OPTIONAL DISTRIBUTIONS UNDER NEW ZEALAND'S IMPUTATION AND RESIDENT WITHHOLDING TAX SYSTEMS

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ABSTRACT

This paper reviews the taxation of optional distributions in New Zealand. Three types of optional dividend plan have been used: bonus election plans, dividend reinvestment plans and profit distribution plans. This paper also looks at share repurchases which are similar to optional dividends as they also give shareholders a choice between cash and shares. Originally each type of optional dividend was taxed according to its component transactions, but their taxation was subsequently aligned due to their economic similarity and to minimise opportunities for dividend streaming. However, although share repurchases are similar they are taxed differently, potentially allowing dividend streaming. Dividend reinvestment plans are the most common form of optional dividend used in New Zealand, despite profit distribution plans providing much higher levels of reinvestment. This paper identifies issues with calculating resident withholding tax (RWT) on taxable bonus issues and the misalignment of company, RWT and personal tax rates as possible reasons why companies are not using profit distribution plans.

I. INTRODUCTION

For more than thirty years New Zealand's (NZ) listed companies have offered optional distributions to their shareholders.[1] This paper examines the income tax implications of giving shareholders a choice between cash and shares through optional dividend plans or share repurchase programmes. As the basis for taxing optional dividends changed from legal to economic form the range of viable options has been reduced. However, viable options could be increased by removing the misalignment of company and individual tax rates and correcting inconsistencies in the calculation of Resident Withholding Tax (RWT) for different types of non-cash distribution. Without these changes the tax treatments of optional dividends and share repurchases remains inconsistent despite their economic similarities.

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1 Distributions are broadly defined to include dividends and other financial transfers from companies to shareholders, such as bonus share issues and payments arising from share repurchases.

New Zealand companies have used three types of dividend plan; the Bonus Election Plan (BEP), the Dividend Reinvestment Plan (DRP) and the Profit Distribution Plan (PDP).[2] BEPs let shareholders choose between cash dividends and bonus shares in lieu of dividends. With DRPs all shareholders are paid a dividend, but shareholders who choose reinvestment receive shares purchased using the dividend funds.[3] With PDPs all shareholders are issued bonus shares, but they can choose to receive cash instead through these shares being repurchased by the company.

Originally each plan was taxed differently, according to their component transactions. Their taxation was subsequently aligned to prevent companies and shareholders using them to change whether a dividend is paid and tax credits received. Under current NZ tax law there is no advantage to the shareholder in choosing either cash or shares irrespective of the type of plan used.[4] Share repurchases are similar in making cash distributions optional but they are taxed differently; off-market repurchases may allow some shareholders to receive a taxable dividend and the associated tax credits.

When first introduced BEPs allowed reinvesting shareholders to avoid receiving dividend income. Later, as part of the move to dividend imputation, bonus shares issued in lieu of dividends became taxable which aligned BEP and DRP taxation. Similarly, when introduced PDPs combined non-taxable bonus issues with optional repurchases structured as taxable dividends so only shareholders receiving cash received a taxable dividend and imputation or RWT credits. PDPs later changed to taxable bonus issue and non-taxable share repurchase, so all shareholders would receive taxable income. This change aligned PDP taxation with BEPs and DRPs. All three plans contain two transactions; with DRPs and PDPs the transactions are sequential and the second transaction is optional, with BEPs the choice is between two simultaneous and mutually exclusive alternatives. Taxing the transactions independently is different to taxing the whole transaction based on its overall economic effect.

There are three main problems with the current taxation of optional dividends. Firstly, due to RWT some cash cannot be reinvested even if the shareholder is in a low tax bracket and will claim a refund of the RWT. Secondly, companies have stopped using PDPs and are missing the higher levels of reinvestment PDPs generate. Thirdly, the taxation of optional dividend plans is inconsistent with the taxation of share repurchases despite their economically similarities. Possible solutions to the first two problems include aligning the

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2 New Zealand bonus election plans and dividend reinvestment plans are similar to Australian bonus share plans and dividend reinvestment plans respectively, there is no Australian equivalent to the profit distribution plan although one New Zealand company using a PDP was dual listed on the Australian Stock Exchange.

