Corporate Taxpayers Group

c/- Alex Mitchell | Deloitte | PO Box 1990 | Wellington | +64 (0)4 470 3778

4 October 2012

Australian & New Zealand Productivity Commissions
Strengthening Economic Relations between Australia and New Zealand

BY EMAIL

Dear Sir / Madam

**STRENGTHENING ECONOMIC RELATIONS BETWEEN AUSTRALIA AND NEW ZEALAND**

We refer to the draft report on *"Strengthening economic relations between Australia and New Zealand"* ("the draft report"), prepared jointly by the Productivity Commissions of New Zealand and Australia.

The draft report comments in detail on mutual recognition of imputation credits, but does not reach a firm view on whether mutual recognition should be progressed.

The Group acknowledges that there are a number of complexities involved in moving to mutual recognition, and these are highlighted in the draft report. However, as a recent report from the New Zealand Institute of Economic Research and Sydney's Centre for International Economics found, mutual recognition would result in considerable benefit to trans-Tasman GDP.

The Group continues to support mutual recognition of imputation credits being progressed. The Group emphasises that it is important that a final view on mutual recognition is reached as a result of this joint study, in order to provide certainty to taxpayers. As the report itself acknowledges, mutual recognition has been on the agenda for more than 20 years without resolution. Whilst accepting the issues are complex, given the length of time over which this issue has been considered, the Group believes that it is preferable that a resolution is reached in order to bring finality to the issue.

The Group also notes that mutual recognition is the only tax issue that the draft report comments on. Whilst acknowledging the importance of mutual recognition and the sizeable barrier that the resulting double taxation creates, the Group notes that there are a number of opportunities for tax reform outside of mutual recognition that would further integrate the Australian and New Zealand economies. The Group's original submission raised the following areas as examples where the tax system, if reformed, would support further economic integration and strengthen economic relations between Australia and New Zealand:

- Tax base integration (barriers to capital flows); and
- Non-resident employee issues

These issues are real areas of concern to Corporate New Zealand. The Group has raised these particular issues because we believe they provide an opportunity for positive tax reform that would benefit both economies.

We re-attach our submission dated 31 May 2012, which provides an explanation of both the above issues. We urge you to consider this submission in the context of your final report.

The Group would be happy to meet and discuss these issues further with you, and explain further the reasoning behind raising these particular issues.

For your information, the members of the Corporate Taxpayers Group are:

1. Air New Zealand Limited
2. Airways Corporation of New Zealand
3. AMP Life Limited
4. ANZ National Bank Limited
5. ASB Bank Limited
6. Bank of New Zealand
7. Contact Energy Limited
8. Downer New Zealand Limited
9. Fisher & Paykel Healthcare Limited
10. Fletcher Building Limited
11. Fonterra Cooperative Group Limited
12. General Electric
13. IAG New Zealand Limited
14. Infratil Limited
15. KiwiRail Limited
16. Lion Nathan Limited
17. Meridian Energy
18. New Zealand Post Limited
19. Opus International Consultants Limited
20. Origin Energy New Zealand Limited
21. Powerco Limited
22. Rio Tinto Alcan (New Zealand) Limited
23. Shell (Petroleum Mining) Company Limited
24. SKYCITY Entertainment Group Limited
25. Sky Network Television Limited
26. Solid Energy New Zealand Limited
27. Telecom New Zealand Limited
28. Telstra Clear Limited
29. The Todd Corporation Limited
30. TOWER Limited
31. Turners and Growers Limited
32. Vodafone New Zealand Limited
33. Westpac New Zealand Limited
34. ZESPRI International Limited

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

Yours sincerely

**John Payne**
**For the Corporate Taxpayers Group**

Corporate Taxpayers Group

c/- Alex Mitchell I Deloitte I PO Box 1990 I Wellington I +64 (0)4 470 3778

CTG

31 May 2012

Australian & New Zealand Productivity Commissions
Strengthening Economic Relations between Australia and New Zealand

BY EMAIL

Dear Sir / Madam

## STRENGTHENING ECONOMIC RELATIONS BETWEEN AUSTRALIA AND NEW ZEALAND

The Corporate Taxpayers Group ("the Group") is writing to comment on the issues paper *"Strengthening economic relations between Australia and New Zealand"* ("the issues paper").

By way of background, the Group is an organisation of major New Zealand companies that works with key Inland Revenue and Treasury officials to achieve positive changes to tax policy in New Zealand. A number of Group members have a business presence in Australia, and around one third of members' parent companies are Australian resident taxpayers.

For your information we have attached to this submission a document providing further background details about the Group.

## EXECUTIVE SUMMARY

The Group welcomes the release of the issues paper and supports the prospect of greater integration between Australia and New Zealand. The Group's submission is focused on the following three questions raised in the issues paper:

- What would be the costs and benefits of mutual recognition of imputation credits?

- What other policy-related barriers are there to trans-Tasman capital flows? What should be done about them?

- What policy-related barriers are there to trans-Tasman labour mobility and the movement of people more generally? Are there valid reasons for these barriers remaining in place?

The Group's submission is accordingly divided into the following three appendices providing detailed submission points in respect of these three questions:

- Appendix One – Mutual recognition of imputation credits
- Appendix Two – Other policy barriers to capital flows
- Appendix Three – Barriers to labour mobility

We also attach our previous submission to the New Zealand imputation review in 2008 and details about the Group.

**Contact the CTG:**
c/o Alex Mitchell, Deloitte
PO Box 1990
Wellington 6140, New Zealand

**We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.**

For your convenience, the key submissions points are summarised below.

### Mutual recognition of imputation credits

The Group has been an active supporter of mutual recognition of imputation credits and franking credits between New Zealand and Australia for a number of years. The Group sees mutual recognition as being a logical step in enhancing Closer Economic Relations between Australia and New Zealand, and working towards a Single Economic Market.

The Group's submission summarises the benefits of mutual recognition, and highlights some potential issues that will require consideration.

The Group's submission also stresses the need to progress towards mutual recognition within a reasonable timeframe. The Group does not want to see either government committing material resources (at the expense of other policy options) in the absence of a credible commitment from both the Australian and New Zealand governments that they support mutual recognition and will advance it within a defined timeframe.

### Other barriers to capital flows

The Group considers that 'integration' of the tax position of the investor is a key issue with the New Zealand tax system and that imputation is one of the delivery mechanisms through which this can be currently achieved in many, but not in all, instances. Without proper integration, double taxation can result which broadly either results in behaviours to minimise that double taxation or if such cannot be legally achieved increases the hurdle (and required return) on investment.

Tax base integration is not currently able to be achieved in all instances, particularly where non-resident (for example Australian) corporates seek to invest in New Zealand. This can have a number of commercial implications, including for Australian businesses seeking to invest in New Zealand. The key issues we wish to highlight are that:

- The current tax rules in New Zealand may cause a misalignment between what an Australian business wants to achieve from a commercial perspective by investing in New Zealand, and what the tax rules incentivise that business to do;

- Ultimately the inability to integrate tax bases can result in behaviour which not only reduces the total New Zealand tax paid, but which can also have other negative economic consequences to New Zealand;

- The above can mean that local and trans-Tasman investment do not easily co-habitat, with consequential impacts on capital flows.

The Group's preferred solution to mitigate the above concern is to allow imputation credits to be refunded in certain situations.

### Non-resident employee issues

Another significant barrier to Australian and New Zealand corporates engaging in business with each other are the tax implications for them arising from the presence of their employees in the other jurisdiction. In particular, the risk that, for example, an Australian corporate providing services in New Zealand will be deemed to have a permanent establishment in New Zealand, and as such be required to file New Zealand income tax returns

The theme of this submission is to highlight that New Zealand does not have "special" tax rules for the movement of labour between New Zealand and Australia as regards general business activity. In this respect, our Double Tax Agreement with Australia is much the same as (for example) our Double Tax Agreement with Canada and the United States.

If New Zealand and Australia are to have a special economic relationship governed by CER, and are moving toward a Single Economic Market, then a review of the taxation of labour moving between our two countries, and when a "permanent establishment" exists should be undertaken.

For your information, the members of the Corporate Taxpayers Group are:

1. Air New Zealand Limited
2. Airways Corporation of New Zealand
3. AMP Life Limited
4. ANZ National Bank Limited
5. ASB Bank Limited
6. Bank of New Zealand
7. Contact Energy Limited
8. Fisher & Paykel Healthcare Limited
9. Fletcher Building Limited
10. Fonterra Cooperative Group Limited
11. General Electric
12. IAG New Zealand Limited
13. Infratil Limited
14. KiwiRail Limited
15. Lion Nathan Limited
16. New Zealand Post Limited
17. Opus International Consultants Limited
18. Origin Energy New Zealand Limited
19. Powerco Limited
20. Rio Tinto Alcan (New Zealand) Limited
21. Shell (Petroleum Mining) Company Limited
22. SKYCITY Entertainment Group Limited
23. Sky Network Television Limited
24. Solid Energy New Zealand Limited
25. Telecom New Zealand Limited
26. Telstra Clear Limited
27. The Todd Corporation Limited
28. TOWER Limited
29. Turners and Growers Limited
30. Vodafone New Zealand Limited
31. Westpac New Zealand Limited
32. ZESPRI International Limited

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

Yours sincerely

**John Payne**
**For the Corporate Taxpayers Group**

## APPENDIX ONE – MUTUAL RECOGNITION

### Issues paper comments

*Mutual recognition of imputation credits has been a key taxation issue between the two countries. Currently, imputation credits in Australia and New Zealand are available only for domestic company tax not foreign taxes, potentially creating a bias against offshore investment. The Henry Review found that mutual recognition of imputation credits would have the potential to improve the allocation of investments between the two countries and reduce barriers to competition between Australian and New Zealand companies. It could also reduce incentives for firms to engage in profit sharing between Australia and New Zealand. This would probably be to New Zealand's net benefit (Commonwealth of Australia 2009). However, mutual recognition of imputation credits would have fiscal and initial distributional implications, particularly for Australia.*

***Question 28***

*What would be the costs and benefits of mutual recognition of imputation credits?*

### 1. Introductory comments

1.1. The Group has been an active supporter of mutual recognition of imputation credits and franking credits between New Zealand and Australia for a number of years. The Group sees mutual recognition as being the next logical step in enhancing Closer Economic Relations between Australia and New Zealand, and working towards a Single Economic Market.

