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The Taxation of Profit Distribution Plans  
C/- Deputy Commissioner, Policy  
Policy Advice Division  
Inland Revenue Department  
PO Box 2198  
**WELLINGTON**

By email: [policy.webmaster@ird.govt.nz](mailto:policy.webmaster@ird.govt.nz)

## **The Taxation of Distributions from Profit Distribution Plans (PDPs)**

### **Introduction**

1. The Society's Taxation Committee (the Committee) is grateful for the opportunity to comment on IRD's "The taxation of distributions from profit distribution plans" (the issues paper) released in June 2009. The issues paper proposes (paragraph 3.4) to include within the definition of "bonus issue in lieu" in sYA 1 of the Income Tax Act 2007 (the Act) an issue of bonus shares if shareholders can elect for the issuing company to repurchase those shares - commonly known as a PDP. The proposal is to align the tax treatment of PDPs with that of other dividend reinvestment plans (DRPs), by bringing PDPs within the scope of the "bonus issue in lieu" definition.
2. The issues paper states that (paragraph 1.2):  
  
*"... there is no clear reason why one form of dividend reinvestment plan should be tax-advantaged over the other."*
3. A critical assumption underlying the proposal, therefore, is that PDPs are just a different form of DRP and so should be subject to the same tax treatment as DRPs. A further critical assumption underlying the proposal is that there is uncertainty as to the current tax treatment of PDPs because PDPs are not explicitly covered by the Act ( the issues paper at paragraph 2.7).
4. The issues paper then outlines two particular concerns as regards the tax treatment of PDPs:
  - (a) that shareholders on tax rates above the company tax rate who retain bonus shares under a PDP would face a lower tax impost than that imposed under DRPs (paragraph 2.9); and
  - (b) that the current treatment of PDPs leads to a risk of imputation credit streaming (paragraphs 2.10 and 2.11).

## Summary of submission

5. In summary, we submit that:

- (a) The assumptions underlying the perceived need for reform are questionable. In particular, there are important non-tax differences between PDPs and DRPs which may justify their different tax consequences, and that the current tax treatment of PDPs is not uncertain (see paragraphs 6 to 10 below).
- (b) The proposals, if they proceed, could disadvantage PDPs to the point they are abandoned, or would at least diminish the reinvestment rate, and therefore the utility of PDPs as a means of retaining capital. If tax laws are to be amended to discourage what are otherwise useful commercial transactions, entered into for commercial reasons, there should be clear and convincing grounds for doing so. The issues paper does not meet this threshold. Officials should, as a minimum, consider whether more targeted measures, proportionate to the tax base risk, may be available. (See paragraphs 11 to 14 below.)
- (c) If (contrary to our submissions) the proposal set out in the issues paper proceeds, the drafting proposed in the issues paper seeks to collapse two quite different transactions into the same definition, and in the case of PDPs would tax the wrong event (the bonus issue, rather than the cash distribution). If the issues paper proposal were to proceed, there should be a separate definition or provision treating the buy-back under a PDP as a dividend to all shareholders. (See paragraphs 16 and 17 below).

## Assumptions underlying the issues paper

### *Commercial differences between PDPs and DRPs*

6. A critical difference between PDPs and DRPs is that under PDPs, the default position is that the shareholder receives no cash. Only shareholders who positively elect to sell their bonus shares to the company will receive cash. The issues paper states (at paragraph 2.9):

*“PDPs, on the other hand, make use of a different form of transaction, to provide shareholders with the option of receiving shares or cash. In this case, **when the shareholder chooses to retain shares** the retention of shares may not be taxable as a dividend.”* [Emphasis added]

7. The point of a PDP is that shareholders do not choose to retain bonus shares. The default position is that shares are distributed to shareholders. Only if a shareholder positively elects to sell those shares will the shares be sold to the company resulting in the company receiving cash. The passage therefore overlooks a critical difference between PDPs and DRPs. The difference has important commercial and tax consequences:

- (a) first, as the issues paper acknowledges at paragraph 2.4, PDPs have a reinvestment rate of 60 to 90 percent, which is significantly higher than for DRPs. From a company’s perspective, this is an advantage of PDPs - the effect of shareholder inertia is that a lesser proportion of earnings is required to be

distributed, meaning that the company can retain a greater proportion of its earnings;

- (b) secondly, under a DRP where the default position is that the shareholder receives cash, the shareholder will never be in the position of having a tax liability and no cash receipt with which to meet that tax liability, unless the shareholder has made a positive election to that effect. If shareholders faced the prospect of being taxed on the value of bonus shares issued under a PDP, it is reasonable to assume that the reinvestment rate under PDPs would be materially reduced, and a PDP's attractiveness to companies would be reduced correspondingly. Faced with the difficulty of warning shareholders about the risk of having a tax liability, but no corresponding cash receipt (if no positive election is made to sell the bonus shares) companies may well conclude that PDPs are too difficult. (In this regard, it is important to appreciate that especially where less sophisticated investors are concerned, simplicity is a hugely important factor in the success of any capital markets initiative.)
8. The proposal set out in the issues paper assumes that PDPs and DRPs are commercially the same, and therefore should have the same tax treatment. There are in fact commercial differences, as demonstrated above, which justify different tax treatment.