3 The reinvested funds are retained by the company. Shares are either new issues or treasury shares.

4 The *Income Tax Act 2007* (NZ) includes rules for the taxation of bonus-issues-in-lieu-of-dividends and profit distribution plans but does not mention dividend reinvestment plans.

RWT rate with the company tax rate and changing the way RWT is calculated for PDPs. Aligning the taxation of dividend plans and repurchases will prove a harder problem to solve.

In evaluating the taxation of optional distributions it is useful to keep in mind that tax law is designed to balance trade-offs between four objectives; raising revenue, being fair and equitable, minimising distortions and minimising compliance costs.[5] The main purpose of taxation is to raise revenue for the Government, a process which is more efficient when compliance costs are low. It is also desirable for taxation to be fair and equitable so those who are equally able to pay, pay equally, and those more able to pay, pay more. In an open market economy a well-designed tax system will minimise the price distortions that arise when taxpayers have incentives to act differently simply because those acts would lower their tax liability. In real world tax systems trade-offs between these four objectives are sometimes necessary.

Section two reviews the component transactions used in optional dividends. These are dividends, bonus issues and share repurchases. This includes a review of the relevant history of dividend taxation including the pre-imputation environment, imputation and RWT. Section three examines the relationship between tax rates and corporate distribution policy and the main changes since the introduction of RWT to New Zealand in 1989. Section four describes the history and taxation of the different types of optional dividend: BEP, DRP and PDP. Section five summarises the main findings and outlines possible solutions to the problems identified.

II. THE COMPONENT TRANSACTIONS IN OPTIONAL DIVIDENDS

Optional dividends involve either a choice between two transactions or a sequence of transactions where the second is optional. To understand how optional distributions are taxed it will be useful to first consider the taxation of the component transactions; dividends, bonus issues and share repurchases. Here the distinction between income and capital is critical, as New Zealand does not explicitly tax capital gains, income must be broadly defined to minimise opportunities for tax avoidance and ensure revenue accrues to the Government. However, rules distinguishing income from capital distributions should not distort legitimate corporate decisions.

A. *Dividends*

This section reviews the general principles of dividend taxation in New Zealand. Imputation and the classical double-tax system which preceded it provide a historical context for optional dividends' introduction. RWT, which compliments imputation, is also reviewed. The

5 This framework is consistent with the objectives outlined in Inland Revenue Department 'Briefing for the Incoming Minister of Revenue', October 2014, <http://www.ird.govt.nz/aboutir/who-we-are/minister/briefing/>

taxation of dividends paid to non-residents and non-resident withholding tax is outside the scope of this paper.

Generally dividends occur in transactions between a company and its shareholders when the value transferred from company to shareholder exceeds the value transferred from shareholder to company.[6] Although dividends are taxable income for shareholders companies are not obliged to pay dividends, therefore it is necessary to tax company profits to ensure tax revenue is raised from company profits. However, in countries like New Zealand and Australia there is a single income tax rate for companies and progressive rates for individuals so a fairer and more equitable approach is to tax corporate income at the shareholders' personal rates. The dividend imputation system is designed to facilitate this by giving shareholders credit for income tax paid by the company.

New Zealand's imputation system is an integrated tax system. However, it is not perfectly integrated as tax credits are only imputed to a shareholder's account when dividends are paid and shareholders on low marginal rates can only apply surplus credits to other income. As the value of imputation and RWT credits depends on a shareholder's tax rate there is an incentive for shareholders to transfer the right to receive dividends and tax credits to those who value them the most. Ideally in an integrated system the effective tax rate on company profits should be the average of its shareholders individual tax rates at the time the profits are made. Instead, in practice, it is the average of its shareholders individual tax rates at the time the dividend is paid. This creates an opportunity for shareholders to trade shares in order to minimise the effective tax rate, which is a type of dividend streaming. Tax laws need to prevent streaming to maintain Government revenue.