1.2. The Group submitted to the Australia's Future Tax System Review in 2008 in favour of mutual recognition, and has been supportive of the efforts of the New Zealand government in continuing to raise the importance of mutual recognition with successive Australian governments.

1.3. Whilst there are a considerable amount of issues to be resolved before mutual recognition could be implemented, the Group believes that there is a net benefit to mutual recognition.

1.4. In this submission we have focused on the benefits and potential issues with mutual recognition, and provided comment on the importance of providing businesses with certainty by making a decision on whether reform is to progress, and in what timeframe.

### 2. The benefits of mutual recognition

2.1. Mutual recognition will result in tax efficiency when New Zealanders and Australians (corporates and individuals) seek investment opportunities in each other's companies. This is clearly a major benefit to the corporates of both countries as it provides a larger market place in which to undertake investment and to seek growth opportunities.

2.2. For example, mutual recognition would allow Australian and New Zealand corporates to take significant shareholdings (less than 100%) in each other without effectively reducing their ability to generate credits for shareholders.

2.3. Corporates in both countries will be able to seek the best investment opportunities considering the pre-tax returns. Mutual recognition will increase cross-border investment flows as it will allow both Australian and New Zealand corporates greater investment opportunities as well as allowing corporates to seek equity capital from investors on either side of the Tasman in a tax efficient manner.

2.4. The Group expects that, as a consequence of the above, mutual recognition would ultimately lead to more efficient capital markets in both Australia and New Zealand.

2.5. Mutual recognition would also reduce the tax bias for corporates in either country to shift residency, as their business operations expand in that other country. For example, from a New Zealand perspective there may be less of an incentive for New Zealand businesses expanding in Australia to also move their corporate head office and vice-versa.

2.6. A further benefit to mutual recognition is that Australian investors will not be as incentivised to take 100% ownership of New Zealand companies. Currently there is a tax bias for Australian investors to take 100% ownership of New Zealand corporates so that they can achieve tax efficiency. We have provided further comment on this issue in Appendix Two.

2.7. For completeness, the Group records its support for the comments made in the New Zealand Inland Revenue and Treasury submission to the Australia's Future Tax System Review in 2008. That comprehensive submission should, in the Group's view, be considered in detail by the Commissions for the purposes of this Joint Project.

2.8. While the Group's submission does not examine the question of mutual recognition in the same detail as the Inland Revenue-Treasury submission, the Group is in full agreement with the advantages of mutual recognition set out in that submission, being the following:

- Greater bilateral efficiency of investment;
- Greater product market efficiency;
- More flexible trans-Tasman investment by SMEs;
- Logical step in the CER relationship and Single Economic Market agenda;
- Remove artificial bias from profit streaming;
- More stable tax system

## 3. Potential issues to be considered

3.1. While the Group does not have any direct concerns with mutual recognition as a standalone regime, the Group would be extremely concerned if any fiscal costs arising as a result of mutual recognition were countered by the addition of new or increased taxes, or more restrictive tax rules for businesses.

3.2. To this end, it is critical that economic modelling is undertaken to provide certainty as to the fiscal costs (if any) associated with mutual recognition.

3.3. The Group is also conscious that there will be a number of issues to resolve at both a macro and micro level.

3.4. For example, the Group would expect that for mutual recognition to work in practice there would need to be greater alignment of the continuity regimes in both countries (for example relaxed shareholder continuity tests).

3.5. A further example of a macro issue that will need to be considered is the appropriate taxation of Australian and New Zealand superannuation funds investing on either side of the Tasman. This issue is particularly important to resolve given the divergence of current treatments, the disincentives that would exist if treatments continued to be different, and the possible reluctance of each government to refund imputation credits to superannuation funds in the other jurisdiction.

3.6. The Group would be concerned if issues associated with the refundability of franking/imputation credits to superannuation schemes are not addressed, as it is important that mutual recognition does provide a benefit to such schemes vis-à-vis the status quo, in order that a key benefit of mutual recognition (bilateral efficiency of investment) is realised.

.

## 4. Timeframe for mutual recognition

4.1. A significant period of time has passed since mutual recognition was first floated, and while many papers have been written and many discussions have occurred, mutual recognition does not appear any closer. From a New Zealand perspective, mutual recognition was raised as far back as 1991, in the government discussion document, "*Taxing Income Across International Borders*". That discussion document noted that:

> *"New Zealand will be exploring the possibility of mutual recognition of imputation credits in forthcoming bilateral discussions"*

4.2. The Group stresses the need to progress towards mutual recognition within a reasonable timeframe, given the significant period of time that has already elapsed. The Group does not want to see either government committing material resources (at the expense of other policy options) in the absence of a credible commitment from the Australian government that it supports mutual recognition and will advance it within a defined timeframe.

4.3. Therefore, the Group strongly submits that the Commissions encourage the Australian government to provide a public signal as to its views on mutual recognition, and if it is supportive, an estimated timeframe under which both countries can work towards implementation. This would provide corporates with much needed certainty on the future direction of reform.

## APPENDIX TWO – OTHER BARRIERS TO CAPITAL FLOWS

***Question 29***

*What other policy-related barriers are there to trans-Tasman capital flows? What should be done about them?*

### 1. Introductory comments

1.1. The Group considers that 'integration' is a key issue with the New Zealand tax system and that imputation is one of the delivery mechanisms through which this can be currently achieved in many, but not in all instances.

1.2. Tax base integration is not currently able to be achieved, particularly where non-resident (for example Australian) corporates seek to invest in New Zealand. This can have a number of commercial implications.

1.3. The Group believes that this issue is very relevant to the Joint Project, as it is a clear case of the current tax rules distorting investment behaviour. The key issues we wish to highlight are that:

- The current tax rules in New Zealand may cause a misalignment between what an Australian business wants to achieve from a commercial perspective by investing in New Zealand, and what the tax rules incentivise that business to do;

- Ultimately the inability to integrate tax bases can result in behaviour which not only reduces the total New Zealand tax paid, but which can also have other negative economic consequences to New Zealand.

1.4. To expand, currently an Australian investor into New Zealand is incentivised from a tax perspective to take 100% ownership of the New Zealand business so that integration can be achieved. As a result they are incentivised to "crowd out" local minority investment. As a consequence of that ownership position, they can introduce considerably more debt within the New Zealand business than what would otherwise be the case (if there were minority shareholders) so as to result in less New Zealand tax paid. Further negative consequences to the New Zealand economy include a smaller pool of New Zealand businesses available for New Zealanders to invest in and a greater likelihood that head office economic activity will gravitate out of New Zealand.

1.5. Clearly from a tax policy perspective however, a tax system should be neutral as to whether such investors acquire (say) a direct investment of 50% with the remaining investment held by portfolio interests or a direct investment of 100%.

1.6. There are various ways to reduce the bias for 100% foreign ownership, however for the purposes of this submission the Group is only raising its preferred solution, being to allow controlling shareholders to appropriately debt fund holding companies and obtain a partial refund of imputation credits distributed to them (i.e. ensure they only pay tax to the extent they have net income after the interest costs are deducted, excess imputation credits would then be refunded).

1.7. The Group believes that the net effect of reform in this area would be to remove the tax pressures incentivising controlling Australian shareholders to take 100% ownership of the New Zealand target company. It would also reduce the barriers for existing 100% Australian owned business to introduce a level of local investment (e.g. partial floats).

1.8. The Group has briefly outlined its proposed solution below. Rather than providing a full explanation of our concerns and suggested solutions in this submission, we have attached our submission to the Imputation Review in 2008. This contains a greater analysis of the issue and how it could be resolved. We would of course be more than happy to meet with you and work through the issue if any aspect remains unclear.

## 2. Refundability of imputation credits

2.1. The Group's preferred solution to the concern articulated above is to allow imputation credits to be refunded to New Zealand corporates with tax losses as long as the corporate shareholder owns at least 50% of the company.

2.2. The Group's view is that such refunds should be targeted to only New Zealand resident cornerstone shareholders (e.g. a New Zealand holding company) in companies where there is at least 50% investment in the underlying company. This suggestion is akin to allowing group loss offsets at that level rather than the existing 66% commonality threshold.

