the page only and should contain a brief summary of their main points and recommendations. Submissions should be sent to:

The Chairman
Consultative Committee on
Full Imputation and International Tax Reform
C/- The Treasury
PO Box 3724
WELLINGTON.

All submissions received by the due date will be acknowledged.

1.5 Outline of the Document

Chapter 2 provides an overview of the objectives of the reforms, the problems with the present company tax system and the main issues to be decided in the design of an imputation scheme. These include the method for determining the amount of credits a company can allocate to its shareholders, how dividends and bonus issues should be treated, the taxation of distributions on liquidation and the treatment of tax-preferred income. Chapter 3 elaborates on the analysis of the present company tax system.

Chapters 4 and 5 outline the operation of the full imputation system in more detail. Chapter 4 deals with the provisions of the scheme as they apply to companies. Chapter 5 then outlines how the scheme will affect shareholders.

Finally, chapter 6 deals with the implementation of the imputation scheme and outlines changes to a number of other tax provisions as a consequence of the introduction of imputation.

1.6 Meaning of the Terms Used

A glossary of the terms used is appended at the end of this document.

CHAPTER 2 : OVERVIEW OF FULL IMPUTATION SCHEME

2.1 Introduction

This chapter presents an overview of the objectives of reform of the company tax system, the problems with the current system and the main policy issues to be addressed in the design of a full imputation scheme.

2.2 Economic Objectives of Full Imputation

The basic economic objective of reform of the taxation of business or investment income is to tax such income as it accrues at the marginal tax rates of the owners of the business or capital invested. In the case of companies, the ideal is to pro-rate company income to shareholders and tax it at their marginal rates. This is referred to as full integration. A full imputation scheme differs from full integration but the principle behind the two is the same - namely, to tax as far as practicable the taxable income of companies at the marginal tax rates of their shareholders.

The same principle underlies the objectives of reform of the taxation of superannuation and life insurance. In both cases, the ideal is to impute the income to the members/policy holders and tax it at their marginal rates.

2.3 Deficiencies with the Current System

The deficiencies of the current "classical" company tax system are attributable to:

- a the taxation of company income at the company tax rate rather than the marginal tax rates of shareholders; and
- b the imposition of a second layer of tax when company income is distributed.

Of these, the first is the more important in determining the effective tax rate on corporate income. That is, it is the divergence between the company

tax rate and shareholders' marginal rates which is the main problem with the current system, not the "double taxation" of dividends. Indeed, there is no double taxation of income generated by corporate investment financed by:

- a debt, where the effective tax rate is the effective marginal rate of the lender; or by
- b retained earnings, where the effective tax rate is the effective company tax rate.

A degree of double taxation occurs only when income generated by investment financed from new equity is distributed. All corporate equity income is, however, over-taxed to the extent that the company tax rate exceeds shareholders' marginal rates. The problems with the present tax system are explored further in the chapter 3.

2.4 Full Imputation: Overview

In principle, an imputation scheme approximates the objective outlined in section 2.2 by:

- a in the case of distributed company income, grossing up the distribution by the amount of company tax paid on the income out of which the distribution is made, taxing shareholders on the grossed up amount, and giving them a tax credit for the amount of company tax paid; and
- b treating bonus shares in the same way as cash dividends. This permits companies to impute retained income to shareholders as if it were a cash distribution with the same tax consequences as for cash distributions.

Numerical examples illustrating the basic features of an imputation scheme are shown in the attached Appendix 2.1.

With the company tax rate equal to or above the top personal tax rate, full imputation encourages companies to fully distribute their after-tax profits. To avoid this incentive and the consequential transaction costs of raising

alternative sources of finance, an option for companies to allocate credits by way of bonus issues is an important feature of the imputation scheme. This enables a company to "distribute" imputation credits to its shareholders without having to pay cash dividends so that all of the company's taxable income is effectively taxed at the marginal tax rates of its shareholders. In this event, the imputation scheme would approximate full integration.

Imputation credits will be given only for New Zealand company tax paid by a company, not for foreign company tax. Imputation credits will, however, be given for foreign withholding taxes levied on both portfolio and non-portfolio dividends received by resident companies from companies which are resident of a country with which New Zealand has a double tax agreement.

The other international tax issue relating to imputation is whether credits should be extended to non-resident shareholders of New Zealand companies. The tax system should neither encourage nor discourage foreign investment in New Zealand. If there were no change in the company tax rate, the introduction of full imputation would have no effect on non-resident shareholders. The reduction in the company tax rate proposed by the Government will substantially reduce the New Zealand tax levied on income earned in New Zealand by non-residents and is the best way of maintaining a healthy level of foreign investment in New Zealand. Accordingly, imputation credits will not be refundable to non-residents.

This treatment of non-residents is consistent with the general treatment of resident shareholders. Cash refunds for surplus credits will not be available for either class of investor.

2.5 Design Options for Restricting Credits to New Zealand Company Tax Paid

An essential feature of an imputation scheme is a mechanism for ensuring that credits are given only for New Zealand company tax actually paid. There are two ways of achieving this:

- a by way of a **compensatory tax system** such as the United Kingdom Advance Corporation Tax (ACT) system. Under this system, whenever a company pays a dividend, it is required to pay an amount of ACT equal to the credits

given to shareholders in respect of those dividends. The ACT is then creditable against the company's "mainstream" company tax instalments. Excess ACT unable to be absorbed against mainstream company tax is able to be carried forward indefinitely;

- b by way of an account-based system such as that recently implemented in Australia where the account is referred to as the "franking account". Under this approach, the amount of dividends with imputation credits attached that can be paid is determined by the balance in the franking account. This in turn is determined by the amount of domestic company tax paid by a company and by the amount of credits it receives on dividends from other companies.

The Australian scheme has a balance up at the end of the income year. If a company has an end-of-year deficit in its franking account, it is required to pay "franking deficit tax" equal to the amount of the excess credits paid out. The franking deficit tax is creditable against future company tax payments. This tax is therefore similar to ACT under the United Kingdom system.

A major difference between the two approaches is the way they affect tax preferences (discussed further in section 2.6) and tax-exempt and non-resident shareholders. Under the ACT system, ACT levied on tax-preferred income distributed to these classes of shareholder is an additional tax. In effect, ACT becomes a tax on tax-preferred distributed company income equivalent to company tax, thereby offsetting the advantage of the tax preference. The scheme treats distributed foreign-source company income in much the same way since credits are not given for foreign company tax paid. Thus, ACT is an additional tax (ie a tax not levied under the present tax system) on foreign-source or tax-preferred company income distributed to either tax-exempt or non-resident shareholders. Since the ACT cannot be fully offset against the domestic company tax liability of a company with such income, it provides incentives for mergers and other types of arbitrage between companies motivated primarily by the incentive to utilise surplus ACT.

By contrast, the account-based approach does not impose any additional tax on corporate income. Thus, the corporate income attributable to tax-exempt and non-resident shareholders is not affected under such a system. The effective

rate of tax on corporate income earned by non-residents and tax-exempts is the effective company tax rate, as under the present tax system. Because the ACT system adversely affects companies with tax-preferred or foreign-source income, and because it disadvantages non-resident and tax-exempt entities compared with an account-based system, the latter approach will be adopted for New Zealand.

2.6 Treatment of Dividends Paid Out of Tax-Preferred Income

Tax preferences are features of the tax system which allow certain forms of income to be taxed at less than the statutory rate. They may be explicit provisions in the tax law (such as special rebates, credits, deductions or exemptions), or implicit preferences such as differences between tax and economic depreciation rates. New Zealand now has few explicit tax preferences except the general exemption of capital gains. There are, however, numerous implicit preferences because, for example, of the diverse way in which inflation affects effective tax rates on fixed assets and anomalies in the way in which certain types of capital expenditure are treated.

The ACT system claws back tax preferences unless dividends can be funded entirely from fully-taxed company income. The basic argument against the claw back of preferences is that it is inefficient to do so for companies alone, via an indirect mechanism such as imputation, and not for all taxpayers across the board. Claw-back via imputation discriminates between companies and unincorporated businesses and between companies in tax loss and those in tax profit. If the preferences are regarded as undesirable, the better approach is to remove them for all taxpayers.

It is possible under an account-based system to preserve tax preferences by allowing dividends paid out of tax-preferred income, or "tax-preferred dividends", to be exempt from tax in shareholders' hands. If, however, tax-preferred dividends are taxed, an account-based system claws back tax preferences on corporate income distributed to taxpaying shareholders but not on income distributed to tax-exempt or non-resident shareholders. This is the major difference between the account-based and ACT systems.

The main argument against permitting pass-through of tax preferences to shareholders by exempting tax-preferred dividends is that the existence of any statutory exemption places a great deal of pressure on the tax system by providing incentives to convert other forms of income into the exempt form. Thus, the exemption of tax-preferred dividends may increase the attractiveness of tax avoidance since income exempt from tax at the company level could pass through to shareholders tax-exempt. Under the present system, such dividends would be taxed.