(a) Dividends before Imputation

In the classical system, in place in NZ at the start of the 1980s, corporate profits were subject to double taxation. Company income was taxed when earned, and taxed again when received by non-corporate shareholders. In contrast interest payments were an expense. Interest reduced a company's taxable income and was only taxed in the hands of lenders. This double taxation system was not equitable as interest income was taxed at investors' marginal rates, retained profits were taxed at the company rate and distributed profits were taxed twice. Double taxation created an incentive for companies to favour debt finance over equity, but excessive debt increased financial risk.

One way to avoid double taxation was to distribute capital profits as tax-free dividends. At the time tax-free dividends from capital profits were legal in New Zealand and easy for companies to offer. High inflation in the 1970s and 1980s made it possible for companies to sell capital assets and realise capital profits, which could then be distributed as a tax-free capital dividend. Clearly this was a poor system as tax revenue was reduced. It was also

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6 *Income Tax Act 2007* (NZ) s CD4. With share repurchases shareholders who sell receive cash but, when the shares are cancelled by the company the value of the shares surrendered is not considered. The full amount of cash paid by the company in a repurchase is a dividend unless the repurchase is a capital transaction.

inequitable as some companies had better access to capital profits than other companies. Finally, because companies required court approval to return capital the process was not efficient. Tax-free dividends were abolished when dividends paid from capital sources became taxable income from 20 August 1985.[7]

(b) The imputation system

New Zealand's dividend imputation system took effect from April 1988. Resident shareholders receive credits for tax paid by the company and their dividend income is increased by the value of tax credits received. The net effect is to make a shareholder's marginal rate the effective tax rate on their share of corporate profits, improving tax equity. The process begins as company's tax payments generate imputation credits, later the imputation credits are attached to dividend payments.[8] If dividends are fully imputed then shareholders with marginal tax rates equal to the company rate will receive credits exactly offsetting the tax on their dividend income. Shareholders on marginal rates higher than the company rate receive insufficient credits so are liable for additional tax; shareholders on lower marginal rates receive surplus credits which can be used to reduce their tax liability on other income.

The objective behind introducing imputation was to reduce the influence the tax system had on company policy, especially with respect to capital structure, investment and dividends.[9] By eliminating the double taxation of company profits imputation removed the tax bias in favour of debt financing. However, there is a catch built into the system. For imputation to work companies must pay dividends, but a truly neutral tax system would not encourage dividend payments as a neutral tax system has no effect on corporate policy.

An imputation system is more neutral than the classical system as it removes the strong incentive for companies to use debt finance instead of equity. However, it is not completely neural as it creates shareholder demand for dividends which may be incompatible with a company's need to retain cash for investment. Optional distributions and taxable bonus issues make the imputation system more neural by disconnecting the distribution of cash from the distribution of imputation credits, so companies can satisfy shareholder demand for credits while retaining cash.

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7 See Roger Douglas, Minister of Finance, 'Statement on Taxation and Benefit Reform' presented to Parliament 20 August 1985. Eliminating tax free dividends was part of a wide ranging announcement of proposed changes to the New Zealand tax system; the announcement also included plans to introduce a full imputation system in 1988/89. Implementation of imputation was confirmed in the June 1987 budget.

8 *Income Tax Act 2007* (NZ) s OA 18(2). The maximum amount of credits that can be attached to a dividend is t/(1-t) where t is the company tax rate.

9 Consultative Committee on Full Imputation and International Tax Reform *Consultative Document on Full Imputation* (Wellington, 1987).

(c) Resident Withholding Tax

Resident withholding tax is an additional withholding tax paid when dividends are not imputed to the RWT level, and addresses the problem that some companies may have insufficient imputation credits to pay a fully imputed dividend.[10] As such RWT compliments the imputation system. It was originally announced in the 1988 budget and effective from October 1989.[11] The main benefit of RWT is that it ensures a minimum level of tax is withheld by the company, reducing the risk of tax evasion or misreporting that would occur if authorities had to depend on individuals correctly reporting dividend income. RWT also prevents the deferral of income tax payments that would otherwise occur if companies paid dividends without tax credits at the start of the tax year knowing shareholders' income would not need to be reported and tax paid until the end of the year.