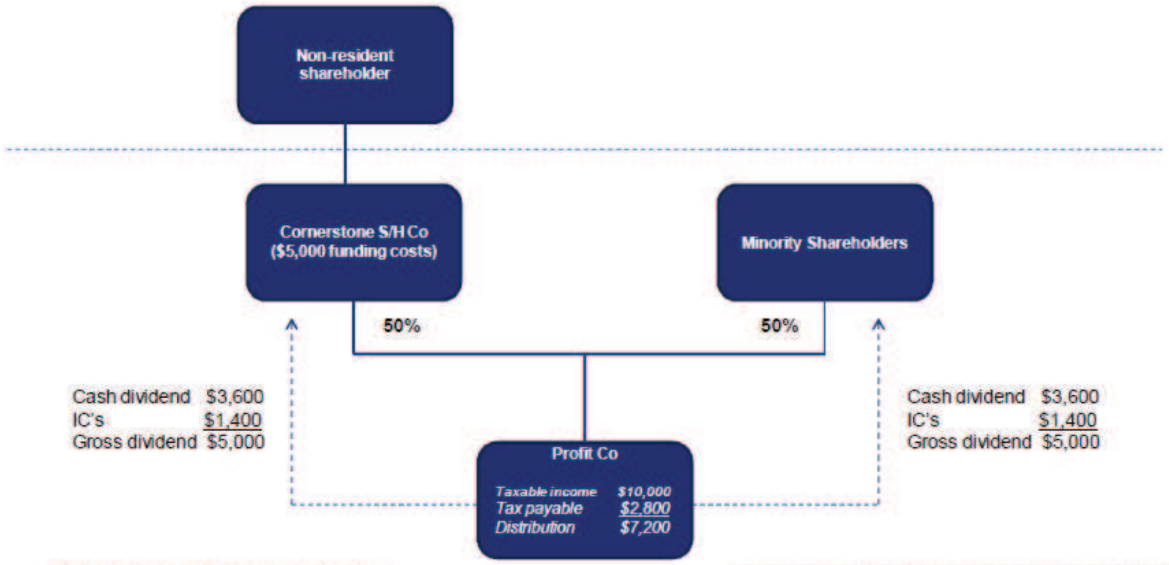
2.3. The following example the tax position that results in the absence of the integration of tax bases:

- Cornerstone Shareholder Co at least partially funds the purchase of the 50% stake in Profit Co with debt.

- Cornerstone Shareholder Co is unable to push that debt into Profit Co without the agreement of the minority shareholders (unlikely to be obtained).

- Cornerstone Shareholder Co is unable to undertake a loss offset with Profit Co due to the 66% commonality threshold for loss offsets

- Cornerstone Shareholder Co receives gross returns from Profit Co which includes imputation credits, and results in Cornerstone Shareholder being in a cash deficit position with tax losses to carry forward. Cornerstone Shareholder Co has limited or no use of the imputation credits.


Non-resident shareholder
Cornerstone S/H Co ($5,000 funding costs)
Minority Shareholders
50%
50%
Cash dividend $3,600
IC's $1,400
Gross dividend $5,000
Cash dividend $3,600
IC's $1,400
Gross dividend $5,000
Profit Co
Taxable income $10,000
Tax payable $2,800
Distribution $7,200

| Cornerstone shareholder tax position | |
|---|---|
| Interest deductions | ($5,000) |
| Gross income | $5,000 |
| Losses to carry forward | $0 |
| Surplus IC's | ($1,400) |
| IC's to carry forward as loss | ($5,000) |
| Cash deficit | ($1,400) |

| Cornerstone shareholder tax position – integrated tax base | |
|---|---|
| Interest deductions | ($5,000) |
| Gross income | $5,000 |
| Taxable income | $0 |
| Tax payable | $0 |

2.4. The Group's proposal is a targeted response to the current bias, and would allow cornerstone shareholders and minority shareholders to co-exist. This would provide the following benefits:

- Remove any potential conflict for the non-resident investor between a commercial desire to only invest up to a 50% shareholding and a tax incentive to acquire 100%.
- Reduced pressure on the operating company to cut spending and jobs in order to increase returns due to the need for higher returns by non-resident shareholders because of tax inefficiency
- Reduced pressure for the operating company to take on additional debt in order to make returns to (all) shareholders via capital reductions.
- The retention of head offices in New Zealand, which includes the benefit of associated spending, employment opportunities, and a greater level of New Zealand identity.
- Providing New Zealand investors with a greater range of investment options. Non-residents may seek to partially list New Zealand operations which are currently 100% owned.

2.5. The Group does not believe that the fiscal costs of this proposal would be significant given the limitation to cornerstone investors holding at least 50%.

2.6. Under a dynamic model, the Group believes that over the longer term the proposed reform would in fact be fiscally positive due to the retention of New Zealand resident investors and the introduction of less debt into New Zealand.

## APPENDIX THREE – NON-RESIDENT EMPLOYEE ISSUES

**Issues paper comments**

The issues paper notes at the outset that submissions may be focused on experiences of doing business across the Tasman, and may address the following questions:

- *What have you found to be the major barriers to doing business across the Tasman?*
- *How have these barriers affected your organisation?*
- *What should governments do to reduce or eliminate these barriers?*

The issues paper also includes a discussion on labour movements between Australian and New Zealand citizens, and poses the following question:

- What policy-related barriers are there to trans-Tasman labour mobility and the movement of people more generally? Are there valid reasons for these barriers remaining in place?

### 1. Introductory comments

1.1. A significant barrier to Australian and New Zealand corporates engaging in business with each other are the tax implications for them arising from the presence of their employees in the other jurisdiction. In particular, the risk that, for example, an Australian corporate providing services in New Zealand will be deemed to have a permanent establishment ("PE") in New Zealand, and as such be required to file New Zealand income tax returns.

1.2. In addition, the Group cannot emphasise enough the tax-related compliance costs associated with the movement of labour between Australia and New Zealand. For example, taxpayers must:

- Track the days of non-resident presence in New Zealand.
- Ensure that non-resident contractors tax ("NRCT") and pay as you earn ("PAYE") obligations are met.
- Keep abreast of DTA changes.
- Monitor PE risk (being a fixed place of business through which the business of the enterprise is wholly or partly carried on).

1.3. The extent to which non-residents engage in activities in New Zealand on behalf of New Zealand taxpayers is such that the Group's members are well-versed in the operational and practical complexities that arise as a result of the presence of non-residents, and the associated compliance costs.

1.4. More and more, members are experiencing frustration with the application of the rules that govern the tax implications of non-residents (predominantly from Australia) performing services in New Zealand. This is simply due to the time and resources spent ensuring that the rules are adhered to, and dealing with the implications when they are not; e.g. when brightlines are exceeded.

1.5. The theme of this submission is to highlight that New Zealand does not currently have "special" tax rules for the movement of labour between New Zealand and Australia in the general business context. Our Double Tax Agreement ("DTA") with Australia is much the same as (for example) our DTA with Canada and the United States.

1.6. If New Zealand and Australia are to have a special economic relationship governed by CER, and are a moving toward a Single Economic Market, then a review of the taxation of labour moving between our two countries, and when a PE exists should be undertaken.

## 2. Double Tax Agreements

2.1. As noted above, the Group is supportive of having unique tax rules to allow greater movement of labour between New Zealand and Australia without unnecessary tax and compliance cost implications.

2.2. New Zealand's and Australia's DTAs are largely based on the Organisation for Economic Cooperation and Development ("OECD") model convention. The OECD model convention is used as a worldwide base framework for all DTAs, with specific rules governing the jurisdiction in which tax liabilities arise (to prevent double taxation) and allowing concessionary rates of withholding taxes on interest, dividends and royalties.

2.3. Like other DTAs, the New Zealand-Australia DTA specifies that a PE means "a fixed place of business through which the business of the enterprise is carried on", and lists some specific "inclusions", for example an office.

2.4. A PE is also deemed to arise when an employee of a corporate resident in the other jurisdiction is present and performing services for more than 183 days in any 12 month period. For example, if a New Zealand business contracts an Australian business to provide services in New Zealand (such as building IT infrastructure) and the employees of the Australian business perform those services in New Zealand for more than 183 days in a 12 month period, the Australian firm is deemed to have a PE in New Zealand.

2.5. When a PE exists, the business with the PE must register as a taxpayer in the other jurisdiction and will incur the associated tax compliance obligations.

2.6. The Group does not believe it is appropriate that the same tax compliance obligations should arise for an Australian firm providing services in New Zealand (or a New Zealand firm providing services in Australia), as a firm resident in another country providing the same services.

2.7. The Group is of the view that it may be time to consider whether the status quo is appropriate, and whether the Australia-New Zealand relationship is deserving of more lenient tax rules, particularly given the recent signing of the CER Investment Protocol, which aims to:

- Strengthen further the economic relationship between New Zealand and Australia to work towards the development of a trans-Tasman Single Economic Market;
- Liberalise barriers to investment between New Zealand and Australia;
- Encourage and promote investment between New Zealand and Australia; and
- Establish a framework of transparent rules conducive to increased investment between New Zealand and Australia to ensure the protection and security of covered investments within each Party's territory.

2.8. CER underpins substantial flows of merchandise trade, services, investment, labour and visitors between Australia and New Zealand, but does not provide taxation relief.

2.9. The CER Investment Protocol does not apply to taxation measures (Article 21), however the Group suggests that further liberalising the existing tax arrangements between Australia and New Zealand would help to achieve the other objectives of the CER Investment Protocol and the wider CER relationship and improve the flow of capital and labour between Australia and New Zealand.

2.10. We have outlined below a specific example of where the current tax treatment gives rise to an objectively inappropriate outcome in the Australia-New Zealand context, in order to help illustrate the extent of this issue.

## 3. A specific example - tax driving inefficient commercial behaviour

3.1. The Australia-New Zealand DTA allows Australian employees to travel to New Zealand and provide services on behalf of their employer for 183 days in a 12 month period, without the income they receive from this employment being taxable in New Zealand. This applies equally to New Zealand employees providing services in Australia.

3.2. If the employee remains in the other jurisdiction for more than 183 days, then their salary becomes taxable in the jurisdiction in which they are providing services.