Further, dividends paid out of earnings generated before the introduction of imputation (and on future income generated by investment of those prior earnings) should ideally continue to be taxed since there are no gains in economic efficiency from exempting them. It would, however, be difficult to devise rules (because, for example, of the problems of measuring retained earnings) to distinguish between dividends paid from pre-imputation retained earnings and dividends paid from untaxed, post-imputation earnings.

An intermediate option between exempting and taxing tax-preferred dividends is to permit certain dividends to be paid tax-free to shareholders. For example, dividends paid from capital profits could be made exempt. This would require companies to keep an "exempt dividend account," in order to record the company's earnings that are exempt from tax because of certain explicit tax preferences. The basic problem with this option is the ease with which capital profits can be generated, especially during times of inflation. This could mean that, in practice, the scheme would closely resemble one in which all tax-preferred dividends were exempt from tax in shareholders' hands. This approach would also be ad hoc in that, while it would be possible to allow the pass-through to shareholders of certain explicit tax preferences, it would be impracticable to allow the pass-through of implicit preferences. In addition, the inclusion of an exempt dividend category would add to complexity.

It is the Government's long-term objective to continue to broaden the tax base and reduce the importance of tax preferences. In the light of the above considerations, all dividends will be assessable in the hands of taxpaying shareholders.

2.7 Bonus Issues

Bonus issues currently have no immediate tax consequences. As they do not constitute a distribution, they are not included in the definition of dividends under section 4(1)(a) of the Income Tax Act 1976. Under section 4(1)(ca), however, any return of capital within ten years of a bonus issue made on or after 1 April 1982 is taxable in shareholders' hands, to the extent that the return does not exceed the aggregate value of bonus issues made within the previous ten years. In the absence of this restriction, companies would be able to distribute their earnings to shareholders as a return of capital free of tax since a bonus issue may result in the conversion of retained earnings and/or reserves, which would generally be taxable upon distribution, into paid-up or issued capital, which can be returned to shareholders tax-free.

For tax purposes, two types of bonus issue may be distinguished: those which capitalise retained earnings or reserves which would be taxable on distribution under the new provisions outlined in this document and those which do not. The first category of bonus issue will be treated in the same way as cash dividends under the imputation scheme. There are three main reasons for this:

- a bonus issues resulting from the capitalisation of retained earnings or reserves in effect transfer such retained earnings or reserves, which would be taxable on distribution, into paid-up capital which is able to be distributed to shareholders tax-free. Thus, a contingent shareholder tax liability would be avoided;
- b conceptually, a bonus issue is equivalent to a cash distribution to shareholders, who then reinvest the cash in new shares in the same company. Such a distribution would be taxable in shareholders' hands; and
- c since the basic objective of imputation is to reduce the influence of the tax system on corporate capital structure, investment and distribution policy, the scheme should not be biased towards distribution. This would be the case when the company tax rate is equal to or higher than the top

personal rate. In such circumstances, there would be pressure on companies to distribute sufficient dividends to fully utilise their available credits. Any resulting capital deficiency would need to be made good by raising new equity or debt, thereby imposing additional transaction costs on companies. To avoid this, it is important to provide companies with a low transaction cost method of fully distributing credits to shareholders. The best such method is to allow credits to be allocated to bonus issues and to tax the bonus issues in the same way as dividends.

For these reasons, bonus issues will be taxable if they are capitalised from earnings or reserves which would be taxable on distribution under the new provisions outlined in this document.

Bonus issues will be exempt from tax if they are capitalised from share premiums paid in cash or equivalent consideration. In an economic sense, share premiums paid are equivalent to the capital represented by the par value of a share. Both are capital contributions paid to a company by its shareholders. The capitalisation of share premiums by way of a bonus issue merely transfers shareholders' capital from a share premium account to paid-up or issued capital. This has no economic consequences and should have no tax consequences. Bonus issues capitalised from share premiums paid will therefore be tax-free to shareholders.

Bonus issues which do not result in the capitalisation of retained earnings or reserves are equivalent to a share split and will not be regarded as a bonus issue for tax purposes.

This distinction between taxable and non-taxable bonus issues means that, for tax purposes, a company's paid-up capital will be defined as the aggregate of the amounts paid in by its shareholders, including any share premiums, on the subscription of shares and the amounts capitalised to paid-up capital by way of taxable bonus issues.

2.8 Distributions of Paid-Up Capital

Since dividends paid from tax-preferred company income will be taxable, all distributions of a company will be assessable other than distributions of paid-up capital (as defined for tax purposes). Money is, however, fungible so

that any particular distribution cannot be sourced to specific funds of a company except in an arbitrary manner. In other words, whether a distribution is attributed to a capital or a revenue source is largely a matter of accounting discretion.

The tax consequences of a distribution to shareholders should not be a matter of their or their directors' discretion. This would largely be the case if a company was free to nominate the source of a distribution as capital or revenue. To minimise such discretions, all distributions made by a company (excluding distributions made on wind-up, which are dealt with in section 2.9) will be treated as a taxable dividend except a return of paid-up capital made on the redemption of shares in the company. As explained in section 2.7, paid-up capital for tax purposes will include share premiums paid in cash or other consideration.

This is in effect an ordering rule which states that all distributions shall be deemed to be paid first from sources other than paid-up capital. It, however, recognises that the redemption of shares is in effect a partial wind-up and thus permits the return of paid-up capital in such circumstances to be made tax free. The amount in excess of the paid-up capital distributed on a redemption of shares will be assessable as a dividend.

2.9 Treatment of Distributions on Liquidation

The following types of distribution to shareholders are currently exempt from tax if they are made upon the winding up of a company, but are otherwise taxable:

- a capital profits, so long as:
 - i the shareholder is not a related company shareholder; and
 - ii the profit did not arise from a transaction with a related person;
- b capital profits arising from a transaction with a related person, where such profits are realised during the course of winding up a private company;

- c company assets, other than those distributed to a related company shareholder;
- d any return of paid-up capital, where the company has not made a bonus issue within ten years of it being wound up. Where the company has made a bonus issue within the previous ten years, any reduction of share capital, up to the amount created as a result of bonus issues within the ten-year period, is treated as an assessable dividend;
- e any distribution from a share premium reserve, so long as the premium:
 - i arose from a cash payment for the purchase of shares; and
 - ii did not arise from the issue of shares at a premium as consideration for the purchase of shares in another company;
- f any distribution in excess of paid-up capital which amounts to a restoration of capital to shareholders previously suffering a loss of capital.

The legislative complexity of the present rules illustrates the difficulty of attempting to treat distributions on wind-up differently from distributions at other times. Any exemption of distributions on liquidation puts great pressure on the rules applying on wind up. While restrictions may be imposed on such an exemption, it is doubtful if they are effective. These rules will therefore be considerably simplified by taxing all distributions on liquidation other than distributions of paid-up capital, as defined in section 2.7.

2.10 Allocation of Credits

The economic objective of full imputation is to tax a company's income at the marginal tax rates of its shareholders. In principle, imputation credits should therefore be pro-rated across shareholders in proportion to their rights to the company's net cash flows. Rules are therefore needed to ensure that companies are not able to direct credits to those shareholders best placed to use them.

The primary allocation rule will be a requirement for companies to pro-rate credits uniformly across dividends and taxable bonus issues paid in any year on all classes of shares. In other words, the ratio of the credit to the aggregate value of the dividends and taxable bonus shares paid or issued per share will have to be constant for all classes of share in a particular year. The ratio may vary from year to year according to a company's tax liability.

2.11 Inter-Corporate Dividends

Dividends received by a resident company from another resident company and foreign-source non-portfolio dividends will remain exempt from company tax under imputation in order to avoid multiple taxation of dividends passing between corporate shareholders. Foreign-source dividends are dividends paid by a non-resident company, or a resident company which is also resident for tax purposes in another country and which is not subject to New Zealand income tax on its foreign-source income. Non-portfolio dividends are dividends received by a company from another company in which the recipient company owns more than 10 percent of the paid-up share capital. Foreign-source non-portfolio dividends will, however, be subject to a withholding payment designed to equate with the tax that an individual shareholder would pay were the dividend received directly. Imputation credits allocated to dividends or bonus shares received by a corporate shareholder will be able to be passed on to its shareholders.

2.12 Dividends Received by Trusts and Partnerships

Credits attached to dividends or bonus issues received by partnerships will be pro-rated amongst the partners according to their respective interests in the dividends or bonus shares. This will be the case irrespective of whether the partnership is a special or ordinary partnership. Where dividends or bonus issues are received by a trust, they will be assessed as trustee's income irrespective of whether a beneficiary is entitled in possession to such income. The resulting after-tax dividend and bonus share income of a trustee may subsequently be distributed tax-free to beneficiaries.

2.13 Residence Requirement

In order to administer the system, the Inland Revenue Department will need full access to the distribution and tax records of companies. Accordingly only New Zealand-resident companies will be eligible for the imputation scheme.

