Regulatory Impact Statement

Tax treatment of profit distribution plans

Agency Disclosure Statement

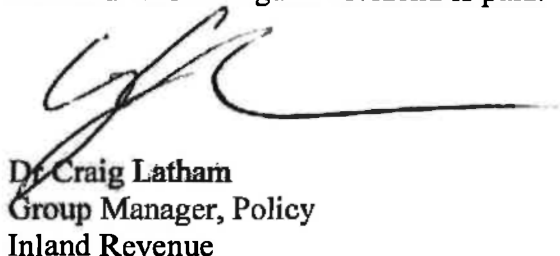
This Regulatory Impact Statement has been prepared by Inland Revenue.

The problem addressed in the Statement is that the current tax treatment of profit distribution plans (PDPs) is inconsistent with the tax treatment of other similar arrangements. The objective is to align the tax treatment of PDPs with the tax treatment of other similar arrangements. This means there would be no opportunity to stream imputation credits, and shareholders would pay tax at their correct marginal tax rate on the distribution of bonus shares.

The analysis assumes that the existing tax treatment applied to similar arrangements should also apply to PDPs, and that PDPs are being used only by listed companies. There are no other key gaps, assumptions, dependencies, significant constraints, caveats or uncertainties concerning the analysis.

In June 2009, consultation on the tax treatment of PDPs was undertaken through a public issues paper. In May 2011, follow-up targeted consultation was undertaken on the draft legislative provisions for tax treatment of PDPs. As a result, alternative solutions for the tax treatment of PDPs were considered and are covered in this Regulatory Impact Statement. We have also consulted with the Treasury, who agree with our analysis.

None of the policy options considered impair private property rights, restrict market competition, or override fundamental common law principles. Submitters have responded that the proposed solution may reduce the incentives for businesses to innovate and invest since the status quo provides an effective way for a company to retain capital rather than pay out dividends. Submitters also responded that the proposed new tax treatment of PDPs would impose additional compliance costs on businesses and shareholders. However, the proposed new tax treatment of PDPs does not impose higher compliance costs than already incurred when a regular dividend is paid.



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1 August 2011

STATUS QUO AND PROBLEM DEFINITION

1. The problem addressed by this Regulatory Impact Statement is that the current tax treatment of profit distribution plans (PDPs) is inconsistent with the tax treatment of other similar arrangements. The current tax treatment of PDPs provides opportunities to stream imputation credits away from shareholders who cannot use them, towards shareholders who can use them. Secondly, shareholders may not be taxed on dividends at their personal tax rates.

2. A PDP is a scheme offered by companies whereby the company advises all its shareholders that they will be issued with bonus shares on a particular date. The shareholders are asked if they would like to have the company repurchase those bonus shares immediately after the shareholder receives them. If the shareholder does not elect to have some or all of their bonus shares repurchased, the default option is for the shareholder to retain the bonus shares.

3. The current tax treatment is that the bonus issue of shares under a PDP are treated as a non-taxable bonus issue and are therefore not subject to tax. Furthermore, the subsequent sale of the bonus shares on the market will not be subject to tax if the shareholder holds the shares on capital account. However, if a shareholder elects for the company to repurchase their bonus shares, the cash that they receive is treated as a dividend and is therefore subject to tax. Imputation credits may be attached to the cash dividend by the company and used to credit the tax payable by the shareholder.

4. In other similar arrangements where shareholders are given the choice of receiving cash or bonus shares, such as a dividend reinvestment plan[1] and a bonus issue in lieu[2], the shareholder receives a taxable dividend whether they choose to receive the cash or shares.

5. Officials are aware of seven companies that have carried out PDPs in the past. In general these plans have been popular with publicly listed companies who have a large numbers of shareholders. However, we are aware of only one company that is currently carrying out PDPs.

6. PDPs are also popular because they are highly effective capital management tools. PDPs are successful at retaining capital because they benefit from lack of shareholder action. If the shareholder does not positively respond to the company and elect to have their bonus shares repurchased, the default position is for the shareholder to retain the bonus shares, thereby retaining capital in the company. If shareholders do not choose the cash option and as a result get bonus shares, they do not need to return these shares in their tax return.