3.3. However where (using the example of an Australian business providing services in New Zealand) an Australian business has a PE in New Zealand, and deducts the remuneration it pays its employee providing those services in New Zealand, the DTA concession does not apply. Where the DTA does not apply, the domestic rules in the Income Tax Act determine the treatment. In this case, the threshold reduces to 92 days, after which employment taxes are payable in New Zealand.

3.4. The effect of this rule is that the Australian employee in the above example must be restricted to being in New Zealand for 92 days or fewer, in order that the amount of remuneration derived is not deemed to be income for New Zealand tax purposes.

3.5. As noted above, given the close relationships between businesses in Australia and New Zealand, it is very easy for a PE to potentially arise. Two issues therefore arise from this:

- Managing staff in and out of New Zealand to ensure they fall within the 92 day exemption (refer section CW 19 of the Income Tax Act);

- Where the employee is present for more than 92 days, complying with the PAYE rules and ensuring the employee has a New Zealand IRD number

3.6. Clearly this can drive inefficient commercial behaviour, as there is a strong incentive to send a particular employee back to Australia on day 90, and replace them with another individual from Australia who does not have the previous 90 days worth of experience. The domestic threshold for Australian employees should be at least 183 days, to ensure that this inefficiency is minimised.

3.7. For completeness we note that the above incentive is exacerbated due to the application of New Zealand's use of money interest regime. Where a non-resident employee inadvertently breaches the 92 or 183 day rule (as described above) the obligation for New Zealand tax arises on day one of the non-resident's time in New Zealand. This gives rise to a use of money interest exposure (i.e. interest payable on unpaid tax), as well as the potential for penalties.

3.8. This is particularly onerous, as even where it is expected that a non-resident will be present in New Zealand for 92 or fewer days, unexpected situations can arise which delay the non-resident leaving New Zealand. At a minimum the Group suggests that in these situations use of money interest / penalties should not be applied where the taxpayer had a reasonable belief at the outset that the 92 or 183 day rules would not be exceeded.

3.9. This same issue applies in the secondment situation. There is a 90 day secondment provision in Article 14(4) of the NZ-Australia DTA. However where a secondment is expected to be less than 90 days but is subsequently extended to more than 90 days, there is a PAYE liability from day one.

# Corporate Taxpayers Group

## What is the Corporate Taxpayers Group?

The Corporate Taxpayers Group is an organisation of major New Zealand companies that works with key Inland Revenue and Treasury officials to achieve positive changes to tax policy in New Zealand.

The Group is forward-looking and proactively raises issues with both policy and operational staff at Inland Revenue to foster a co-operative and mutually beneficial relationship between large taxpayers and the Inland Revenue.

Described by the Inland Revenue as one of the three most active tax special interest groups in New Zealand, the Group regularly makes submissions on tax policy documents, tax bills and Inland Revenue interpretations.

The focus of the Group is on achieving the right corporate tax policy outcomes for New Zealand, not to push individual or industry specific agendas.

## Can I join?

The only prerequisite to joining the Group is an interest in tax! In general members of the Group have in-house tax expertise, but this is not a requirement of membership.

## What are some benefits of joining?

Current members have this to say about the benefits of the Group:

- *"Provides an opportunity for the exchange of tax intelligence amongst corporate taxpayers - a network"*
- *"Provides an opportunity to meet with officials frequently, a situation that an individual taxpayer may struggle to achieve"*
- *"To be involved in tax policy changes and developments that are beneficial to our organisation and corporates as a whole"*
- *"We find the updates and the submissions made a useful reminder and it is one of the ways we keep up with current tax issues"*
- *"[the] ability to submit on tax issues at a relatively lower cost than if submitting alone"*

## Does the Group meet?

The Group meets once a month via video conference to discuss new developments and issues in the taxation field. In addition, subgroups of interested members also meet with tax officials on particular areas of tax throughout the year.

Key officials, as well as the Minister of Revenue, are regularly invited to attend Group meetings to discuss policy developments and important issues to the Group.

If you are interested in learning more about the Group, or would like to consider joining please contact one of us:

John Payne, Chair

Phillippa Harford, Deputy Chair

Thomas Pippos, Deloitte

Patrick McCalman, Deloitte

Robyn Walker, Deloitte

Brendan Brown, Russell McVeagh

## Members

1. Air New Zealand
2. Airways Corporation of New Zealand
3. AMP Life
4. ANZ National Bank
5. ASB Bank
6. Bank of New Zealand
7. Contact Energy
8. Fisher & Paykel Healthcare
9. Fletcher Building
10. Fonterra Cooperative Group
11. General Electric
12. IAG New Zealand
13. Infratil
14. Kiwirail
15. Lion Nathan
16. New Zealand Post
17. Opus International Consultants
18. Origin Energy New Zealand Limited
19. Powerco Limited
20. Rio Tinto Alcan (New Zealand)
21. Shell New Zealand
22. SKYCITY Entertainment Group
23. Sky Network Television
24. Solid Energy New Zealand
25. Telecom New Zealand
26. Telstra Clear
27. The Todd Corporation Limited
28. TOWER
29. Turners and Growers
30. Vodafone New Zealand
31. Westpac New Zealand
32. ZESPRI International

# More about the Corporate Taxpayers Group

The Group's members come from a diverse range of industries - from transport & telecommunications to broadcasting, banking & insurance.

The Group collectively turns over more than $40 billion each year from their New Zealand operations.

The Group collectively pays about $2 billion in income tax each year.

The Group's members have combined total assets of over $500 billion under management.

The Group collectively employs over 100,000 New Zealanders and pays their PAYE of around $1.5 billion to Inland Revenue.

The Group's activities range extensively beyond New Zealand. The Group collectively holds nearly 100 controlled foreign companies, non-portfolio FIF investments and branches.

The large majority of the Group's members are ultimately listed; some in both New Zealand and Australia.

The Group's members have a close association with Australia, with around one third of members being 100% owned by an Australian parent.

# CORPORATE TAXPAYERS GROUP

C/- Deloitte
Attn: Mike Shaw
P O Box 1990
WELLINGTON

4 November 2008

Imputation Review
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
P O Box 2198
**WELLINGTON**

Attention Robin Oliver/Anthony Merritt

Dear Robin and Anthony

**STREAMING AND REFUNDABILITY OF IMPUTATION CREDITS**

The following submission has been prepared by the Corporate Taxpayers Group (the Group) on the Government tax policy discussion document "Streaming and refundability of imputation credits" (the discussion document).

**CONTEXT TO THIS SUBMISSION**

The discussion document deliberately does not consider whether imputation should remain a part of our tax policy framework and explicitly does not invite submissions on this point. Accordingly the Group has not canvassed this issue in any detail in its submission.

While this is the case, the Group's view is that the imputation review should actually consider the long term appropriateness of retaining an imputation system and the alternative regimes available. While there is no easy solution and it is not something that the Group has formed a view on, the Group's view is that this issue would need to be widely and publicly debated as it will involve other structural policy issues outside of imputation.

While this debate needs to be had, in the short to medium term, an imputation system is the reality for New Zealand and the Group is supportive of initiatives which will address some of the shortcomings of and bias' created by the existing imputation regime, initiatives that need to be progressed in a timely fashion.

The Group also notes that certain areas of tax policy reform canvassed within the document can be subsumed within a discussion around the mutual recognition of imputation and franking credits. This topic is again explicitly stated in the discussion document to be outside the ambit of the current review.

The Group strongly believes that while the mutual recognition of imputation and franking credits may alleviate certain issues that currently exist with our imputation rules, the risk is that the mutual recognition matter does not progress on a timely basis. Accordingly, the other "solutions" canvassed in the discussion document and in this submission need to be progressed contemporaneously with any work undertaken on the mutual recognition matter so that these issues can be progressed in a timely fashion that is within New Zealand's control.

Finally, the Group has not provided any comments on the Foreign Investor Tax Credit (FITC) regime, as we understand this will be addressed in upcoming papers and or discussions. However, as with the wider imputation system, we believe the merits of the FITC regime do need to be debated going forward.

## INTRODUCTORY COMMENTS

The Group is pleased that the imputation review that has been foreshadowed over a number of years has progressed to a stage where a public discussion document has been released.

The Group considers that the further integration of tax bases (which is a key aspect of an imputation system) is one of the most important tax policy matters that needs to be progressed and resolved as part of this review. It is therefore pleasing to see integration included as one of the key objectives of the imputation review.

In terms of the key objectives for any changes to the imputation system, they are stated as:

1) Keeping the company tax system as close to a fully integrated system as possible – taxing income derived through companies at the tax rates of the shareholders who own the company at the time the income is derived.

2) Ensuring that New Zealand source-base taxation is retained.

3) Ensuring that the relevant rules do not stand in the way of legitimate business transactions.

4) Continuing to provide a "belt and braces" approach to reducing incentives for company tax to be avoided by continuing to tax domestic shareholders on their unimputed dividends.

The Group agrees that the above listed items are appropriate objectives of an imputation review. The objective set out in 4 above particularly resonates with the Group noting that this objective is equally applicable in many other policy deliberations.

The Group however considers that the above four objectives need to be supplemented with the following additional two objectives to ensure that there is a clear ultimate destination of policy reform that any tax policy changes can be evaluated against. Specifically:

5) Ensuring that New Zealand businesses can thrive in the global economy.

6) Ensuring that New Zealand is able to attract and retain capital.

## EXECUTIVE SUMMARY

The Group provides its detailed comments in the attached Appendix but in summary the Group believes:

- The integration of tax bases is a fundamental issue which needs to be fully recognised, addressed and to the extent not currently resolved, agreed to be resolved as part of this review. The inability to integrate tax bases in certain situations is creating distortions which have detrimental effects on the New Zealand economy.