(d) Dividend streaming

Dividend streaming occurs when dividends are diverted to those who obtain the most value from them instead of being paid to the shareholders who owned the company when the underlying earnings were generated. Streaming reduces revenue by lowering the effective tax rate on company income. For example, taxable income could be diverted to untaxed investors while untaxable capital gains are distributed to taxpaying investors, so no tax is paid. In an imputation system streaming credits to low tax shareholders reduces tax equity. Shares are transferred to low rate shareholders, who receive full value from the imputation credits, but at a price which gives high rate taxpayers more than what they would have received from the dividend after tax.

In the absence of laws preventing it there are two main ways to stream dividends; change a company's ownership prior to paying a dividend, or only pay dividends to selected groups of shareholders. New Zealand's anti-streaming laws mainly address changing ownership. Specifically through the shareholder continuity rule, rules covering share lending and companies joining or leaving a corporate group.[12] These rules are complemented by the imputation credit ratio continuity rule. The continuity rule limits a company's ability to change the proportion of imputation credits attached to successive dividends in a single tax year, even when ownership changes are within allowable limits.[13]

Company law stops companies choosing to only pay dividends to selected shareholders. Otherwise it would be too easy for shareholders' funds to be expropriated by dominant investors. In New Zealand dividends must be paid equally to all shares in the same class

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[10] This is a key difference between the New Zealand and Australian imputation systems, as Australia does not have resident withholding tax.

[11] The intention to introduce resident withholding tax was announced in the 1988 budget and the tax took effect from October 1989, with *Income Tax amendment Act (No.2) 1989* (NZ) introducing a new Part IX A into the *Income Tax Act 1976* (NZ).

[12] *Income Tax Act 2007* (NZ) ss OA8, OB41, OB71, OB72, GB49.

[13] *Income Tax Act 2007* (NZ) ss OA18, OB60-3.

unless some shareholders have waived their rights to the dividend.[14] However, dividends can be streamed to selected shareholders provided all shareholders are initially offered the same dividend and the same choice to take something of similar value in lieu of the dividend. This is the principle behind early versions of BEPs and PDPs which provided an opportunity for shareholders to choose between income and capital distributions. However, these particular schemes no longer provide an opportunity to stream dividends or imputation credits.

B. *Bonus Issues*

Bonus issues are pro rata issues of shares to existing shareholders for no consideration.[15] As bonus issues involve restructuring a company's share capital they are traditionally classified as capital distributions, not income. Although bonus issues were not regarded as income for the shareholder they were subject to bonus issues tax paid by the company until April 1982.[16] That tax's objective was to discourage companies from using regular bonus issues as an alternative to dividends. Bonus issues tax was abolished with the proviso that any capital reduction in the ten years following the bonus issue would make the bonus issue a taxable dividend.[17]

In October 1988 it became possible for New Zealand companies to declare their bonus issues a distribution of taxable income.[18] This change was designed to support the imputation system by allowing companies to distribute taxable income and imputation credits without paying a cash dividend.[19] The viability of taxable bonus issues depends on the net effect on shareholders' taxable income. As long as sufficient imputation or RWT credits are attached a taxable bonus issue does not increase a shareholder's tax payable.

C. *Share Repurchases*

When companies repurchase shares they make a payment to the shareholder, in some cases this payment may be a legitimate return of capital and exempt from income tax. However, to protect revenue, tax law needs to ensure companies cannot use capital repurchases as an alternative to dividends. In New Zealand the presumption is that a repurchase is income

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[14] *Companies Act 1993* (NZ) s53.

[15] Bonus issues are similar to scrip dividends but bonus issues are traditionally capital distributions while scrip dividends are income.

[16] *Income Tax Act 1976* (NZ), Part VI. Bonus issues tax was levied at 17.5 percent.