2.14 Summary : Main Features

The main features of the imputation scheme can be summarised as follows:

- a credits will be given only for New Zealand company tax paid and foreign dividend withholding taxes levied by New Zealand's tax treaty partners;
- b cash refunds for surplus credits will not be given;
- c an account-based approach will be adopted as a means of limiting credits to the amount of New Zealand company tax and foreign withholding tax which has been paid;
- d bonus issues, other than those which capitalise share premiums paid, will be treated in the same way as cash dividends. Such bonus issues will therefore be assessable but the shareholders' tax liability will be offset by any credits allocated to them;
- e all distributions made otherwise than on wind-up will be assessable in the hands of non-corporate taxpaying shareholders except a return of paid-up capital made on the redemption of shares;
- f all distributions on liquidation will be assessable, other than distributions of paid-up capital as defined for tax purposes;
- g credits will be pro-rated uniformly across dividends and bonus issues paid on all classes of share in any year;

- h New Zealand-source and foreign-source non-portfolio dividends received by companies will remain exempt. Credits allocated to dividends or bonus shares received by companies will be able to be passed on to their shareholders;
- i. only New Zealand-resident companies will be able to pay dividends with credits.

APPENDIX 2.1: BASIC MECHANICS OF FULL IMPUTATION

This appendix illustrates how a company's taxable income is treated under full imputation. The total tax levied on such income depends on the marginal tax rates of the company's shareholders. For the purposes of the example, it is assumed that shareholders have sufficient non-dividend income to be able to fully utilise the credits.

It is also assumed that the company fully distributes its after-tax income.

A Company level

	\$
1 Company taxable income	1000
2 Tax liability [at 48 percent]	480
3 After-tax income [1 - 2]	520

B Shareholder level

Shareholder's marginal tax rate (%)	0	15	30	48
	\$	\$	\$	\$
4 Dividend or bonus issue [equal to 3]	520	520	520	520
5 Imputation credit [equal to 2]	480	480	480	480
6 Taxable income [4 + 5]	1000	1000	1000	1000
7 Tax liability [6 x MTR]	-	150	300	480
8 Tax credit [equal to 5]	-	480	480	480
9 Net tax liability [7-8]	-	(330)	(180)	0
10 Total company and share- holder tax [2 + 9]	480	150	300	480

Note that the total tax rate on corporate income attributable to taxpaying shareholders is the shareholder's marginal rate. Because tax-exempt shareholders are unable to directly utilise credits, the tax rate on income attributable to them remains the company tax rate.

CHAPTER 3 : THE PRESENT COMPANY TAX SYSTEM**3.1 Introduction**

This chapter considers in more detail the effects of the present classical (or separate company and shareholder) tax system. It first outlines the main features of this system and then considers how these influence effective tax rates on corporate income. Finally, the chapter examines the economic costs which arise under the present system.

3.2 Main Features

The main features of the existing tax treatment of corporate income are:

- a taxable income derived by a company is taxed at the company tax rate; and
- b dividends paid to shareholders are assessed at their marginal tax rates.

The definition of dividends is contained in section 4 of the Income Tax Act 1976. In essence, a dividend is defined as "all sums distributed in any manner under any name among all or any of the shareholders of a company" in excess of the paid-up capital contributed by shareholders. There are two main exclusions from the definition of dividend relating to distributions of capital profits and share premiums on the wind-up of a company, as outlined in section 2.9.

Dividends received by companies are generally exempt from tax under section 63 of the Act. There are two main restrictions on this exemption. First, dividends received by life insurance companies are assessable. Secondly, dividends which are deductible to the company paying them (which may be the case for certain dividends paid by non-resident companies) are assessable to the recipient company.

In contrast with the treatment of corporate income, unincorporated business income such as that earned by sole proprietors and partnerships is taxed at the marginal tax rates of the taxpayer earning the income.

3.3 Effective Tax Rates on Investment Income

The impact of the tax treatment of different types of investment income (ie income generated from capital as distinct from labour) can be explored by considering the effective tax rates levied on such income. In general, the effective tax rate on an investment is the rate e , where:

$$e = (1 - r/R) \times 100$$

and r = the after-tax rate of return on the investment;

R = the pre-tax rate of return on the investment.

For example, if an investment generates a 10 percent rate of return before tax and a 7.5 percent rate of return after tax, the effective tax rate is 25 percent.

Effective tax rates depend on the tax treatment applying to the investment and the timing rules for the recognition of income and expenditure and for the payment of provisional and terminal tax. In practice, the timing provisions can have a major impact on effective tax rates (in both the unincorporated and corporate sectors). The timing rules for the recognition of income and expenditure were reformed recently with the introduction of accrual rules enacted as sections 64B-64M and 104A of the Income Tax Act 1976. Changes have also been made to the rules for the payment of provisional and terminal tax.

There are two aspects to the tax treatment of an investment. The first is the extent to which the (nominal or real) economic income produced by the investment is taxed. This depends on the definition of the tax base (ie the rules for the measurement of taxable income, where taxable income means gross assessable income less allowable deductions). The second is the rates of tax levied on this tax base and where the statutory liability for these taxes rests. It is this second aspect, which in relation to companies can be referred to as the "company tax system", which is the subject of this document. The term company tax system is used to mean the set of statutory tax rules for determining the rates of tax and the statutory liability for tax on company income.

In order to focus on the effect of the present company tax system rather than the effect of the timing rules or the definition of the tax base, the remainder of this chapter assumes that tax is levied and paid on the nominal economic income produced by an investment as it accrues.

3.4 Unincorporated Sector

In the unincorporated sector, effective tax rates are independent of whether an investment is financed by debt or equity and depend (given the assumptions outlined in section 3.3) only on the effective marginal tax rate of the investor (ie the person who contributed the capital to finance the investment). The term effective marginal tax rate here means the rate of tax which results from combining the nominal tax scale rates with the rates at which benefits or rebates abate.

Where the investment is debt-financed, the lender obtains a deduction for the accrued interest expense. Income derived by the borrower which is paid out as interest is therefore not subject to tax in the borrower's hands. The only tax levied on the interest income is that levied on the lender. The effective tax rate on investment income paid out as interest is therefore the effective tax rate of the lender. Any residual income remaining after meeting interest expenses is taxed at the effective marginal tax rate of the equity participants (ie the owners of the business).

In general, all income accruing to owners of unincorporated businesses is taxed at their effective marginal tax rates. Thus, the income accruing to both equity and debt holders is taxed at the effective marginal tax rates of the investors. This meets the objective of taxing capital or investment income at the marginal tax rates of the owners of the capital. It ensures that there is no bias in the tax system between debt and equity finance.

3.5 Corporate Sector

By contrast with unincorporated investment, effective tax rates in the corporate sector depend on whether investment is financed by debt, retained earnings or new equity and, in the case of the latter, when the income is distributed.

3.5.1 Debt

As in the unincorporated sector, interest on money borrowed to finance investment is deductible to a corporate borrower. This means that a borrower does not pay company tax on income paid out as interest. The only tax levied on the interest is that levied on the lender. The effective tax rate on debt-financed investment income is therefore the effective tax rate of the lender. This is the appropriate treatment. The income is taxed at the marginal tax rate of the provider of the capital. Thus, debt-financed corporate investment is taxed on the same basis as debt- and equity-financed investment in the unincorporated sector and in accordance with the economic objective of taxing capital income at the tax rates of the owners of the capital.

Note that if interest were not deductible to the borrower, two layers of tax would be levied on interest, one in the hands of the borrower and one in the hands of the lender. The effective tax rate on debt-financed investment would then be some combination of the rates applying to the borrower and lender and would certainly exceed the rate applying to the owner of the capital, the lender.

3.5.2 Retained Earnings

Retained earnings consist of after-company tax income retained by a company rather than distributed as a dividend to shareholders. In accounting terms, retained earnings form part of the shareholders' funds. Shareholders' funds in turn consist of the equity of the owners of the company, measured as the excess of the company's assets over its liabilities.

Under the present tax system, retained earnings are assessable if they are distributed as dividends to shareholders. This tax liability can be avoided by capitalising the retained earnings as a bonus issue and making a return of capital more than 10 years after the bonus issue. A return of capital does, however, require the approval of the High Court pursuant to the Companies Act 1955.

Because retained earnings are taxable on distribution, shareholders forgo only $\$(1 - m)$ for each dollar of earnings which are retained rather than distributed, where m is the shareholder's effective marginal tax rate. If the pre-tax rate of return per annum generated by the company from the investment of the retained earnings is R , given the assumption set out in section 3.3 that nominal economic income is taxable on an accrual basis, the after-(company) tax rate of return will be $R(1 - c)$ where c is the statutory company tax rate. At the end of one year, the company will have $\$[1 + R(1 - c)]$ available to distribute per dollar of retained earnings invested. If this were distributed, the after-(company and shareholder) tax distribution to the shareholder would be $\$[1 + R(1 - c)](1 - m)$. By forgoing distribution for one year, the shareholder's original capital stake of $\$(1 - m)$ has increased to $\$[1 + R(1 - c)](1 - m)$ per dollar of retained earnings invested. The rate of increase after all taxes is therefore $R(1 - c)$. Since R was the before (company and shareholder) tax rate of return, the effective tax rate on the investment is c , the statutory company tax rate. This result holds irrespective of the period of the investment. Thus, the effective tax rate on corporate investment financed by retained earnings is the company tax rate.