- Consistent with the sentiment within the discussion document the Group does not support unlimited dividend streaming.

- The Group does however support limited forms of dividend streaming, in particular the following options:

    - Streaming of foreign income to non resident shareholders.

    - Streaming for companies listed on both the New Zealand and Australian stock exchanges.

- The Group also supports the refundability of imputation credits for certain shareholders where this is consistent with integration and consistent with New Zealand source based taxation. For example, where shareholders are individuals, charities, and cornerstone shareholders of listed companies.

- The Group believes that shareholder continuity rules should remain in place, but the continuity threshold should be reduced to 49%. Also that share sales between non residents should be disregarded for the purposes of the calculation.

- The Group does not support extending the ambit of the benchmark dividend rules nor having tax rules which target companies with different classes of shares.

- Finally, the Group considers that as part of this review Officials should consider limited rules to allow companies to distribute capital gains to shareholders tax free outside of liquidation.

For your information, the members of the Corporate Taxpayers Group are:

1. Airways Corporation of New Zealand
2. Air New Zealand Limited
3. AMP Life Limited
4. ANZ National Bank Limited
5. ASB Bank Limited
6. AXA New Zealand
7. Bank of New Zealand
8. Contact Energy Limited
9. Fisher & Paykel Healthcare Limited
10. Fletcher Building Limited
11. Fonterra Cooperative Group Limited
12. General Electric
13. The Hongkong and Shanghai Banking Corporation Limited (New Zealand branch)
14. IAG New Zealand Limited
15. Infratil Limited
16. KiwiRail Limited
17. Lion Nathan Limited
18. New Zealand Post Limited
19. Opus International Consultants Limited
20. Rio Tinto Alcan (New Zealand) Limited
21. Shell New Zealand Limited
22. SKYCITY Entertainment Group Limited
23. Sky Network Television Limited
24. Solid Energy New Zealand Limited
25. Telecom New Zealand Limited
26. Telstra Clear Limited
27. TOWER Limited
28. Turners and Growers Limited
29. Vector Limited
30. Vodafone New Zealand Limited
31. Westpac New Zealand Limited

32. ZESPRI International Limited

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the view of individual members.

Yours sincerely

**John Payne**
**For the Corporate Taxpayers Group**

## APPENDIX – DETAILED COMMENTS

| | | |
|---|---|---|
| 1. | BACKGROUND TO IMPUTATION | 5 |
| 2. | INTEGRATING TAX BASES – REFUNDING IMPUTATION CREDITS | 7 |
| | Refundability of imputation credits | 8 |
| 3. | STREAMING OF IMPUTATION CREDITS | 12 |
| | Streaming of foreign sourced income | 13 |
| | Streaming for dual listed companies | 14 |
| 4. | MUTUAL RECOGNITION OF IMPUTATION CREDITS | 15 |
| 5. | OTHER IMPUTATION ISSUES | 16 |
| | Shareholder continuity | 16 |
| | Same credit ratios | 18 |
| | Distributions of capital gains | 18 |

### 1. BACKGROUND TO IMPUTATION

1.1. The full company imputation system has been in place since the 1988/89 income year.

1.2. In the preface to the Consultative Document on Full Imputation (the Consultative Document) released in December 1987, it was stated that (emphasis added):

> "*The main theme of all 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.*
> ...
> *"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.*
> ...
> *"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.*
> ...
> *"Shareholders will focus increasingly on a company's pre-tax rather than its post-tax returns."*

1.3. Full integration of tax bases was acknowledged as an issue which was partially solved by full imputation in the Consultative Document:

> *"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.*
>
> ...
>
> *"All corporate equity income is, however, over-taxed to the extent that the company tax rate exceeds shareholders' marginal rates."*

1.4. At the time of introduction, imputation was popular worldwide, with systems running in Australia and Europe. Since then there has been widespread abandonment of imputation, with imputation regimes reported to only still be in existence in New Zealand, Australia and Sri Lanka.

1.5. A reason why imputation has become less popular is its inability to easily deal with multinational situations. Specifically the fact that imputation regimes essentially discriminate against foreign investment in favour of domestic investment.

1.6. This shortcoming of an imputation regime does however provide an insight into the ability of imputation regimes to buttress the tax base. This point was acknowledged at paragraph 1.19 of the discussion document:

> *"The imputation rules offer incentives for New Zealand-owned firms to pay tax in New Zealand because they can offer imputation credits to New Zealand shareholders. That provides some safeguards against erosion of the domestic tax base."*

1.7. The bias imputation regimes provide towards domestic investment has also been recognised in Australia, as the extracts below from the Australia's Future Tax System Review document show (emphasis added):

> *"Most foreign income earned by Australian companies is not taxed at the Australian company level. This treatment is preserved on distribution by specific conduit foreign income rules. As a result, non-resident owners of Australian companies are generally not liable to tax on foreign income. This outcome is consistent with 'capital ownership neutrality' (Box 8.6) and enhances the ability of Australian multinational companies to obtain foreign equity.*
>
> *"For resident owners, it is at the shareholder level that Australian tax is typically collected. The exemption for most foreign income derived by resident companies means the company income tax does not generally operate as a withholding tax on offshore income. Rather, resident shareholders are effectively taxed on foreign income (net of foreign taxes) when they receive the income as a dividend or realise a capital gain by selling their shares. This is because dividend imputation only credits Australian company income tax.*
>
> *"The lack of a credit for foreign tax paid can offset incentives that could otherwise exist to invest offshore in low-tax jurisdictions and defer taxation at the resident shareholder level (Chart 8.10). This approach is consistent with achieving 'national neutrality'. Dividend imputation also provides an incentive to pay Australian company income tax in preference to foreign tax and, hence, to allocate profits where possible to an Australian company especially where franking credits are valued. As discussed above, neither of these biases may be operative where non-resident investors are the marginal source of funds for an Australian company."*

1.8. The upshot of the above is that the Group recognises that in certain cases imputation regimes raise real challenges around their desirability and effectiveness within a wider economic framework. However, given that the discussion document deliberately does not consider whether imputation should remain a part of our tax policy framework and explicitly does not invite submissions on this point, the Group does not expand on these challenges in this submission.

## 2. INTEGRATING TAX BASES – REFUNDING IMPUTATION CREDITS

2.1. The Group considers that 'integration' is a key issue with the tax system and that imputation is one of the delivery mechanisms through which this can be currently achieved in many, but not in all instances.

2.2. The Group has therefore focussed its submission on the areas where integration is not currently able to be achieved and the reasons why the current rules need to be aligned to enable integration to properly occur in those wider circumstances.

2.3. A reason why the Group is focussing on this matter is that ultimately the inability to integrate tax bases can result in behaviour which not only reduces the total New Zealand tax paid, but which can also have other negative economic consequences to New Zealand.

2.4. A clear example where this is the case is that any major non resident shareholder is currently incentivised to take 100% ownership of a New Zealand business so that integration can be achieved. As a consequence of that ownership position, they can introduce considerably more debt within the New Zealand business than what would otherwise be the case so as to result in less New Zealand tax paid. Further negative consequences to the New Zealand economy include a smaller pool of New Zealand businesses available for New Zealanders to invest in and a greater likelihood that head office economic activity will gravitate out of New Zealand.

2.5. Elaborating on the above, some of the challenges in a domestic and non resident investor context include:

2.6. In the domestic context –

2.6.1. The imputation system provides an inherent disincentive to invest in equity investments for non taxpayers and a major incentive to invest in other forms of passive investment like debt instruments that provide returns in a pre tax form. The impact being a reduced level of investment capital in New Zealand.

2.7. In a non-resident portfolio investor context –

2.7.1. Non resident portfolio investors accept that income tax is payable when they invest in New Zealand companies similar to when investments are made in other jurisdictions. However, real issues arise when those non resident investors are also exposed to New Zealand tax on the income that their New Zealand investments earn from outside of New Zealand.

2.7.2. The inability to efficiently pass foreign sourced income to non resident shareholders can:

2.7.2.1. Put pressure on companies to migrate, including transferring key management and headquarter activity out of New Zealand.

2.7.2.2. Put pressure on companies to spin off and separately list international operations.

2.8. In a non-resident direct investor context –

2.8.1. In addition to the challenges that exist with portfolio investors canvassed immediately above, the current imputation rules do not allow those direct investors to effectively place any debt against their New Zealand investments.

2.8.2. As expanded in paragraph 2.4 above, such investors are incentivised by the tax system to take 100% positions in New Zealand companies at the expense of the New Zealand tax base and wider economic activity.

2.9. It is also noted that the issues faced by non resident direct investors are also faced by resident direct investors (including say resident entrepreneurs that partially debt fund interests in New Zealand corporates that they float) that don't have a sufficient other tax base through which to offset interest deductions.

2.10. Again, from a tax perspective, such direct investors have an undesirable tax preference to take 100% ownership in target companies; that is the current rules prevent cornerstone shareholders coexisting with portfolio investors. This results in listed companies being delisted and debt funding being increased (that is companies being under capitalised), and New Zealand head office activities being reduced.

***Refundability of imputation credits***

2.11. Refundability of imputation credits addresses the issues canvassed above other than those raised in paragraph 2.7 which are addressed by the limited streaming rules canvassed in section 3 below. For this reason the Group strongly supports refundability of imputation credits in the above cases.