[17] Before the *Companies Act 1993* (NZ) the law was strongly focused on capital maintenance and capital reductions were limited, so shareholders receiving bonus issues would have a reasonable expectation that there would not be a capital reduction and the bonus issue would not be reclassified as a dividend.

[18] *Income Tax Act 2007* (NZ) ss CD8, CD29. A company may elect to make a bonus issue a taxable dividend, if no declaration is made the default is a non-taxable bonus issue. A non-taxable bonus issue is not a dividend.

[19] Consultative Committee on Full Imputation and International Tax Reform, above n 9.

unless specific criteria are met.[20] The bright line test treats a repurchase of fifteen percent or greater as a capital transaction. A repurchase of less than ten percent of capital is income. Repurchases between ten and fifteen percent may be classified as capital following an application to the Commissioner.[21]

Repurchases may be either on-market or off-market.[22] On-market repurchases are not dividends.[23] Not taxing on-market repurchases as income to the shareholder is fair as there is no way for the seller to know the buyer's identity and receive imputation or RWT credits. An off-market repurchase and pro rata cancellation is not a dividend if it meets the bright line test and is not in lieu of a dividend. To the extent a repurchase is income taxable it is a dividend and may carry imputation credits.

Irrespective of size, a repurchase is a dividend when it is in lieu of a dividend. This is similar in principle to the taxation of bonus-issues-in-lieu-of-dividends. However, the bonus issue rule applies when shareholders are given an explicit choice between a cash dividend and a bonus issue of shares, determining whether a repurchase is in lieu of a dividend requires evaluation of company policy on a case-by-case basis. Certainly, if a company cancelled its dividends and started making similarly sized repurchases there is a strong argument that the repurchases are in lieu of dividends. It would be much harder to prove that a company that did not previously pay dividends, choosing between commencing dividends and using repurchases, chose to use repurchases in lieu of dividends.

III. TAX RATES AND CORPORATE DISTRIBUTION POLICY

The relative levels of company, personal and RWT tax rates determines the extent to which tax affects personal and corporate distribution decisions. From its introduction the rate of RWT has remained fixed at 33 percent. Since the introduction of imputation, company tax has gradually been reduced from 33 percent to 30 percent then 28 percent. Over the same period the top marginal rate for individuals was increased from 33 to 39 percent, fell slightly to 38 percent then returned to 33 percent.[24] Through these changes companies have

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20 The taxation of share repurchases became much more important with the *Companies Act 1993* (NZ) making it much easier for a company to redeem or repurchase its shares. Accordingly many of the specific rules for taxing repurchase were introduced in the *Income Tax Act 1994* (NZ).

21 *Income Tax Act 2007* (NZ) s CD22

22 On-market repurchases, or buybacks, involve a company purchasing its own shares through the stock exchange. With off-market repurchases the company purchases its shares directly from shareholders, usually through a tender offer or a negotiated deal. A company can purchase up to 5% of any class of its own shares, effectively holding shares in itself, *Companies Act 1993* (NZ) s 67A, shares held in this way are called treasury stock. Alternatively the company may cancel the shares.

23 *Income Tax Act 2007* (NZ) s CD24

24 See Roger Douglas and Trevor de Cleene, press release 7 October 1988, as reported (December 1988) *New Zealand Current Taxation* 460. When first announced the intended RWT rate was 28 percent which matched the prevailing

continued to pay cash dividends and use DRPs, but alternatives such as taxable bonus issues have fallen from favour, indicative of changing tax rates have affecting distribution policy choices. Table 1 summarises the main tax rates since the introduction of RWT.

Table 1: Tax rate Alignment since the Introduction of RWT

Companies		RWT		Individuals	Time Period
33%	=	33%	=	33%	1/10/1989–31/03/2000
33%	=	33%	<	39%	1/4/2000–31/03/2008
30%	<	33%	<	39% / 38%	1/4/2008–30/09/2010
28%	<	33%	=	33%	1/10/2010 –

Company tax, RWT and the top marginal rate for individuals since October 1989.