7. The current tax treatment of PDPs provides an opportunity for imputation credits to be streamed. New Zealand resident companies can attach imputation credits to dividends paid to its shareholders, and shareholders can generally use the credits to reduce their tax payable in New Zealand. However, for some shareholders (such as foreign or tax exempt shareholders), imputation credits have little or no value as they can only be offset against taxable New

[1] A dividend reinvestment plan (DRP) is where a company provides all shareholders with a cash dividend, and then gives them the option of reinvesting their cash dividends in shares of the company. This can be advantageous for the company, allowing it to maintain a dividend payment policy, while providing an opportunity to increase cash retentions. DRPs are also convenient for shareholders as they are a method for shareholders to reinvest their cash dividends in a company at a lower cost and effort than purchasing shares on the market. If the shareholder does not make an election, the default option is to receive a cash dividend.

[2] A "bonus issue in lieu" is a tax concept. It is a bonus issue of shares made under an arrangement where a company gives its shareholders a choice whether to receive a bonus issue or money or money's worth. Under a bonus issue in lieu arrangement, regardless of whether the shareholder chooses to receive bonus shares or money, they are subject to tax.

Zealand income. This creates an incentive to direct the credits to those shareholders who are best able to use them (a practice known as imputation credit "streaming"). Tax rules generally prevent imputation credit streaming.

8. Imputation credit streaming can take place under a PDP when shareholders self-select whether to redeem their bonus shares for a cash dividend, depending on whether or not they can utilise imputation credits that would be attached to a cash dividend. Those shareholders who are unable to utilise imputation credits, for example foreign or tax exempt shareholders, may elect to receive bonus shares that are non-taxable. As the bonus shares are non-taxable, imputation credits will not be attached, preserving the credits for shareholders who can best use them. This defeats the current policy settings for the imputation system.

9. The current tax treatment also raises issues related to equity. Under a PDP:

- shareholders on personal tax rates higher than the company rate may not pay tax at their marginal tax rate on the distribution of the shares from the company; and
- shareholders who are receiving social assistance may receive entitlements that they would not receive if the bonus shares were taxable.

10. The current tax treatment of PDPs was the subject of a specific Inland Revenue product ruling in 2005. This ruling was made subject to certain conditions, including that the company making the bonus issue has sufficient credits in its imputation credit account to have fully imputed a cash dividend equal to the bonus issue not redeemed. On 31 March 2009, that product ruling expired.

11. On 16 April 2010, the Minister of Finance and the Minister of Revenue announced that the Government would clarify the law to ensure that bonus issues of shares distributed under PDPs are taxed in the same way as shares issued under other dividend reinvestment plans.

12. If the current tax treatment is retained, the tax treatment of PDPs will remain inconsistent with other similar arrangements. In addition, no action in this area may encourage imputation credit streaming.

13. We estimate that retaining the status quo rather than adopting the recommended option would result in a fiscal loss of approximately $0.76m per annum.

OBJECTIVE

14. The objective is to align the tax treatment of bonus shares provided under a PDP with the tax treatment of other similar arrangements. This is satisfied if the following two conditions are met:

1. **PDPs are not able to be used to stream imputation credits**
   There are tax rules that prevent imputation credits from being directed to shareholders who can best use them (streaming).

2. **Equity**
   Under current policy settings, a taxpayer's total annual income should be taxed at their personal tax rates under the progressive tax rate structure. In addition, all the income of taxpayers should be taken into account for social assistance purposes.

15. Alongside this objective, we have also taken into account compliance and administration costs. As far as possible, the compliance costs faced by taxpayers should be minimised.

REGULATORY IMPACT ANALYSIS

16. A number of options have been considered for the tax treatment of PDPs:

- **Option 1 (our recommended option):** treat the bonus shares issued under a PDP as a taxable dividend. Shareholders would be taxed when they receive their bonus shares. If shareholders are required to file a tax return, they must include the dividend income in their return.