2.12. The Group specifically believes that imputation credits should be refunded in the following situations

2.12.1. Tax exempt charities.

2.12.2. Individuals.

2.12.3. New Zealand corporates with tax losses as long as the corporate shareholder owns more than 50% of the company.

2.13. The Group is not supportive of the wholesale refunding of imputation credits to non resident shareholders unless they are covered above. That is, while the Group supports lower taxes on non residents, this should be achieved by reductions in the head line tax rate, not by any wholesale refunds of imputation credits which would effectively jeopardise source taxation.

*Tax exempt charities*

2.14. Tax exempt charities are unable to benefit from imputation credits as they are not taxed on dividends and are not entitled to a refund of the imputation credit. As such, this status quo is inconsistent with integration and therefore the Group is in support of allowing imputation credits to be refunded to tax exempt organisations. Again, if the government's policy is that charities are not taxed, then we believe that as a matter of principle they should be entitled to a refund of all imputation credits.

2.15. As is noted in the Australia's Future Tax System Review document, Australia currently permits imputation credits to be refunded to certain people (emphasis added):

> *"Where the franking credit exceeds the amount of tax they would otherwise have to pay, they can claim the offset as a refund if they are: an individual; a complying superannuation fund; a life insurance company where the dividends relate to shares held for the benefit of policy holders; or an eligible tax exempt body or deductible gift recipient, such as a charitable institution."*

2.16. The Group supports the statements in the discussion document that company tax is effectively a withholding tax for shareholders, such as at paragraph 4.8:

> *"... one of the principles underpinning the imputation ... is that shareholders should, as far as possible, be treated as if the income earned by the company were earned by them directly."*

2.17. The Group believes that to the extent imputation credits exceed the shareholders marginal tax rate a refund of the excess should be available in the same way as refundable credits as defined in section YA 1 of the Income Tax Act 2007.

2.18. This treatment is particularly justified due to the ability to achieve the same effective outcome if direct investments were not made in equities. That is, charities could choose to invest in interest returns or directly into businesses, both which do not result in any tax.

2.19. We believe that in allowing imputation credits to be refunded, it will remove the disincentive that currently exists for tax exempt entities to invest in shares. Ultimately, this should encourage investment into New Zealand listed companies and further strengthen our capital markets. The fact is charities continue to operate in an environment where their investment decisions are distorted by the unfavourable tax treatment they receive from investing in equities, when compared with investments in other types of income streams.

2.20. The refundability position is even stronger when the charity is a direct investor in a taxpayer. In the absence of refundability, the charity, like the non resident direct investor in earlier examples, is incentivised to take 100% of the investment and in this case either seek for that investment to also achieve charitable status or otherwise shelter the entirety of its profits through deductible donation payments to the charity.

2.21. The above distortions are further highlighted by the use of portfolio investment entities (PIEs) by charities. That is, charities can efficiently invest in unlisted PIEs (such as property PIEs) that recognise their tax exempt status whereas the same recognition can not be achieved by investing in listed PIEs; we believe that this distortion is unwarranted.

2.22. We note that there is the theoretical possibility that certain taxpayers could consider engaging in tax planning techniques, for example by temporarily transferring shares to tax-exempt organisations and extracting the refund to the benefit of both parties – as illustrated in Example 8 of the discussion document. We can understand that Officials might have concerns with other taxpayers looking to manipulate these rules, and support rules which carve out these potentially offensive transactions including targeted avoidance provisions.

*Individuals*

2.23. We also support individuals being able to obtain refunds on the basis that it is principled, it aligns the treatment with the approach taken in Australia and the fiscal cost is likely to be minimal. Refunding excess imputation credits to individuals is also consistent with the key objectives of the review.

*Refunds to certain companies*

2.24. Of most relevance to the Group and the area where the Group sees as the clear priority for reform is refundability to certain companies.

2.25. The Group's view is that such refunds should be targeted to only New Zealand resident cornerstone shareholders in companies where there is more than 50% commonality in shareholdings and the refundability issue is akin to allowing group loss offsets at that level in a manner that also addresses minority shareholder equity concerns.

2.26. Consider the example below (see the box below) which is a simplified structure which can and does arise when a cornerstone shareholding is taken in a company. Note, for simplicity in this example we have assumed a 50% ownership stake, albeit we propose amendments only for shareholdings which are greater than 50%.

2.26.1. Cornerstone Shareholder Co at least partially funds the purchase of the 50% stake in Profit Co with debt.

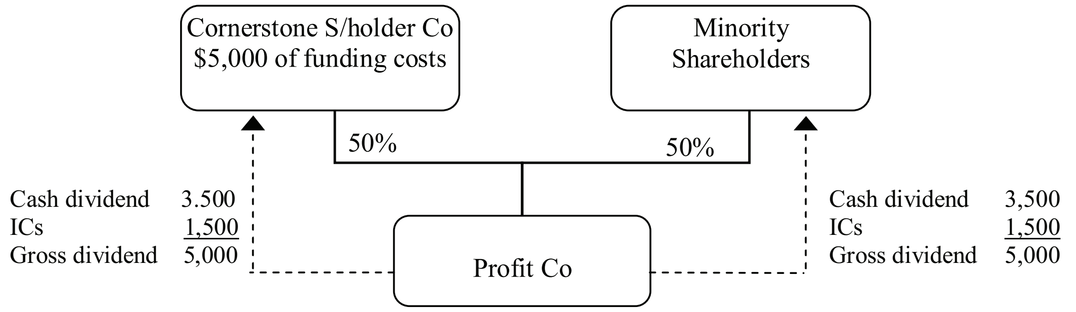
2.26.2. Cornerstone Shareholder Co is unable to push that debt into Profit Co without the agreement of the minority shareholders.

2.26.3. Cornerstone Shareholder Co is unable to undertake a loss offset with Profit Co due to the 66% commonality threshold for loss offsets.

2.27. If the tax positions of Cornerstone Shareholder Co and its 50% share in Profit Co were able to be integrated, the position would be:

| | |
|---|---|
| Income (assumed) | $5,000 |
| Deductions (assumed interest expense) | $5,000 |
| Taxable income | Nil |
| Tax payable | Nil |

2.28. Instead, on an unintegrated basis, Cornerstone Shareholder Co receives gross returns from Profit Co which includes imputation credits and results in Cornerstone Shareholder Co being in a cash deficit position with tax losses to carry forward. Cornerstone Shareholder Co has limited or no use for the imputation credits, but may seek to enter into funding arrangements, such as redeemable preference share issues, in order to obtain some level of benefit from them.



| Profit Co | |
|---|---|
| Taxable income | 10,000 |
| Tax payable@ 30% | (3,000) |
| Cash distribution available | 7,000 |

| **Cornerstone shareholder company tax position** | |
|---|---|
| Interest deductions | (5,000) |
| Income from Profit Co (Div incl. ICs) | 5,000 |
| Losses to carry forward | Nil |
| Surplus Imputation credits | (1,500) |
| ICs converted into losses to carry forward | (5,000) |
| **CASH POSITION - deficit** | **(1,500)** |

2.29. In the example above, the cornerstone shareholder has a major incentive to undertake a full takeover in order to be able to integrate the two tax bases. We believe there should be no such tax bias.

2.30. Refundability of imputation credits to the cornerstone shareholder would solve these issues.

2.31. As an alternative, a lowering of the loss offset threshold from 66% (an arbitrary threshold) to greater than 50% would also achieve the same outcome, albeit in a slightly more complicated fashion. Under this mechanism the additional matter that may need to be legislatively addressed is ensuring that the offsets can be undertaken without prejudicing minorities.

2.32. The Group submits that the proposal is consistent with the objective to maintain source-based taxation. What is proposed is not wholesale refunds of New Zealand tax to non residents, rather it is a targeted response to allow cornerstone shareholders and minority shareholders to co-exist, which includes the following benefits:

2.32.1. Reduced pressure on the operating company to cut spending and jobs in order to increase returns due to the need for higher returns by non resident shareholders because of tax inefficiency.

2.32.2. Reduced pressure for the operating company to take on additional debt in order to make returns to (all) shareholders via capital reductions.

2.32.3. The retention of head offices in New Zealand, which includes the benefit of associated spending, employment opportunities, and a greater level of New Zealand identity.

2.32.4. Providing New Zealand investors with a greater range of investment options. Non residents may seek to partially list New Zealand operations which are currently 100% owned.

2.32.5. Simplified financial reporting as for accounting purposes the cornerstone shareholder and its subsidiary are treated as integrated.

2.33. Given the proposed parameters (i.e. only for cornerstone shareholders holding greater than 50% interests), for this reform, the Group does not consider that the fiscal costs of this proposal will be great, and in fact over the long term the amendment would be fiscally positive due to more companies retaining New Zealand shareholders and thereby having reduced debt levels.

2.34. Again, in most situations, if the cornerstone shareholder is forced to buy out all minority shareholders, we suspect the additional debt funding will materially reduce the tax that will be payable; along with a reduction in the other benefits of head office activity in New Zealand and a reduction in New Zealand's capital markets.

2.35. It is also noted that the level of refundability is directly influenced to the extent that the New Zealand operating company is paying dividends which in the current market circumstances may reduce, but in any event would as a generalisation always be less that the entirety of profits made.

2.36. For completeness, the Group believes the above proposal satisfies the four key objectives outlined in the discussion document.

*2.36.1. Keeping the tax system as close to a fully integrated system as possible.*

What is proposed is a greater level of integration; therefore it is consistent with this objective.

*2.36.2. Ensuring that New Zealand source-basis taxation is retained – that is taxing non residents on the income tax is derived on their investments in New Zealand.*

Introducing a mechanism to integrate tax bases would not contravene this objective. This is particularly the case if all companies involved are ultimately majority New Zealand owned.