***PDPs are explicitly covered by the legislation***

9. The issues paper states that PDPs are not explicitly covered by legislation, and that their tax treatment is therefore uncertain (paragraph 2.7). However, this is not so. A PDP involves a non-taxable bonus issue, and a share buy-back in respect of the bonus shares (to the extent shareholders elect to sell their shares back to the company). The consequences of both steps are explicitly set out in the Act as it stands, and those consequences are both clear and certain. Moreover, the "bonus issue in lieu" definition does not apply under PDPs, as all shareholders receive shares; there is no ability to elect to receive either shares or money.
10. To the extent there is uncertainty concerning the treatment of PDPs, the uncertainty grew out of the perception that Inland Revenue has become increasingly prone to seek to overturn, either through legislative amendment, or pursuant to section BG 1 of the Act, any arrangement (however commercially orthodox) that involves some apparent tax advantage. (The proposals in respect of stapled stock<sup>1</sup> are a recent example.) No uncertainty arises as a result of the existing state of the law regarding the tax consequences of PDPs.

**Officials' concerns regarding the existing law**

***Loss of tax revenue***

11. The issues paper reveals a specific concern that some investors could enjoy tax advantages under PDPs relative to investors in DRPs (paragraph 2.9). Again this concern is based on the paradigm that PDPs and DRPs are (commercially) the same arrangement, and so should have identical tax consequences. This paradigm is not appropriate, for the reasons set out above. Aside from this, the tax advantage seen to be of concern is limited to those investors with marginal tax rates above the company

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<sup>1</sup> (Government counters stapled stock revenue loss, Government media release, 25 February 2008)

tax rate (ie certain natural persons and trustees). Yet, as a tax policy matter, it is accepted that natural person taxpayers on the 38% marginal tax rate may reduce that tax rate on investments, by investing:

- (a) through a trust, reducing the tax rate on dividends received to 33%; or
  - (b) through a PIE, reducing the tax rate on dividends received to 30%;
  - (c) through a company, which temporarily reduces the tax rate on dividends received to 30%. For a company owned by a trust, an additional 3% tax would apply on distribution.
12. Given those possibilities, it is difficult to accept that there is any “norm” that dividend income denied by New Zealand residents should be taxed at the highest applicable marginal rate for individuals. Moreover, medium term Government policy is to move towards a rate structure that eliminates differential rates as between companies, trusts and the top rate for individuals. Those factors suggest that relatively little weight should be placed on the concern about shareholders on higher rates than the company rate avoiding the tax effect of the tax rate differential through use of PDPs.

### ***Imputation concerns***

13. Paragraph 2.10 of the issues paper refers to the principles underlying the imputation system. The issues paper does not identify any particular inconsistency between those principles and the use of PDPs, but the implication is that PDPs may result in higher tax rate or non-resident shareholders not having the appropriate share of the company’s income imputed to them, and/or in gains untaxed at company level not being taxed at shareholder level.
14. The concern in respect of higher tax rate shareholders is the same as that discussed above and the comments discussed above apply. Furthermore, the traditional definition of “imputation streaming” is not appropriate in this context. As embodied in legislation, imputation credit streaming involves arrangements whereby shareholders who can use credits receive a greater share of the credits than taxpayers who cannot. The Government’s primary concern with a PDP appears to be that taxpayers on higher marginal rates do not receive dividends. However such taxpayers can use imputation credits. The issue would be better described as “dividend streaming” rather than “imputation streaming”.
15. The concern in respect of non-resident shareholders, and in respect of gains untaxed at company level, can only arise in respect of dividends which cannot be fully imputed. It is undesirable that companies that could fully impute a cash dividend to all shareholders should be effectively denied the use of PDPs on the basis of concerns that do not apply to them. Given the non-tax advantages of PDPs (especially in current economic circumstances) it should be incumbent on officials to at least consider more targeted measures.

### **Definitional issues**

16. The proposed amendments to the definition of “bonus issue in lieu” attempt to make two different types of transaction into a single concept. Providing money “in lieu of” something and providing money “in exchange for” something are different

transactions, yet the proposed definition treats them as equivalent. The consequence is that, under a PDP, the bonus issue would become the taxing event, whereas it is the cash distribution that should be the taxing event.

17. The bonus issue under a PDP is made pro-rata to all shareholders, and is in effect a mere share split. The subsequent buy-back is a separate transaction, albeit that under a PDP it is part of the same arrangement. If the Government decides to proceed with a proposal to tax all shareholders under a PDP as if they had received a cash dividend, there should be a separate definition to achieve that. In effect, the new rule would be that where a company makes a pro-rata buy-back offer in respect of bonus shares issued under a PDP, shareholders who do not take up the offer should be taxed as if they had.

If you have any queries regarding this submission please contact Diana Brown, Committee Secretary, phone 04 463 2967 or email [diana.brown@lawsociety.org.nz](mailto:diana.brown@lawsociety.org.nz).

Yours sincerely

A handwritten signature in black ink, appearing to be 'Casey Plunket', written in a cursive style.

Casey Plunket  
**Co-Convenor, Taxation Committee**