A. *Period One: When Rates Were Aligned*

From the introduction of RWT, in October 1989, until April 2000 New Zealand's company tax rate, RWT, and the top marginal rate for individuals were all aligned at 33 percent. Alignment meant companies paying fully imputed dividends did not need to withhold RWT. Alignment between RWT and the top marginal rate meant that resident shareholders would receive sufficient tax credits, either imputation credits or RWT, to cover the tax payable on dividends.

During this period fully imputed taxable bonus issues allowed companies to distribute imputation credits without using cash and to distribute profits without imposing a net tax liability on shareholders. Individuals on the top marginal rate received sufficient credits to cover the tax payable on bonus issue income. Individuals on lower rates received surplus credits they could use to offset tax on other income.[25]

B. *Periods Two and Three: A Higher Marginal Rate for Individuals*

Between April 2000 and September 2010 the top marginal rate was higher than the RWT and company rates.[26] Individuals on the highest rate paid additional tax on dividend income as the imputation credits and RWT could not cover the tax on dividend income. This should cause market distortions as it creates a disincentive for those individuals to invest in dividend paying firms. It also increases compliance costs as individuals need to file tax returns to disclose and pay the additional amount.

company tax rate. When RWT was introduced both company and RWT rates were 33 percent, this change suggests the intention was to link the RWT rate to the company rate but the link was not formalised.

25 See Hamish Anderson, Steven Cahan and Lawrence Rose 'Stock dividend announcement effects in an imputation tax environment' (2001) 28 *Journal of Business Finance and Accounting* 653. Positive share price reactions to the announcement of taxable bonus issues, indicated shareholders valued these distributions.

26 From April 2000 to March 2008 the company and RWT rates were 33 percent and the top rate for individuals 39 percent. From April 2008 to September 2010 the company rate was 30 percent, RWT 33 percent and the top rate for individuals initially 39 percent but later reduced to 38 percent.

Taxable bonus issues are not suitable in this environment as shareholders on the top marginal rate do not receive sufficient tax credits to cover their dividend income. Although this also applies to cash dividends, at least cash provided liquid funds to cover the payment.[27] It should be no surprise that taxable bonus issues became very rare for listed companies during this period.[28]

C. *Periods Three and Four: A Lower Rate for Companies*

Since October 2008 the company tax rate has been lower than the RWT rate, see Table 1. As the imputation credit ratio is based on the company rate all dividends now need to be topped-up with RWT credits unless shareholders are RWT exempt. This increases compliance costs for companies as they need to process RWT exemptions, which they previously could have avoided by paying fully imputed dividends.

In October 2010 the top marginal rate for individuals returned to 33 percent and into alignment with the RWT rate. That removed the problem of high rate individuals receiving insufficient tax credits when paid a dividend or taxable bonus issue. Despite the re-alignment companies have not returned to using taxable bonus issues. It is possible that after many years of disuse financial managers simply have no inclination to start using them again, it is also possible that confusion over RWT is discouraging companies from using taxable bonus issues.

The method for calculating RWT for taxable bonus issues may be causing confusion for companies about their RWT obligations. There are different formulae for calculating RWT on cash and non-cash dividends and taxable bonus issues. However, the formula for taxable bonus issues mirrors the formula for cash dividends despite clearly being a non-cash dividend.[29]

With cash dividends RWT is simply withheld from the cash amount so the shareholder receives less cash. For non-cash dividends RWT is an additional amount paid by the company, with taxable income grossed up. This is because it is usually impractical to withhold, and convert to cash, a non-cash benefit. Similarly it is impractical to partially withhold a bonus issues to pay RWT so, like other non-cash dividends, a company needs to

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27 See Hamish Anderson, Steven Cahan and Lawrence Rose 'Taxable bonus issues: A good way to distribute accumulated imputation credits?' (2001) 3 *University of Auckland Business Review* 48.

28 Taxable bonus issues have rarely been used by New Zealand listed companies since April 2000. While they are no longer suitable for regular use they may be used of one-off transactions when the company needs to distribute imputation credits, for example before a major restructuring, when the credits would otherwise be lost.