In the event of non resident ownership, what is proposed is simply to tax those investments on the basis of the actual net income derived by non residents from that investment, i.e. after the controlling non resident shareholder is allowed to appropriately debt fund their controlling investment. This will leave the non resident in a less favourable tax position than if they had acquired 100% of the New Zealand business which would allow them to move to the 75% debt to asset ratio if they choose and take a deduction for that interest cost irrespective of the dividend payments of the New Zealand business. But it would at least allow them to integrate their tax positions to some extent so as to considerably reduce the tax bias to acquire 100% interests in New Zealand companies.

Again, given the above, New Zealand source based taxation is retained.

2.36.3. *Ensuring the relevant rules do not stand in the way of legitimate business transactions.*

The current rules currently act as a strong deterrent for investors in a widely held company context owning less than 100% of a New Zealand business. That is, tax unduly drives taxpayers to own 100% (or at least at a minimum 66%).

In the widely held context, if forces investors to acquire 100% of the target, which means de-listing those companies and removing investment opportunities for other New Zealand investors. Undertaking our proposal would allow cornerstone shareholders to co-exist with minority shareholders and would help lead to more competitive and efficient capital markets.

2.36.4. *Continuing to provide a belts and braces approach to reducing incentives for company tax to be avoided by continuing to tax domestic shareholders on their unimputed dividends.*

What is proposed will not contravene this objective. Where insufficient tax has been paid at the operating company level distributions will remain subject to tax. Note however our comments at paragraphs 5.14 – 5.23 in respect of the ability to distribute capital gains tax free.

2.37. In summary, we submit that the tax regime should allow shareholders owning greater than 50%[1] of companies to integrate tax bases. For example:

2.37.1. Allow such shareholders to obtain a refund of excess imputation credits ; or

2.37.2. Allow loss offsets to occur with a shareholder of greater than 50% of a company (noting that in this case additional matters may also need to be addressed to deal with minority equity issues); or

2.37.3. Another mechanism to achieve tax efficiency.

## 3. STREAMING OF IMPUTATION CREDITS

3.1. The discussion document raises imputation streaming and provides a clear message that the introduction of unlimited imputation streaming is not viewed favourably.

3.2. The Group agrees that unlimited streaming would not be desirable; however options for limited streaming should be fully considered on their merits.

3.3. There are two main forms of limited streaming which are of most interest to the Group:

3.3.1. Effectively allowing foreign sourced income to be streamed to foreign shareholders and New Zealand resident income to New Zealand shareholders via the introduction of a foreign income memorandum account.

[1] The threshold can be less than 50%, however a 50% threshold also enables the thin capitalisation and transfer pricing rules to come into play to safeguard excessive interest deductions in New Zealand or excessive transfer pricing out of New Zealand when non resident investors are involved.

3.3.2. Allowing Australian owned companies which are listed on the New Zealand stock exchange to stream New Zealand sourced income to New Zealand shareholders, with imputation credits attached.

3.4. The above mentioned initiatives are targeted policy initiatives which will maintain or enhance New Zealand's capital markets and thereby the attractiveness of New Zealand as an investment destination.

*Streaming of foreign sourced income*

3.5. At paragraph 2.46 of the discussion document it is acknowledged that *"[a]t least in principle, however, a case could be made for allowing domestic income to be streamed to domestic residents and, perhaps, foreign active income to be streamed for foreign residents."* Paragraph 2.53 goes onto say that *"[t]he government would need to be convinced that the current rules were causing particularly difficult problems and that any rule change could be reasonably contained to the identified problem. It would also need to be convinced that the benefit of allowing streaming would outweigh the costs."*

3.6. It is clear that the current imputation system is problematic for New Zealand resident companies who earn income offshore and want to effectively repatriate that income back to New Zealand shareholders. That is, as New Zealand sourced income decreases as a percentage of total worldwide income, imputation credits generated will never be sufficient to distribute profits to all shareholders efficiently. This discourages New Zealand widely held companies from expanding outside New Zealand given it negatively impacts on its New Zealand based shareholders. This is particularly relevant for large New Zealand corporates which have limited opportunities to expand their New Zealand operations given their relative size in the New Zealand market.

3.7. The position is exacerbated further when the New Zealand corporate has material non resident shareholders that are taxed on this foreign income simply because it passes through New Zealand but otherwise has no connection to New Zealand.

3.8. The Group is supportive of proposals which address concerns with the ability of the tax system to retain New Zealand based multinational organisations. One member of the Group has separately submitted on this issue.

3.9. That member, with material levels of portfolio non resident shareholders, has stated that the tax rules currently introduce inefficiencies that increase their cost of capital which leaves them requiring a higher rate of return from their offshore investments.

3.10. We briefly restate below the key elements of the members proposal:

3.10.1. The rules would apply only to New Zealand resident companies that are listed on a registered stock exchange.

3.10.2. Such companies would maintain a memorandum account of foreign income to the extent such income is relieved from New Zealand tax (via the active income exemption or through foreign tax credits).

3.10.3. A credit to the memorandum account would be obtained using the following formula:

$$\frac{\text{Foreign income x New Zealand company tax rate}}{1 - \text{New Zealand company tax rate}}$$

3.10.4. Dividends paid to shareholders would all be credited to the same extent; however it would be possible to attach foreign income credits (in place of / as well as imputation credits) to dividends paid to non resident shareholders.

3.10.5. For the purposes of NRWT / FITC etc, a foreign income credit would have the same effect as if it were an imputation credit.

3.10.6. Foreign income credits would not be of value to New Zealand resident shareholders.

3.11. The Group considers the major benefit of the above proposal is that the current tax disincentive for companies seeking to expand offshore to also migrate from New Zealand is removed (at least from a tax perspective). The Group considers that any fiscal costs of allowing the above proposal would be:

- Potentially nil as such companies would still be subject to tax in New Zealand on New Zealand sourced income. That is, the fiscal cost is in relation to the New Zealand shareholders obtaining imputed returns when otherwise they may not have received imputed returns.

- Outweighed by the level of economic activity (and corresponding second order tax revenue) generated through the retention of head offices in New Zealand. The head office spend of a listed company can be significant, not the mention the benefits of retaining talented individuals in New Zealand.

*Streaming for dual listed companies*

3.12. Addressing a separate matter to those already canvassed, a substantial proportion of New Zealand's largest corporates are wholly Australian owned. It is currently tax inefficient for New Zealanders to invest in these Australian companies because they can only benefit from imputation credits to the limited extent possible via triangular tax. This is despite the companies having material New Zealand operations and pay significant amounts of New Zealand tax.

3.13. The result of the above is that New Zealand investors are discouraged from investing in such businesses.

3.14. One member of the Group is particularly supportive of this initiative and has submitted to the Government that limited streaming should be allowed where companies maintain full equity listings on stock exchanges in both New Zealand and Australia. Under this proposal, companies will only be required to attach imputation credits to dividends paid to holders of ordinary shares on the New Zealand stock exchange.

3.15. The Group sees some of the major benefits of this proposal as:

3.15.1. The expansion of the New Zealand stock exchange, providing investors greater choice of investing in equity and obtaining imputed returns.

3.15.2. Allowing Australian companies to have a greater balance of New Zealand shareholders vis-à-vis New Zealand sourced profits.

3.15.3. Encouraging of New Zealanders to own shares in companies with substantial New Zealand operations.

3.15.4. Encouraging Australian companies with significant New Zealand operations and New Zealand shareholders to be generating both New Zealand profits and paying New Zealand tax in order to allocate imputation credits.

3.15.5. Providing a practical step towards a single economic market with Australia and can potentially be viewed as a step towards mutual recognition.

3.16. From a New Zealand perspective there are a number of issues that this proposal also raises:

3.16.1. It could immediately incentivise New Zealand companies to relocate to Australia as then they could simply stream imputation credits to the New Zealand shareholders and not "waste" them on non residents while still being able to access the deeper Australian capital markets.

3.16.2. It allows New Zealand investors to invest in predominately Australian businesses and receive fully imputed returns.

## 4. MUTUAL RECOGNITION OF IMPUTATION CREDITS

4.1. Paragraphs 1.20 to 1.22 of the discussion document raise the topic of mutual recognition of franking credits and imputation credits in New Zealand and Australia. We note that the Group has already submitted on this topic in previous years and has recently written a letter to Officials expressing its views on the prospect of having mutual recognition. We reiterate the main views of the Group below.

4.2. An underlying theme in the discussion document is that while no submissions are sought on this topic, Officials would welcome the mutual recognition of imputation credits with Australia, and Officials seem reluctant to pursue any reforms which could jeopardise the potential of Australia agreeing to mutual recognition.

4.3. As has been submitted by the Group, the Group would be supportive of mutual recognition if the Australian Government also was willing to pursue this initiative and other matters such as the refundability of imputation credits by Australian superannuation funds was also addressed. Such an initiative would reduce impediments to trans-Tasman investment and increase the ability of trans-Tasman New Zealand companies to attract and retain Australian shareholders (and vice versa) and therefore significantly reducing the cost of equity funding.

4.4. However, the Group would like to reinforce that mutual recognition is only one potential solution, and there are other policy alternatives which should also be investigated as alternatives. These include:

4.4.1. Allowing limited forms of streaming of imputation credits (as canvassed above).

4.4.2. Refundability of imputation credits for cornerstone shareholders in companies (as canvassed above).

4.4.3. Reducing the NRWT rate for distributions of foreign income (as canvassed above).

4.4.4. Treating foreign tax credits as imputation credits.

4.4.5. Offering a lower rate of tax for specific industries looking to invest into New Zealand.

4.5. The Group is also conscious that whilst 50% of New Zealand's FDI comes from Australia, the rest of the world (which makes up the remaining 50%) should not be forgotten in this process. As mutual recognition is localised to Australia and New Zealand, one of the alternative solutions that could apply to all jurisdictions may be a more efficient way to encourage FDI.