If the company tax rate is higher than the marginal tax rates of investors, corporate income generated from retained earnings will be over-taxed relative to debt-financed investment and investment in the unincorporated sector. At present, the statutory company tax rate is aligned with the top personal tax rate so that a large proportion of investors (ie actual or potential shareholders) will be on statutory rates lower than the company rate. Based on a comparison of statutory rates, corporate investment financed by retained earnings is therefore over-taxed under the present tax system.

When effective tax rates are considered (ie when we drop the assumption that the nominal economic income produced by an investment is taxed on an accrual basis), corporate investment financed by retained earnings is over-taxed if the effective tax rates on such investment exceed those on debt-financed or unincorporated investment. Effective tax rates may differ substantially from statutory tax rates. There is no reliable data on effective tax rates on

corporate income in New Zealand, but it may be expected that these rates will rise relative to personal tax rates as a result of the tax reforms already implemented by the Government and the international tax reforms. This makes it more likely that effective company tax rates will exceed those applying to interest and unincorporated investment income.

3.5.3 New Equity

New equity refers to additional capital (ie shares) subscribed by shareholders. This is recorded in a company's accounts as issued or paid-up capital. If the new shares are issued at a premium over their par value, the excess would normally be recorded in a share premium reserve.

In this case, the investor must contribute one dollar of after-tax income for each dollar subscribed. The effective tax rate on the investment depends on both the company and investor tax rates and on the period in which the income is retained in the company. An illustration of these effects is presented in Appendix 3.1. The appendix shows that the longer the income is retained in the company, the lower the effective tax rate. As the period before distribution increases, the effective tax rate approaches the company tax rate. Thus, the effective tax rate on corporate investment financed by new equity always exceeds the company tax rate, and hence the tax rates of investors, with the size of the excess rate higher the shorter the period before distribution.

It follows that corporate investment financed by new equity is the most heavily taxed form of investment under the present tax system. The effective tax rate on new equity-financed investment exceeds that on debt-financed investment and investment financed by retained earnings. Similarly, new equity-financed investment is taxed more heavily than investment in the unincorporated sector.

The tax burden on corporate investment financed by new equity depends primarily on the company tax rate. This is because the company rate is the rate at which income is taxed each year whereas the rate of tax on dividends, the shareholder's tax rate, is relevant only when the income is distributed. As the period before distribution increases, the present value of the dividend tax liability decreases.

3.5.4 Conclusion

Summarising the above analysis:

- a the effective tax rate on corporate investment financed by debt is the effective tax rate of the lender;
- b the effective tax rate on corporate investment financed by retained earnings is the effective company tax rate; and
- c the effective tax rate on corporate investment financed by new equity exceeds the effective company tax rate, but decreases towards that rate the longer the income is retained in a company.

As indicated earlier, the objective of reform of the company tax system is to tax corporate income as far as possible at the effective tax rates of shareholders. It follows that reform of the current system needs to focus on ensuring that, as far as possible, the rate at which company income is taxed each year is the effective tax rate of shareholders. This is the objective of the imputation scheme outlined in this document.

3.6 Economic Costs of the Present Tax System

The costs of the present tax system are largely efficiency rather than equity costs. Investors purchasing existing shares can take into account any excess tax burden on corporate equity investment in the price they pay for the shares. If the excess tax liability on the shares is fully capitalised into share prices, new purchasers would be fully compensated. The excess tax liability would be borne by the owners of the shares at the time the current system was introduced.

Similarly, investors subscribing new equity to companies do so in the light of the present tax system. It cannot be argued that the present tax system is "unfair" to investors who voluntarily invest in such equity.

Thus, the costs of the present tax system are predominantly efficiency costs. These costs can be summarised as follows:

- a increased expected costs of financial distress and agency costs associated with higher debt levels than would exist under a more neutral tax system:
- i the cost of equity is the after-company tax rate of return which a company must earn in order to generate the (pre-personal tax) rate of return required by investors. This cost is higher than it would be under a neutral tax system and certainly higher than the cost of debt. When a significant proportion of investors are on effective marginal tax rates below the effective company rate, a company must generate a higher after-tax rate of return than that needed to service the cost of debt. This means that debt finance has a tax advantage over equity under the present company tax system;
 - ii it can therefore be expected that companies will borrow more than they would under a more neutral tax system. This raises two types of cost: the expected costs of financial distress and agency costs. The former include the legal costs associated with bankruptcy and, more importantly, the investment opportunities forgone as a result of financial distress. The loss of investment opportunities relates primarily to the effect of bankruptcy on a company's intangible assets such as research and development. Projects which are under development may not proceed if the company is wound up or if they cannot be funded. Alternatively, a company in financial distress may pass up profitable investments because all of the benefit would accrue to its debt holders rather than its shareholders;
 - iii agency costs arise because of the costs imposed on a company in complying with debt covenants required by lenders. These become increasingly onerous as a company's debt level rises. Such costs arise because the interests of debt holders diverge from those of shareholders. In the extreme, for example, a company could borrow to pay a dividend to its shareholders. As a result, lenders frequently impose various forms of debt covenant such as information-reporting requirements, prohibitions on the sale of assets, or the maintenance of a minimum interest cover. These costs can severely constrain a company's operating and investment flexibility;

- iv since the cost of new equity is higher than the cost of retained earnings, the additional costs imposed by the present tax system will be greatest for companies which need to resort most to new equity finance. These are generally new or expanding companies which cannot fund growth through retained earnings;

- b increased agency costs as a result of the adoption of non-corporate organisational forms. Non-corporate organisational forms, particularly partnerships, have been relatively popular in New Zealand partly because of the tax advantages they offer over companies. Non-corporate widely-held investment vehicles such as partnerships do, however, raise agency costs associated with monitoring management performance. One obvious difference between corporate and non-corporate organisations is the absence of monitoring of the latter by sharemarket analysts. In other words, agents who specialise in monitoring managerial performance on behalf of owners are generally absent in the case of non-corporate organisational forms;

- c increased costs of portfolio diversification. Investors will generally wish to hold a diversified portfolio of debt and equity in order to minimise risk. For investors on effective marginal rates below the effective company rate, portfolio diversification will involve a cost in the form of a lower after-tax return, after adjusting for risk, on equity than that available on debt. Portfolio diversification therefore imposes costs on some investors that would not exist under a more neutral tax system; and

- d increased incentive for corporate takeover. The shareholder tax on dividends under the present tax system will to some extent be capitalised into share prices. In principle, such capitalisation may reduce the sharemarket valuation of a company below its net asset backing. To the extent that this occurs, there will clearly be incentives for companies to acquire assets by taking over other companies, rather than investing in the assets directly.

3.7 Conclusion

It is impossible to measure the magnitude of the efficiency costs arising from tax-induced investment and financing decisions. Thus, the significance of the costs outlined in section 3.6 is a matter of judgement. These costs will largely be a function of the extent to which the effective tax rate on equity-financed corporate investment exceeds the effective tax rate on debt-financed and unincorporated investment. The effective tax rate on the latter forms of investment is the effective marginal rate of the investor. The effective tax rate applying to corporate investment financed by retained earnings is the effective company rate, while that applying to corporate investment financed by new equity will be higher than that and certainly much higher than shareholders' effective marginal tax rates. This divergence in effective marginal tax rates influences firms' capital structure, choice of organisational form and investment decisions. Because these tax influences have an effect over such a large part of economic activity, the national welfare costs they impose are likely to be substantial.

APPENDIX 3.1: EFFECTIVE TAX RATE ON NEW EQUITY UNDER THE PRESENT TAX SYSTEM

1 Introduction

This appendix examines the effective tax rate on corporate investment financed by new equity under the present company tax system. The assumption outlined in section 3.3 of this chapter is applied in this appendix, ie the nominal economic income produced by the investment is assumed to be taxable on an accrual basis. This enables the effect of the company tax system to be considered separately from the effect of the tax base definition and timing rules.

2 Effective Tax Rate

The effective tax rate on an investment is the proportion of the pre-tax rate of return that is levied in tax (including both company and shareholder tax). If Y is the after-(company and shareholder) tax distribution received by the investor as a result of \$1 of investment financed by new equity, R is the pre-tax rate of return on the investment and t is the number of years before the distribution is made, then the effective tax rate on the investment is e where:

$$Y = [1 + R(1 - e)]^t$$

The value of Y depends on the value of R , the company tax rate, c , the shareholder tax rate, m , and the term before distribution, t . In particular:

$$Y = [1 + R(1 - c)]^t - \{[1 + R(1 - c)]^t - 1\} m$$

3 Results

The attached table shows the effective tax rates on the investment for different rates of shareholder tax on the dividends. For the purposes of illustration, the company rate is set at the present rate of 48 percent.

Three shareholder marginal tax rates are shown: 0 percent, 30 percent and 48 percent. In the 0 percent case, the effective tax rate on the investment is always equal to the company tax rate since company tax is the only tax levied on the investment.

In the other two cases, the effective tax rate on the investment is always higher than the company tax rate but tends towards that rate as the period before distribution increases. This decline is due to the deferral of the shareholder tax liability on the dividend. If the income is permanently retained in the company (ie the period before distributions is infinite), the effective tax rate is the company tax rate.