- **Option 2:** treat the bonus shares issued under a PDP like a taxable dividend, and also give shareholders who are already required to file a tax return the **option** to include the bonus shares as a dividend in their return.

- **Option 3:** require the company to debit its imputation credit account (ICA) when issuing bonus shares, and also pay a levy as compensation for shareholders that may be on the top marginal tax rate and who, as a result of this proposal, do not return the income and pay tax at their personal tax rate. The ICA would be debited at the maximum imputation ratio (ordinarily 28%) on the value of the bonus shares that are retained by recipient shareholders. The additional levy could be up to 5%.

- **Option 4:** require the company to debit its ICA at the maximum imputation ratio (ordinarily 28%) with respect to the bonus shares that are retained by recipient shareholders, without requiring payment of an additional levy.

- **Option 5:** retain the status quo. Shareholders who retain their bonus shares issued under a PDP are not taxed, while shareholders who redeem their bonus shares are treated as receiving a taxable dividend.

17. Option one was the option originally proposed by officials in the 2009 issues paper. In May 2011 legislation was drafted based on this option and sent out for targeted consultation. Options two, three and four arose from consultation with interested parties.

18. Officials' analysis of the options is summarised in the following table:

Options	Costs	Benefits	Conclusion
One: treat bonus shares issued under a PDP as a taxable dividend.	- Higher compliance costs than the status quo, borne by shareholders and the company. - May discourage capital raising when compared to the status quo, but not when compared to substitutable arrangements.	- Limits imputation credit streaming opportunities. - Equitable as it ensures shareholders are taxed at their personal tax rates. - Ensures substitutable arrangements are treated the same. - Fiscally positive.	Recommended option **Net impact:** positive. Improvement on the status quo (equitable outcome, equivalent treatment with substitutes, and prevents streaming opportunities). However, does increase compliance costs.

Options	Costs	Benefits	Conclusion
Two: treat bonus shares as a taxable dividend and give shareholders an option to include bonus shares in their tax return.	- Does not treat substitutable arrangements the same. - Income may not be counted for social assistance purposes which may mean that taxpayers receive benefits that they would not receive if the payment was taxable.	- Limits imputation credit streaming opportunities.	Not recommended **Net impact:** marginally positive. Improvement on the status quo (prevents streaming). However, results in inequitable outcome, and does not result in equivalent treatment with substitutes.
Three: require company to debit ICA and pay an additional levy.	- Does not treat substitutable arrangements the same. - Low rate shareholders are effectively taxed at higher rates. - Income is not counted for social assistance purposes which may mean that taxpayers receive benefits that they would not receive if the payment was taxable. - Administratively complex because it is likely to require the creation of a new revenue item for Inland Revenue systems, and new forms/guides for the company.	- Limits imputation credit streaming opportunities. - Low compliance costs for shareholders. - Addresses fiscal concerns with shareholders not paying their personal tax rates on income.	Not recommended **Net impact:** negative. High administrative costs, inequitable outcome, and does not result in equivalent treatment with substitutes. However, does reduce compliance costs for shareholders, and prevents streaming.
Four: require company to debit ICA.	- Does not treat substitutable arrangements the same. - Low rate shareholders are effectively taxed at a higher rate, and higher rate shareholders are taxed at a lower rate. - Income is not counted for social assistance purposes which may mean that taxpayers receive benefits that they would not receive if the payment was taxable. - Fiscally negative: estimated at $7m revenue loss per annum. Costs borne by the Government.	- Limits imputation credit streaming opportunities. - Low compliance costs for shareholders. - A cheap and effective way of raising capital, and because tax treatment is concessionary, companies may be encouraged to use PDPs in order to raise capital.	Not recommended **Net impact:** negative. Inequitable outcome, fiscally negative, and does not result in equivalent treatment with substitutes. However, does reduce compliance costs for shareholders, and prevents streaming.
Five: retain status quo.	- There are imputation credit streaming opportunities. - Shareholders in similar arrangements are subject to more tax. - Bonus issues are not counted for social assistance purposes which may mean that taxpayers receive benefits that they would not receive if the payment was taxable. - Estimated revenue loss of $0.76m per annum when compared to the recommended option	- Low compliance costs for the company and its shareholders - A cheap and effective way of raising capital.	Not recommended **Net impact:** negative. Maintains status quo (streaming opportunities, and inequitable outcome)