4.6. The introduction of mutual recognition would be a fundamental change for both countries. Consequently there will be a number of associated issues which will need to be considered, either prior to committing to mutual recognition or before it is implemented.

4.7. Issues to resolve include:

4.7.1. The refundability of franking credits to Australian superannuation funds (as mentioned above).

4.7.2. Requirement for thin capitalisation / interest allocation rules for investment between the countries.

4.7.3. Non-resident withholding tax on dividends (presumably a nil rate will apply).

4.7.4. What will happen with the Foreign Investor Tax Credit (presumably it will remain for all other countries).

4.7.5. Alignment of tax systems, for example imputation continuity rules.

4.7.6. Allowing businesses to easily transfer between jurisdictions, for example tax rules for migration of companies.

4.7.7. Existing balances of franking credits and imputation credits – i.e. are imputation credits and franking credits earned prior to mutual recognition able to be mutually recognised in the other jurisdiction.

4.7.8. Tax avoidance considerations when investing in Australia.

## 5. OTHER IMPUTATION ISSUES

***Shareholder continuity***

5.1. The discussion document seeks comments on the practical compliance consequences or commercial constraints created by the existing shareholder continuity rules.

5.2. It is the Group's understanding that subject to some limited exceptions Australia does not have continuity rules and allows franking credits to be utilised by the current shareholders irrespective of whether or not those same shareholders owned the company when the tax was paid that give rise to the franking credits. The Group understands that this approach to continuity is buttressed by Australia's capital gains tax and the rules around exempting credits.

5.3. The Group would not support any relaxation of the continuity requirements if such a move needed to be buttressed with a capital gains tax or the introduction of exempting credit rules. That said the existing rules could be amended to be more flexible, particularly in regard to non resident shareholdings.

5.4. For most listed companies, the single notional shareholder test provides a great deal of protection against breaches in continuity in any event. However, in the event of a change in major shareholders, a breach may easily occur given the current 66% threshold.

5.5. While it is noted that companies do have the ability to undertake taxable bonus issues in order to utilise imputation credits if a continuity breach is known to be imminent, bonus issues are not optimal, particularly given:

5.5.1. The additional tax liability that arises to New Zealand resident shareholders with a marginal tax rate in excess of 30% or 33% (depending of level of imputation of the bonus issue), and the potential pressure to fund that tax liability with a corresponding cash dividend.

5.5.2. Many shareholders not necessarily understanding bonus issues and the associated tax consequences (i.e. the company generally has a compliance cost of fielding queries from shareholders).

5.5.3. The cost of issuing dividend statements to shareholders in a widely held context.

5.6. To partially deal with this issue the Group considers the continuity threshold should be reduced to 49%, particularly given this threshold is used elsewhere in the Act, including in the Foreign Investor Tax Credit rules.

5.7. As a related point, the Group submits that the notional single person test and in particular to qualifications to its application, as set out in sections YC 10, YC 14 and YC 15 of the Income Tax Act 2007, are difficult to satisfy and should therefore be amended. Specifically, the Group notes the requirement in section YC 15 for the directors to have no specific knowledge of the share transfers is too subjective and should be removed. We have copied the relevant sections below for your reference.

> *Section YC 15 Directors' knowledge of failure to meet requirements of continuity provision*
>
> *When this section applies*
>
> *(1) This section applies if -*
>
> *(a) for a company at a time, the requirements of a continuity provision would not have been met but for the application of section YC 10, YC 11, or both; and*
>
> *(b) the failure, but for that concessionary application, to meet the requirements was not due only to -*
>
> *(i) the sale of shares in a company in the ordinary course of trading on a recognised exchange between less than 10% holders:*
>
> *(ii) the cancellation of shares in a unit trust, that falls within paragraph (a), (b), or (c) of the definition of widely-held trust, held by less than 10% holders:*
>
> *(iii) the cancellation of shares in a unit trust, that falls within paragraph (a), (b), or (c) of the definition of widely-held trust, which were acquired from less than 10% holders by the manager or trustee of the unit trust in the ordinary course of their activities in relation to the unit trust; and*
>
> *(c) the directors of the company know or could reasonably be expected to know, without making enquiries specifically for the purposes of applying the continuity provisions, that the requirements of the continuity provision would not have been met but for that concessionary application.*

5.8. Alternatively, to reduce the subjectiveness of the above section, the single notional person test could be expanded to apply to all shareholders who own less than 20% of the company.

5.9. The Group also considers that when measuring continuity, the shareholdings of non residents (including supplementary dividend holding companies[2]) should be disregarded if shares are transferred from a non resident to another non resident. This is because imputation credits are generally of limited or no value to non residents and therefore are not factored in when non residents buy or sell New Zealand shares. That is, imputation credits simply provide a mechanism to reduce NRWT for payments to non residents and if a non resident transfers its shareholding in a New Zealand company to another non resident then why should the distribution of any dividend now be subject to NRWT?

5.10. For example, if a multinational company has a wholly owned New Zealand taxpaying subsidiary and changes in the ultimate shareholders in the MNC result in a 34% shareholding change in New Zealand, the Group submits that the profits before the shareholding change should be still be able to be distributed to the non resident parent company without a NRWT impost.

5.11. The purpose of the foreign investor tax credit regime is to limit the taxation payable by non residents that invest in New Zealand resident companies and was intended to attract foreign investment into New Zealand; we submit having the continuity rules apply in this situation is against the objectives of the policy to attract investment by non residents into New Zealand companies. Like the continuity provisions applying to the conduit tax relief regime, we believe the continuity rules should disregard

[2] Supplementary dividend holding companies are the Income Tax Act 2007 equivalent of "Section LE 3 Holding Companies under the Income Tax Act 2004.

changes between non residents and only be concerned where there is a change between non residents and residents.

***Same credit ratios***

5.12. The Group does not support the proposal in paragraph 3.40 of the discussion document to amend the imputation rules to target transactions that consistently pay dividends only on certain classes of share or from special purpose vehicles, and to extend the benchmark dividend rules to all entities within a group of companies.

5.13. Company law allows companies to have different classes of shares and for different classes of shares to have different rights attaching to them. The Group does not want to see this right conflicted by tax rules.

***Distributions of capital gains***

5.14. While not covered by the discussion document, the Group wishes to comment on the ability of companies to distribute capital gains as this is an imputation issue.

5.15. The fourth objective set out in the discussion document is that of employing a 'belt and braces' approach to ensure shareholders are taxed on unimputed dividends. The Group has a concern about this objective when it comes to distributing capital gains to shareholders.

5.16. From a policy perspective, if a corporate is not taxed on the gain made from the disposal of a capital asset then the Group can not see the policy merits of why its shareholders should be taxed if the gain is then distributed to those shareholders. That is, if the policy is not to tax capital gains, why should the distribution of capital gains be subject to tax?

5.17. The Group notes the following comments from the Consultative Document where the problem has previously been acknowledged:

> *"... 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..."*

5.18. The Consultative Document, did however go on to raise issues with such an approach:

> *"...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."*

5.19. In regard to the above we note:

5.19.1. We are currently operating in times of low inflation and material capital gains can only be generated when a sizeable portion of the corporates business is disposed of. As discussed below, it seems undesirable that the company must liquidate to be able to distribute such gains.

5.19.2. Regarding exempting tax preferred dividends, we agree as this the correct tax policy. If a gain is legislatively not subject to tax then it should be able to be distributed tax free to the shareholders (without having to liquidate the company).

5.19.3. Regarding implicit tax preferences, it is not clear what the implicit tax preferences are. As you are aware, only capital amounts can be distributed tax free by a corporate. We would simply see a memorandum account (similar to imputation credits) being maintained to track capital gain amounts. This would only be credited with such gains; as such other gains would not qualify for this treatment. Alternatively, such capital gain amounts could simply be converted into available subscribed capital of the company at the time the gain is made.

5.19.4. We note the comment regarding adding to the complexity of the Income Tax Act. As noted above, corporates already need to track capital gain amounts hence the additional compliance costs are not considered material by the Group.

5.20. Despite the above, the Group notes that corporates are able to distribute capital gains tax free on liquidation; however this seems extremely restrictive and extreme to achieve tax integration in this instance.

5.21. Further, tax policy has moved on since the Consultative Document was written; in particular PIEs now exist. If such a company was a PIE, the gain would have legislative protection from being taxed and it could immediately distribute that gain to its shareholders free from tax. Again, there does not seem any policy rationale why such entities, many of which cannot elect into the PIE regime, can not achieve the same benefits as PIEs. Also, for closely held corporates, they can elect into the qualifying company regime upon which all capital gains can be distributed tax free to shareholders.

5.22. We believe corporates should be able to distribute capital gains to shareholders without tax (other than noting that revenue account shareholders should still be subject to tax). We also consider this issue should be addressed through this imputation review.

5.23. We appreciate the concern that regular dividends could be sourced from capital gains therefore reducing the tax payable by shareholders. If this is a concern, the Group notes that this issue arose with the share repurchase rules where various dividend substitution rules were introduced. These rules could equally apply to capital gains made by corporates to ensure that they are treated consistently with that of available subscribed capital (as noted at paragraph 5.19.3 such amounts could simply create available subscribed capital). Again, we believe that the current policy framework of requiring corporates to liquidate in order to distribute capital gains is too extreme and restrictive.