The higher the rate of tax on the distribution, the higher the effective tax rate. This is illustrated by the difference between the 30 percent and 48 percent shareholder tax rate columns in the table.

4 Conclusion

The effective tax rate on corporate investment financed by new equity always exceeds the effective tax rate of shareholders. The extent of the excess depends on the level of the company rate relative to the shareholder rate and the period before the earnings are distributed.

Table 3.1 : Effective Tax Rates on New Equity

Personal tax rate (%)	0	30	48
Company tax rate (%)	48		
Pre-tax rate of return (%)	10		
	<u>Effective</u>	<u>Effective</u>	<u>Effective</u>
	<u>tax rate</u>	<u>tax rate</u>	<u>tax rate</u>
<u>Personal Tax Rate</u>	0%	30%	48%
<u>Period</u>	%	%	%
1	48.0	63.6	73.0
2	48.0	63.3	72.6
3	48.0	63.1	72.3
4	48.0	62.8	72.0
5	48.0	62.5	71.7
6	48.0	62.3	71.3
7	48.0	62.0	71.0
8	48.0	61.8	70.7
9	48.0	61.5	70.4
10	48.0	61.3	70.0
11	48.0	61.0	69.7
12	48.0	60.8	69.4
13	48.0	60.6	69.1
14	48.0	60.4	68.8
15	48.0	60.1	68.5
16	48.0	59.9	68.2
17	48.0	59.7	67.9
18	48.0	59.5	67.6
19	48.0	59.3	67.3
20	48.0	59.1	67.0
30	48.0	57.3	64.4
40	48.0	55.9	62.1
50	48.0	54.8	60.2
100	48.0	51.7	54.8

CHAPTER 4 : COMPANY LEVEL OPERATION OF FULL IMPUTATION

4.1 Introduction

Chapter 2 examined the main issues relating to the design of a full imputation system. This chapter outlines in more detail the way in which the proposed scheme will operate at the corporate level. Chapter 5 considers the effect of the scheme on shareholders.

The main features of the scheme were developed in chapter 2. These were that:

- a an account-based approach will be adopted rather than a compensatory tax approach;
- b credits will be given only for New Zealand company tax paid and for certain foreign withholding taxes on dividends. Credits will not be given for foreign company tax paid;
- c bonus issues will be treated in the same way as cash dividends, other than bonus issues capitalised from share premiums paid in cash or other consideration;
- d all dividends will be taxable in shareholders' hands; and
- e all distributions on liquidation will be assessable, except distributions of paid-up capital (including share premiums paid).

The way in which these features will operate in practice is elaborated in this chapter.

4.2 Imputation Credit Account

4.2.1 Introduction

The general principle behind imputation is that tax paid by a company results

in its shareholders receiving a credit for an equal amount of tax. For this purpose, it is necessary for companies to keep an account of the tax they have paid and the imputation credits they have allocated to shareholders. This account will be called the "Imputation Credit Account", or "ICA".

4.2.2 ICA Credits

Credits in the account will arise from:

- a the payment of New Zealand provisional or terminal company income tax to the Inland Revenue Department. The amount of the credit will equal the amount of tax actually paid. Credits will not arise from the payment of foreign company taxes, penalty tax (such as additional tax payable for late payment), nor for taxes such as fringe benefit tax, land tax or GST. The credit in the ICA will arise on the day company income tax is paid;
- b the receipt by a company of an imputation credit attached to a dividend or bonus share issued by another company. The amount of the ICA credit will be the amount of the imputation credit received. The ICA credit will arise on the day the dividend is paid or the bonus share is issued; and
- c the receipt by a company of a dividend from a company which is resident in a country with which New Zealand has a double tax agreement that has borne non-resident withholding tax in that country. The amount of the credit will be the New Zealand dollar value of the non-resident withholding tax. The credit will arise on the day the dividend is paid and will be equal to the non-resident withholding tax paid. This rule ensures that foreign-source dividends paid by companies resident in New Zealand's tax treaty countries to resident non-corporate taxpayers bear the same New Zealand tax liability irrespective of whether they are received directly or indirectly through a resident company.

4.2.3 ICA Debits

Debits in the ICA will arise from the allocation of imputation credits to dividends and bonus shares paid or issued to shareholders during the year.

The size of the debit will equal the amount of the credits so allocated. The debit in the account will arise on the day on which dividends are paid or bonus shares are issued, as the case may be.

A debit in the ICA will also arise from a refund of New Zealand company income tax. The debit will arise on the day on which the Commissioner of Inland Revenue issues a notice of assessment indicating that a refund is due. The size of the debit will depend on the end-of-year balance in the ICA, as explained in section 4.3 below.

4.2.4 Opening Balance

The accounting year applying to the ICA of any company will be the same as the company's financial year. The opening balance in a company's ICA on the implementation date of the imputation scheme will be zero. The closing balance in the account at the end of a company's financial year will be determined as:

	Opening balance
Plus	Credits arising during the year
Less	Debits arising during the year
Equals	Closing balance.

The opening balance for a financial year after the year of commencement of the scheme will be the closing balance of the previous year.

4.3 Allocation of Imputation Credits

4.3.1 Taxable Distributions

Imputation credits will be allocated to shareholders on the payment of taxable distributions or the issuing of taxable bonus shares. As explained in chapter 2, all dividends will be taxable to shareholders. All other distributions made prior to wind-up, other than a return of paid-up capital made on the

redemption of shares, will also be assessable. On wind-up, distributions from paid-up capital, including share premiums paid in cash or other consideration, will be exempt from tax in shareholders' hands. Bonus shares issued before wind-up will also be taxable in shareholders' hands, other than bonus shares which capitalise share premiums paid in cash or other consideration.

4.3.2 Allocation Rules

The principle behind imputation is to tax a company's taxable income at the marginal tax rates of its shareholders. This means that the credits need to be allocated in such a way that a company's taxable income is simultaneously allocated to its shareholders. For example, with a statutory company tax rate of 48 percent, a credit of \$48 should be accompanied by a taxable dividend or bonus issue of \$52. The shareholder would be taxed on the sum of the taxable dividend and the credit but would be able to utilise the credit to offset the resulting tax liability.

In principle, imputation credits should be allocated to shareholders in proportion to their interests in the capital of the company. Because of the variety of types of share, options and rights to acquire shares, a direct allocation of a company's taxable income on this basis is not practicable. Nevertheless, the objective of imputation is to ensure that, as far as possible, credits are allocated in a way which reflects shareholders' economic interests in a company. For example, shareholders holding the same class of share should be allocated the same credit per share.

In order to meet the objectives set out above, the following provisions will apply to the allocation of credits:

- a the ratio of the credit to the taxable value of a dividend or bonus share will not be able to exceed the following ratio:

$$\frac{\text{company tax rate}}{1 - \text{company tax rate}}$$

For example, with a company tax rate of 48 percent, this ratio would be 48/52. This would be the maximum ratio of the credit to the taxable value of the dividend or bonus share to which the credit was allocated. Credits could, of course, be allocated so that the ratio of credit to taxable value was less than the maximum;

- b the ratio of the credit per share to the aggregate taxable value of the dividends and bonus shares paid or issued per share during a financial year must be the same for all classes of share in that financial year. The aggregate taxable value of the dividends and bonus shares paid in respect of any class of share means the sum of the taxable dividends (whether interim or final) and taxable bonus shares paid or issued to holders of that class of share during the year;
- c on any day that imputation credits are allocated to any holders of a class of share, the credit allocated per share must be the same for all shares of that class on issue on that day.

As noted in section 4.2.3 above, debits in the ICA arise from two sources - the allocation of imputation credits to dividends or bonus issues and the receipt of a notice of a company tax refund. Since the objective of the scheme is to allow shareholders credits for company tax actually paid, the balance in the ICA should not be permitted to fall below zero as a result of the allocation of credits to dividends and bonus issues. Thus, the maximum aggregate amount of imputation credits allocated to dividends or bonus shares paid or issued on any day in a company's financial year will be limited to the credit balance in the ICA on that day.

In the absence of rules to the contrary, the balance in the ICA may, however, fall below zero as a result of a company tax refund. In order to discourage companies from over-paying provisional tax and allocating the corresponding imputation credits to shareholders (which, once allocated, cannot be recovered), the payment of a company tax refund by the Inland Revenue Department to a company will be limited to the credit balance in the ICA of

the company at the end of the financial year in respect of which the refund is due. Any balance of the refund due but not paid may be used by the company to offset provisional tax payable in the next financial year or, if any balance of a refund remains, the subsequent income year and so on.

Because of differences in the time at which dividends are paid during a year and uncertainty over the size of the dividend to be paid on a particular class of share, it may transpire at the end of a company's financial year that it has not met conditions (b) and (c) outlined above. At that stage, it would not, however, be practicable to recover credits previously allocated to shareholders. In these circumstances, notional credits will be deemed to be allocated to particular classes of shareholder as necessary in order that the two conditions are met. Any such credits deemed to be allocated will be debited to the ICA as if they had actually been allocated to those shareholders. If this results in the ICA balance falling below zero, the company will be required to make an advance payment of provisional tax, payable within one month of the company's balance date, sufficient to bring the balance in the ICA back to zero. Such advance payments of provisional tax may be credited against future provisional tax liabilities of the company.