19. Option one is the recommended option. This option treats substitutable arrangements the same for tax purposes, and as such, it meets the key objective. As such, it prevents opportunities for imputation credit streaming, and it ensures that shareholders are taxed at their personal tax rates on distributions from the company. It addresses the concerns regarding social assistance because a shareholder must include the bonus shares issued under a PDP in their tax return. Option one (the recommended option) results in more revenue being raised when compared to the status quo.

20. Officials note that option one imposes higher compliance costs on shareholders and the company when compared to the status quo. However, these costs are no higher than if a cash dividend was paid. Therefore, we do not anticipate that this option would impose significant costs beyond those already being incurred in the normal course of business. This is because publicly listed companies generally already have mechanisms in place for withholding resident withholding tax (RWT) or non-resident withholding tax (NRWT) on dividends[3]. If RWT is correctly deducted, a resident shareholder will not be required to file a tax return, simply because they receive a dividend under a PDP. A resident shareholder will only have to put the dividend in their tax return if they are already filing a tax return because, for example, they have income that has not had tax deducted at source (such as rents). For these shareholders, due to the rate of RWT on dividends, it is unlikely that the shareholders would face a tax liability as a result of the dividend. As such, we do not expect this to result in cash-flow problems for shareholders.

21. Although options two, three and four prevent opportunities for imputation credit streaming, they do not result in consistent treatment with substitutes and therefore do not tax shareholders at their personal tax rates. Therefore, these options are not recommended. They also raise concerns with social assistance entitlement, administrative simplicity and fiscal constraints.

22. Option five does not meet any of the objectives, and it also raises equity concerns. Therefore, this option is not recommended.

23. The economic, fiscal, compliance and social implications of the options are outlined in the table above. None of the options have environmental or cultural impacts.

CONSULTATION

24. Officials have consulted interested parties in two formal rounds of consultation.

25. The first round of consultation was open to the public where officials released an issues paper in June 2009. The issues paper proposed to amend the definition of "bonus issue in lieu" to include shares issued under a PDP, so that they would be subject to tax. Six submissions were received in response to this issues paper.

26. The feedback received from the first round of consultation was generally negative. All six submitters opposed the change that was proposed. The key reasons were:

- The form and substance of dividend reinvestment plans (DRPs) and PDPs differ and the tax treatment should be determined by the form rather than the substance of the transaction.

[3] NRWT is a final tax for non-resident shareholders.

- PDPs result in a high rate of retention of reserves. This outcome is good for New Zealand companies and the economy. Taxing the bonus issue of shares under PDPs would result in PDPs no longer being a viable mechanism to retain cash reserves.

- The tax consequences of PDPs would become too complicated to explain to shareholders, particularly as a result of the inconsistency in the resident withholding tax (RWT) rate on dividends (33%) compared with the company tax rate and the maximum imputation ratio (generally 28%).

- Relatively little weight should be placed on the concern that investors with marginal tax rates above the company rate benefit from a tax advantage. These taxpayers are equally able to reduce their tax liability by investing in a trust, portfolio investment entity or company and the medium-term Government policy is to move towards alignment.

- The proposal to tax PDPs like a bonus issue in lieu could lead to double taxation.

- Any potential fiscal cost would only be minimal, and the fiscally positive aspects of PDPs (such as additional tax revenue generated from the business operations) were not factored in.

- It would be more appropriate to include PDPs in a wider review of imputation.