Provisions will be included to counteract arrangements, such as "stapled stock" schemes, which are intended to avoid the allocation rules.

4.4 Classes of Share

Two shares will be defined to be the same class of share if they have the same or substantially the same entitlement to dividends, bonus shares and distributions on wind-up. Shares may differ in their voting power but such differences are not relevant for the present purposes unless they affect the entitlements mentioned in the previous sentence.

There may be a great deal of variety in the rights attached to different classes of share. The "true" owners of a company might be regarded as its ultimate residual claimants, ie the shareholders with the last claim on the company's assets after all other claimants, including any holders of shares

with preferential claims, have been satisfied. These shareholders would generally be holders of the company's "ordinary" shares. It is, however, impossible to adequately define the term "ordinary share" for tax purposes because of the myriad of rights which may attach to ordinary shares in practice.

At the other extreme from ordinary shareholders are holders of redeemable preference shares. These are shares which have a prior claim over ordinary shares in respect of dividends and are redeemable in cash. They are comparable to debt but generally rank below debt in terms of security. It is, however, common for the payment of both the dividends and redemption amount to be indemnified by another party such as an associate company or a bank. Where this occurs, a redeemable preference share is equivalent to a debt instrument.

Between redeemable preference shares, on the one hand, and ordinary shares on the other, there is a range of equity instruments. It is more or less arbitrary where a distinction is drawn in this continuum. For the purposes of the allocation rules outlined in section 4.2.3, all classes of shares will be included.

4.5 Taxable Value of a Bonus Issue

As explained previously, bonus issues, other than those capitalised from share premiums will be treated in the same way as cash dividends and will be taxable in shareholders' hands. The taxable value of a taxable bonus share will be calculated as the aggregate amount of earnings or reserves capitalised to paid-up capital (as defined for tax purposes) as a result of the issue divided by the number of bonus shares so created.

4.6 Notification Requirements

Companies will be required to notify shareholders, at the time at which dividends are paid or bonus shares are issued, of the amount of the imputation credit, if any, allocated to the dividend or bonus share.

In addition, companies will be required to provide the following information to the Inland Revenue Department at the time they file the annual tax return:

- a the opening and closing balances of the ICA;
- b a reconciliation of the differences between the two, noting the source of all debits and credits to the ICA;
- c details of the number of classes of share the company has on issue, of the number of shares on issue in each class, and of any new shares issued during the financial year to which the return relates;
- d details of the manner in which any credits distributed during the financial year were allocated amongst each class of share.

4.7 Residence Requirements

The imputation scheme will apply only to companies which are New Zealand residents for tax purposes. The residence of a company is determined by section 241(2) of the Income Tax Act 1976. In general, a company is resident in New Zealand if it is incorporated here or it has its "centre of administrative management" here.

The ICA balance of a company will be deemed to be zero at the time it commences to be a New Zealand resident irrespective of whether it has previously been a New Zealand resident or whether it has paid New Zealand company tax before it becomes a resident.

4.8 Life Insurance Companies

Life insurance companies are taxed on their net investment income pursuant to section 204. This income is attributable in part to policyholders and in part to shareholders of the company. The current rate of tax, which is intended to approximate the average marginal tax rate of policyholders, is 33 percent.

The tax treatment of life offices is the subject of a separate review. For the purposes of the imputation scheme, tax payable by a life insurance company pursuant to section 204 will be excluded from the ICA and thus will not be available as an imputation credit to shareholders.

4.9 Corporate Trustees

A company may act in the capacity of a trustee. In these circumstances, the tax paid by the company is payable on behalf of the beneficiaries of the trust, rather than on behalf of the shareholders of the company. Consequently, the imputation scheme will not apply to tax paid by companies acting in the capacity of a trustee.

4.10 Unit Trusts

Section 211 of the Income Tax Act 1976 deems unit trusts to be companies for tax purposes. Unitholders of a unit trust are similarly deemed to be shareholders in the company. Correspondingly, distributions by a unit trust to unitholders are treated as dividends under section 4(1)(g). This treatment will continue under the imputation scheme.

4.11 Co-operatives and Mutual Associations

Co-operative and mutual associations are currently taxed under a special regime in section 199 of the Act. The basic difference between co-operatives and other companies is that the latter distribute profits to shareholders in accordance with each shareholder's claim over the company's assets, while co-operatives typically distribute profits to members in accordance with the amount of business undertaken with the co-operative by each member.

Certain co-operatives dealing in primary products are currently exempt from tax on income derived from carrying on "qualifying activities". The Minister of Finance announced in his Economic Statement of December 1987 that these exemptions will be repealed with effect from the income year commencing 1 April 1988. Co-operatives presently exempt from tax on all or some of their income will thereafter be treated on the same basis for tax purposes as all other co-operatives.

Under the present tax rules, co-operatives are able to deduct rebates paid to members within six months of the end of the co-operative's financial year. Where the rebate arises from a member's business transactions with the co-operative, it is assessable in the member's hands. This treatment is equivalent to a dividend deduction system and is comparable to the treatment of credited dividends or taxable bonus shares under the imputation scheme. In both cases, the income is taxed once at the recipient's marginal tax rate.

Rebates arising out of non-business transactions between a co-operative and its members are tax-free to members. This treatment is more concessionary than the treatment of non-co-operative company income. Income retained by those co-operatives subject to tax is assessable on a similar basis to company income.

The introduction of imputation facilitates much greater consistency between the tax treatment of co-operatives and other companies. Co-operatives will be treated in the same way as other companies except that, in order to permit them to distribute their taxable profit on the basis of members' transactions rather than their shareholdings, co-operatives will be able to allocate imputation credits to rebates paid to members, as well as to dividends or bonus shares. All rebates will be assessable in member's hands. A rebate will be defined as a payment in cash or other consideration made by a co-operative to a member calculated by reference to the member's transactions with the co-operative. The sum of the rebate and any credit allocated to it will be assessable in the member's hands in the same way as if it were a dividend. In all other respects, co-operatives will be treated in the same way as companies.

As with dividends and bonus shares, it is necessary to ensure that members are assessed on the appropriate amount of income at the same time as they claim imputation credits. The maximum ratio of credit to rebate paid will therefore be the following ratio:

$$\frac{\text{company tax rate}}{1 - \text{company tax rate}}$$

This rule corresponds to that outlined in section 4.2.3, applying to dividends and bonus shares.

CHAPTER 5 : EFFECT OF FULL IMPUTATION ON SHAREHOLDERS

5.1 Introduction

This chapter outlines the way in which full imputation will affect shareholders. Compared with the present tax system, there will be two major changes:

- a shareholders will receive tax credits from companies which they can use to offset their own income tax liabilities; and
- b bonus shares which result from the capitalisation of earnings or reserves, other than share premiums, to paid-up capital will be taxable.

5.2 Taxable Income

As explained in chapter 4, all dividends received by a shareholder will be assessable. Distributions of paid-up capital made on the redemption of shares or upon liquidation will, however, be tax-free to shareholders. Paid-up capital will be defined to include share premiums paid in cash or other consideration.

In addition, as noted above, certain bonus shares will be assessable. The taxable amount attributable to each bonus share will be notified to shareholders by the company making the bonus issue. The taxable amount will be calculated as the amount of shareholders' funds capitalised to paid-up capital divided by the number of bonus shares so created.

5.3 Imputation Credits

Imputation credits will be allocated by companies to shareholders on the payment of dividends or the issuing of taxable bonus shares. Shareholders will be notified by the company of the imputation credits to which they are entitled. Shareholders will include in their assessable income for each financial year the amount of any credits along with the taxable value of the dividends and bonus shares which they have received that year. The shareholder's tax liability on the resulting income will be able to be offset

by the imputation credits received. Any excess of the imputation credits over the tax liability on the income so calculated may be used to reduce the shareholder's tax liability on other income in the income year to which the credits relate.

Example: In the 1989 income year, a shareholder receives a dividend of \$520. The shareholder's dividend notice shows that a credit of \$280 has been allocated to the dividend. The shareholder's tax position would be as follows, assuming that he or she is on a 30 percent marginal tax rate:

	\$
Cash dividend	520
Credit	280
	——
Taxable income	800
Tax at 30%	240
LESS Credit	280
Net tax liability	-40

The shareholder would be able to use the net credit of \$40 to reduce tax payable on other income in the 1989 income year.

Shareholders will receive notices from companies showing their dividend and bonus share entitlements and the imputation credits which have been allocated to those dividends or bonus shares. They will be required to include these notices in their tax return in order to support the claim of an imputation credit against their own tax liability.

5.4 Excess Credits

In some cases, the total amount of imputation credits received by a shareholder in a particular financial year may exceed the shareholder's tax liability in that year. The excess credits will not be able to be carried forward but will lapse if they are unable to be utilised in the year to which they relate.

5.5 Residence Requirement

Imputation credits will be able to be offset only against a New Zealand income tax liability. Thus, only shareholders who are New Zealand residents at the time of payment of a dividend or taxable bonus share to which a credit is allocated will be able to utilise the credits.