27. After the first round of consultation, the Capital Markets Development Taskforce (the Taskforce) reported, stating that it:

> *...considers it important that the tax system treats substitutable transactions neutrally. If PDPs are substitutable for ordinary dividend payments with optional reinvestment, the tax treatment should ideally be identical in both cases. The same goes for other close substitutes. Otherwise, there is a danger that investment decisions will be biased towards companies that offer PDPs, and that there could be significant loss of tax revenue from normal dividend taxation.*
>
> *At the same time, the Taskforce considers it desirable that the tax system does not impede the supply of capital. A decision on the tax treatment of PDPs should, therefore, take into account the fact that PDPs are an effective way for companies to raise capital.*
>
> ***Recommendation:*** *We recommend that changes to the tax treatment of PDPs should be made as part of a broader review of tax settings and take into account any adverse impacts on capital-raising costs.*

28. Officials considered the Taskforce's report and agreed with their concerns around substitutability. Following this report, officials consulted on a solution that provided for a more consistent tax treatment across close substitutes.

29. Consequently we proposed treating bonus shares issued under PDPs like a taxable dividend. In May 2011, we began our second round of consultation by seeking comments on draft legislation, which would have treated bonus shares issued under a PDP in the same way as a taxable dividend. The draft legislation was sent to the six parties that had responded to the earlier round of consultation, as well as one other party who officials considered would be interested in the issue.

30. Several submitters provided feedback about the wording of the draft legislative provisions. This feedback would be taken into account in any drafting.

31. Some submitters also commented on policy matters. One submitter expressly supported the proposed change, and considered that shares issued under a PDP were the same as a taxable dividend for all practical purposes. Other submitters expressed concerns with the proposed tax treatment. The concerns that differed from the first round of consultation were:

- A PDP is not a dividend because it does not involve a transfer of value.
- There are other related inconsistencies in the tax acts that should be addressed, such as the RWT rules.
- Additional consultation was needed.

32. In addition to these two formal consultation rounds, the Minister of Revenue has on a number of occasions announced the progression of work on PDPs, and officials have been involved in a number of discussions with interested parties. Options two, three and four arose out of those discussions. These three options, along with option five, would allow PDPs to continue to be viable and cost-effective capital raising tools.

33. The key argument made by submitters has been that the proposed change would increase compliance costs for companies and shareholders to the extent that PDPs would no longer be a viable mechanism to achieve retention of cash reserves.

34. We acknowledge that after the change in the tax treatment there may be higher compliance costs for shareholders and for the company. However, as already noted, we do not anticipate that these costs would be significant.

35. It should be noted that the compliance costs of the recommended option are no greater than those currently faced by companies that pay dividends. Companies paying dividends are already required to report this in their tax returns. Under current law, many shareholders can already choose to not file a tax return even when they receive taxable dividends. This will be the case, for example, where the only other income they are receiving is employment income, or interest or dividends that have had tax correctly deducted at source. Shareholders will generally be required to recognise dividend income in their tax return only if they are required to file for some other reason (for example, if they have income which has not had tax deducted at source, such as rents).

CONCLUSIONS AND RECOMMENDATIONS

36. Option one is the recommended option and involves treating the bonus shares issued under a PDP in the same way as a taxable dividend. This would ensure that substitutable transactions are treated the same way for tax purposes, opportunities for imputation credit streaming are minimised, and dividends are effectively taxed at the shareholders' personal tax rates.

37. Although many of the other options prevent opportunities for imputation credit streaming, they do not treat substitutable arrangements the same. They also raise other concerns, such as equity and fiscal concerns.

IMPLEMENTATION

38. It is proposed that the necessary legislative changes be included in the tax bill that is due to be introduced in September 2011, with application from a prospective application date after date of enactment. There would be no need to implement transitional rules.

39. If option one (the recommended option) is adopted, the new rules would be administered by Inland Revenue through existing channels. Companies would be required to recognise bonus shares issued under a PDP in their tax returns as a dividend paid out. Shareholders who currently file tax returns would be required to include the bonus shares issued under a PDP as dividend income in their tax returns.

MONITORING, EVALUATION AND REVIEW

40. Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process (GTPP) to confirm that they match the policy objectives. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves a post-implementation review of the legislation and the identification of remedial issues. Opportunities for external consultation are also built into this stage.