5.6 Corporate Shareholders

At present, companies are generally exempt from tax on dividends under section 63 of the Income Tax Act. This exemption will remain in respect of dividends and bonus shares received from other resident companies. Foreign-source portfolio dividends received by companies after the Minister of Finance's Statement on 17 December 1987 will be assessable. Foreign-source non-portfolio dividends will be exempt but will be subject to a withholding payment, as outlined in the Minister of Finance's Statement. Any credits allocated to dividends or bonus shares received from resident companies will be added to the ICA of the recipient company.

5.7 Trusts

In principle, dividends or bonus shares received by a trustee should be allocated to the beneficiaries of the trust according to their interests in the trust and taxed at their marginal tax rates. Frequently, however, the beneficiaries are not specified or, if they are, the trust income to which each beneficiary is entitled is not specified but is left to the discretion of the trustee. This necessarily makes the tax treatment of such trusts somewhat arbitrary.

This leaves two broad options. First, rules could be derived in an attempt to ensure that dividends and bonus shares received by a trustee were allocated appropriately and ultimately taxed in the hands of the beneficiaries upon eventual distribution. Secondly, the dividends or bonus shares could be taxed in the hands of the trustee, with no further tax consequences upon eventual distribution.

There are two problems with the first option. First, the necessary rules would undoubtedly be complex. Secondly, such rules may not be consistent with the provisions outlined in the previous chapter concerning the allocation of imputation credits by companies. For these reasons, the second approach will be adopted. Dividends and bonus shares will be assessable in the hands of the trustee with that tax being a final tax irrespective of whether or not a beneficiary is entitled in possession to them.

The relevant tax rate will be the tax rate applying to trustees' income. The after-tax income remaining to the trustee will then be able to be distributed to beneficiaries tax-free as capital. Corporate trustees will be assessable on dividends and bonus shares received at the company tax rate. Any imputation credits attached to such income will be able to be offset against the corporate trustee's tax liability. As noted in chapter 4, tax payable by a company in the capacity of trustee (including tax payable on dividends and bonus shares) will not be able to be credited to the ICA of that company.

5.8 Partnerships

Section 10 of the Income Tax Act 1976 requires partnerships to make a return of income of the partnership and the share attributable to each partner. Each partner is, however, separately assessed on his or her total income, including his or her share of partnership income.

Any assessable income derived by a partnership from shares should be allocated to the partners in proportion to their interest in that assessable income. Taxable dividends, bonus shares and imputation credits received by the partnership must be allocated to the partners in accordance with their interests so defined.

5.9 Maori Authorities

The taxation of Maori authorities is dealt with in sections 234 to 239 of the Income Tax Act 1976. The definition of a Maori authority includes the Board of Maori Affairs, the Maori Trustee, an incorporation within the meaning of Part IV of the Maori Affairs Amendment Act 1967 and any other person administering or controlling property in trust for Maoris.

Where the authority is acting on behalf of more than 20 people, its distributed income is taxed at a rate of 7.5 percent and is further taxed as a dividend in the hands of the recipient. Any undistributed income of such an authority is taxed at a rate of 20 percent. Aside from the concessionary tax rates, this regime is therefore similar to that currently applying to companies in that distributed income is taxed twice. Where, however, an authority derives income on behalf of fewer than 20 people, it is taxed as a trustee.

With the introduction of imputation, it is not appropriate to continue with the present treatment of Maori authorities having more than 20 beneficiaries since that would be a more penal regime than that applying to companies. The distinction for tax purposes between authorities according to their number of beneficiaries is also arbitrary and ignores their differing legal and economic status.

Maori incorporations closely resemble companies incorporated under the Companies Act 1955 and will be treated as companies for tax purposes. All other Maori authorities are in substance trustees and will be treated as trustees for tax purposes.

5.10 Provisional Taxpayers

Provisional taxpayers may take into account in the calculation of their provisional income in any income year the imputation credits they expect to receive in that year. The normal rules applying to the estimation of provisional income and the penalties for under-estimation will apply.

CHAPTER 6 : IMPLEMENTATION AND OTHER ASPECTS**6.1 Introduction**

This chapter outlines how the full imputation scheme will be implemented. It also covers other miscellaneous issues not dealt with in previous chapters.

6.2 Implementation

The three main dates relevant to the implementation of the scheme are:

- a the date on which companies' tax payments are able to be credited to the ICA. This date will be the commencement of the 1989 income year, ie the income year commencing on 1 April 1988 or equivalent accounting year commencement dates. Thus, provisional and terminal tax payments relating to the 1989 and subsequent income years will be creditable to the ICA of a company. Company tax payments relating to earlier income years such as 1988 terminal tax will not be creditable to the ICA. For companies with early balance dates, the 1989 income year may have commenced as early as 1 October 1987. Provisional tax payments made by such companies before 1 April 1988 are creditable to the ICA;
- b the date on which companies may first allocate imputation credits to dividends or bonus shares. This date will be 1 April 1988 though it may be deferred if the relevant legislation has not been enacted. Dividends paid or bonus issues declared on or after that date may be credited with imputation credits;
- c the time at which foreign withholding taxes levied by New Zealand's tax treaty partners on (portfolio or non-portfolio) dividends received by New Zealand companies may first be credited to the ICA. This will be the time of the Minister of Finance's Statement on 17 December 1987. Thus, such foreign withholding taxes paid on dividends received by New Zealand companies after that time will be creditable to the ICA.

6.3 Taxation of Bonus Issues

Bonus shares, other than bonus shares which are capitalised from share premiums paid, will be taxable to shareholders. This change will apply to bonus issues declared after the time of the release of Minister of Finance's Statement on 17 December 1987. Bonus issues declared on or after 1 April 1988 (or, if that date is deferred, the subsequent implementation date) may have imputation credits allocated to them which will offset in whole or in part the shareholder's resulting tax liability.

Taxable bonus shares issued to non-resident shareholders will be subject to non-resident withholding tax as if they were cash dividends. This will apply to taxable bonus issues declared after the Minister of Finance's Statement on 17 December 1987. Non-taxable bonus shares will not be subject to the withholding tax.

6.4 Definition of Paid-Up Capital

The paid-up capital of a company consists broadly of the amount paid in by its shareholders on the subscription of shares. It may be paid in money or money's worth. Paid-up capital is augmented when a company makes a bonus issue to capitalise reserves or earnings. With the changes to the taxation of bonus issues outlined above, the paid-up capital of a company for tax purposes will consist of the sum of:

- a its paid-up capital as at the time of the Minister of Finance's Statement on 17 December 1987;
- b the amounts subscribed after that time in money or money's worth by its shareholders on the subscription of shares, whether in respect of their par value or in respect of any premium over par; and
- c the aggregate taxable value of taxable bonus issues declared after the Minister of Finance's Statement on 17 December 1987.

As explained in the next section, any part of paid-up capital attributable to a bonus issue declared after 1 April 1982 may be assessable on distribution.

6.5 Distributions of Paid-Up Capital

Under the new regime outlined in this document, all distributions will be taxable in shareholders' hands, other than distributions of paid-up capital made on the redemption of shares or on wind-up. The present treatment of distributions of paid-up capital following a bonus issue made within the previous 10 years will, however, be retained as a transitional measure. Thus, a return of paid-up capital will remain assessable to the extent that the paid-up capital is attributable to a bonus issue made on or after 1 April 1982 and before the Minister of Finance's Statement on 17 December 1987, and the bonus issue is made within a period of 10 years immediately preceding the return of capital. The purpose of this provision is to retain the current treatment set out in section 4(1)(ca) and its proviso where bonus issues are made on or before the time of the Minister of Finance's Economic Statement.

6.6 Excess Retention Tax

"Privately controlled investment companies" are currently subject to excess retention tax imposed under sections 246 to 257 of the Income Tax Act 1976. A privately controlled investment company is defined in section 247 as any proprietary company which is engaged exclusively or principally in the investment of money or the holding of or dealing in shares, securities, investments, or estates and interests in real property. A "proprietary company" is in turn defined in section 2 as a company which is under the control of four or fewer persons.

Excess retention tax at rate of 35 percent is imposed on any "insufficient distribution" of a company subject to the provisions. In essence, an insufficient distribution arises if a company does not distribute all of its dividend income and at least 40 percent of its other income, excluding dividends, remaining after the payment of tax. The basic objective of the tax is therefore to ensure that non-corporate taxpayers cannot defer personal tax liability on dividend income by holding their shares in a company. In addition, the tax seeks to reinforce the present classical company tax system by requiring a minimum distribution of income each year.

With the introduction of imputation, the second objective referred to above is clearly no longer relevant. Furthermore, there will be no incentive for a company to retain dividends which bear imputation credits. Companies may still be used to defer shareholder tax liability on dividends without credits but this opportunity exists for all companies, not just privately controlled investment companies. For these reasons, excess retention tax will be repealed with effect from the commencement of the 1989 income year.

6.7 Proprietary Company Dividends

Section 4(2) of the Act treats as dividends any expenditure incurred by a proprietary company for the benefit of a shareholder or an associated person of the shareholder. This treatment applies only where the expenditure is non-deductible to the company. Because it is non-deductible, the expenditure is in effect taxed at the company tax rate. Under an imputation system, it is not appropriate to impute any further tax liability to the shareholder. Consequently, section 4(2) will be repealed with effect from the commencement of the 1989 income year.

6.8 Deemed Dividends

Several provisions in the Act are concerned with deemed dividends. One such section is section 97 which deals with the payment of excessive salary or wages by a company to an employee who is a relative of a director or shareholder. It permits the Commissioner of Inland Revenue to allocate the income of the company, before the deduction of any amount payable to the relative, between the company and the relative and treat the amounts so allocated as assessable income of the parties. Any amount allocated to the company is then taxed as a dividend to the relative.

The section therefore has a two-fold objective. It aims to counter income-splitting between related persons and to ensure that the present classical tax system is not avoided by the payment of dividends which are purported to be wages or salaries. The income-splitting concern will largely be met by the introduction of a flat personal tax scale as announced by the

Minister of Finance in his Statement of 17 December 1987. The objective of reinforcing the present classical company tax system will no longer be relevant with the introduction of an imputation system. Consequently, section 97 will be repealed with effect from the commencement of the 1989 income year.

A similar provision is contained in section 190 of the Act. This applies where the Commissioner considers that the remuneration paid to a director or shareholder of a proprietary company or a relative of those persons is excessive. In these circumstances, the amount of the excess is not allowed as a deduction to the company and is treated as a dividend in the hands of the recipient. For the same reasons as those outlined in the previous paragraph, it will not be necessary to retain this section once imputation is introduced. It will therefore be repealed with effect from the commencement of the 1989 income year.

6.9 Distribution of Trading Stock to Shareholders

Section 197 deals with the distribution by a company of trading stock to a shareholder. The distribution is treated as a sale by the company and a purchase by the shareholder at the market value of the trading stock. In addition, subsection 197 (3) permits the Commissioner to treat as a dividend the excess of the deemed market price over an amount which is regarded as a return of capital.

Under imputation, the appropriate treatment is to tax the shareholder on the market value of the trading stock. It is not necessary to impute any tax liability to the company. Distributions of trading stock will therefore be taxed as dividends in the hands of shareholders. Such deemed dividends will be treated in the same way as cash dividends for the purposes of the rules for allocating imputation credits. This amendment will also apply from the commencement of the 1989 income year.

6.10 Fringe Benefits Received by "Major Shareholders"

Fringe benefits provided by a company to employees who are shareholders in the company are subject to fringe benefit tax except where the benefit is granted by a private company to an employee who is a "major shareholder". In brief, a

major shareholder of a private company is a shareholder who owns 10 percent or more of the company. Fringe benefits received by major shareholders of private companies are treated as dividends under section 4 of the Act.

This treatment of fringe benefits granted to major shareholders will be repealed with effect from 1 April 1988. From that date, fringe benefits provided by a company to any shareholder/employee will be subject to fringe benefit tax.

6.11 Specified Preference Shares

Dividends payable on specified preference shares issued pursuant to a binding contract entered into before 23 October 1986 are deductible under section 194 of the Act. These types of preference share are thus treated as debt for tax purposes. Accordingly, dividends payable on specified preference shares will not be able to be credited under the imputation scheme.

6.12 Section 192 Debentures

Debentures issued by a company which pay a rate of interest related to the company's profit are treated as equity by virtue of section 192 of the Act. Thus, the interest payable on such instruments is non-deductible and is treated as a dividend to the recipient under section 4(1)(e). This provision is intended to prevent companies issuing debentures which, because they pay a rate of interest related to the profits of the company, are similar to equity.

Under full imputation, equity will be taxed in a comparable way to debt. The removal of section 192 would, however, facilitate what would in effect be a dividend deduction system. This would not be consistent with the Government's decision to introduce an imputation scheme as the preferred reform option. Section 192 will therefore be retained. Debentures covered by that section will be treated in the same way as ordinary equity for the purposes of the rules outlined in chapter 4 concerning the allocation of credits.

6.13 Section 195 Debentures

Section 195 has an objective similar to that of section 192. It aims to prevent companies issuing debentures to their shareholders on which deductible interest would be paid, rather than dividends on the shareholders' equity. As

noted in section 6.12 above, a de facto dividend deduction system would not be consistent with the introduction of a full imputation system. Section 195 will therefore be retained, along with section 192.

6.14 Convertible Notes

Convertible notes issued after 23 October 1986 are subject to the accrual rules set out in sections 64B and 64M of the Act. Under these sections, they are treated as an amalgam of a debt and an equity instrument. The return on the debt component is accrued over the term of the note. Gains or losses attributable to the equity component of the note are not subject to the accrual rules.

Depending on their term, convertible notes issued prior to 23 October 1986 are treated as either debt or equity instruments. Those which are convertible into shares of the company issuing them within 5 years of the date of issue are treated as debt, with the interest payable being deductible to the issuer. Other convertible notes are treated as equity instruments. Interest on these is non-deductible and the holder is deemed to be a shareholder. Correspondingly, the interest is treated as a dividend under section 4(1)(f).

There will be no change to the existing treatment of convertible notes on the introduction of full imputation. Convertible notes which are deemed to be equity under section 196(3) will be treated in the same way as ordinary equity for the purposes of allocating imputation credits. Convertible notes on which interest is deductible will be treated as debt instruments and will not be able to be credited under the imputation scheme.

6.15 Dividend Stripping

Two sections in the Act are specifically concerned with dividend stripping. These are section 99(5) and section 198. Dividend stripping typically refers to the purchase of a company by a corporate sharetrader which then disburses all of the retained earnings of the company as a dividend and sells the shares. Because the retained earnings of the company are paid out, the sale

realises a loss which is deductible to a sharetrader. Since, however, the sharetrader is usually a company, the dividends are not assessable. The overall result is that a tax loss is created even though the sharetrader has suffered no loss in an accounting or economic sense.

The incentive for dividend stripping will remain under imputation. Anti-dividend stripping provisions will therefore be retained. The existing provisions will be reviewed with the aim of improving their effectiveness.

GLOSSARY OF TERMS

Accounting year - the 12-month period ending with the taxpayer's balance date.

Bonus issue - an issue of shares by a company without consideration. Bonus issues result from the capitalisation of earnings or reserves to paid-up capital. The shares created in this process are referred to as bonus shares.

Capital income - income produced from real or financial assets.

Company tax system - the statutory tax rules for determining the rates of tax and the legal liability for tax on company income.

Corporate income - income derived by a company.

Economic income - in respect of any person and any period, the sum of the increase in the market value of the net assets of the person over the period and the amount consumed by the person in that period.

Dividend deduction system - a company tax system whereby a company receives a tax deduction for dividends which are then assessable to both corporate and non-corporate shareholders.

Effective tax rate - in relation to an investment, the proportion of the pre-tax rate of return of the investment which is taken in tax. It can be measured as one minus the ratio of the after-tax to the pre-tax rate of return. In relation to personal tax, the effective marginal tax rate means rate of tax which results from combining the nominal tax scale rate with the rates at which benefits and rebates abate.

Full Imputation - a company tax system, such as that set out in this document, whereby the tax paid by a company is imputed to its shareholders on distributions. Shareholders are taxed on the corresponding gross of company tax income and receive a tax credit for the tax paid by the company.

Full integration - a company tax system whereby the taxable income of a company is pro-rated to its shareholders and taxed in their hands. Shareholders receive a tax credit for the tax paid by the company.

Income year - the year ending 31 March. For example, the 1989 income year is the year ending 31 March 1989. Income year is defined in section 2 of the Income Tax Act 1976.

Imputation Credit - a tax credit which may be allocated by a company to its shareholders. Imputation credits arise from the payment of provisional and terminal tax, the receipts of credits from other companies and the receipt of foreign-source dividends on which non-resident withholding tax has been paid.

Imputation Credit Account - an account to be established by companies to record the amount of imputation credits available for allocation to shareholders.

Inter-corporate dividend - a dividend paid by one company to another company.

Labour income - income derived from human capital, such as wage and salary income.

Non-portfolio dividends - dividends received by a company from another company in which the first company owns 10 percent or more of the paid-up share capital.

Par value - the nominal or face value of a share.

Paid-up share capital - the amount of money or money's worth paid in by shareholders on the subscription of shares at their par value. As conventionally used, paid-up capital refers to the aggregate par value of the shares of a company which are on issue. Amounts subscribed in excess of the par value of issued shares are shown as share premiums and are recorded separately from paid-up capital.

Portfolio dividends - dividends received by a company from another company in which the first company owns less than 10 percent of the paid up-share capital.

Retained earnings - earnings (or net profit) of a company which is retained by the company rather than distributed to its shareholders.

Share premium - an amount paid in money or money's worth on the subscription of a share in excess of the par value of the share.

Tax Base - the way in which taxable income is defined in the Income Tax Act 1976.

Taxable income - assessable income less allowable deductions.

Taxable value - in relation to a dividend, the amount of the dividend in money or money's worth; in relation to a bonus issue, the amount transferred to paid-up capital as a result of the issue divided by the number of shares issued.

Tax preference - a feature of the tax system which allows certain forms of income to be taxed at less than the statutory rate.