29 *Income Tax Act 2007* (NZ) s RE13 for cash dividends, s RE14 for non-cash dividends excluding certain share issues, s RE 15 for bonus-issues-in-lieu and shares issued under a profit distribution plan. The formula for bonus-issues-in-lieu is the same as the formula for cash dividends except the cash dividend amount is replaced by an 'alternative amount' representing the cash that would otherwise be paid if the shareholder did not take the shares.

make a separate payment to cover RWT.[30] However, unlike other non-cash dividends this payment does not become part of the shareholder's taxable income. The need to pay RWT and confusion over this inconsistency in the tax law could be discouraging companies from using taxable bonus issues and PDPs incorporating taxable bonus issues.

IV. OPTIONAL DIVIDENDS AND THEIR TAXATION

New Zealand companies have responded to the taxation and corporate law environment through the design and use of optional distributions. Optional dividends and repurchases provide companies with more choices in corporate distribution policy, and let companies cater to a broad range of shareholder clienteles while officially treating all shareholders equally.

There are two approaches to taxing optional distributions. One is to treat each transaction independently, the other is to consider the combined transactions. The former concentrates on the legal form of each transaction, the latter concentrates on the economic substance of the whole. The following sections will show that optional dividends were initially taxed through their component transactions, but later BEPs and PDPs were taxed according to their economic substance due to their similarity with DRPs.

A. *Bonus Election Plans*

The first optional dividend plan adopted by a listed New Zealand company, Bunting and Company Limited, was a BEP.[31] This was soon followed by National Insurance Limited and Hallenstein Brothers Limited, which simultaneously offered both BEP and DRP options.[32] It is likely that these companies were copying the development of similar bonus share schemes and DRPs in Australia, but it is unlikely they would have introduced BEPs without the abolition of bonus issues tax in 1982.[33]

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30 It is unlikely that the RWT payment would match the value of a round number of shares, so the company cannot repurchase shares and use the payment for RWT, nor can companies issue or repurchase fractions of a share. The only practical way to pay RWT is through an additional cash payment, in which case the dividend should be grossed up by that amount, but the formula does not allow that. With the RWT rate higher than the current company tax rate all taxable bonus issues require RWT payments unless all shareholders are exempt.

31 Michael Shelton 'Dividend reinvestment the money or the shares' (1984) 31 *Management (NZ)* 80. It is not clear whether the Bunting and Company Ltd BEP became operational before the company was taken over and delisted in May 1984.

32 Offering both BEP and DRP makes sense if the company has a limited ability to issue bonus shares. Taxed individual shareholders would use the BEP while untaxed corporate shareholders would choose the DRP, leaving more reserves for future BEP issues.

33 In Australia FAI Insurances Limited offered a bonus share plan (BSP) with their 1978 final dividend. BSPs were introduced before Australia adopted capital gains tax (CGT) and dividend imputation, allowing companies to offer tax free distributions. After the introduction of CGT the distributions became tax deferred as the gain would be taxed when the shares were sold. Later developments in anti-streaming rules have gradually cut back on BSP tax benefits by

An issue of bonus shares is a capital transaction so companies offering a BEP need suitable accounting reserves to capitalise. As some companies were more likely to have these reserves than others BEPs were not viable for all companies or available to all shareholders, reducing tax equity. Limited access to suitable reserves also means companies would be concerned about the long-term sustainability of a BEP programme as companies traditionally like to maintain a stable dividend policy.[34]

The tax benefits of using a BEP changed frequently during the 1980s. Early BEPs allowed shareholders to choose between taxable dividends and tax-free shares; BEPs offered a clear tax advantage over normal dividends and DRPs when the dividend was taxable.[35] However, when first introduced tax-free capital dividends were common and corporate shareholders were not taxed on dividend income. So, for companies paying capital dividends and corporate shareholders there was no benefit in using a BEPs. Briefly, following the abolition of tax-free dividends, in 1985, BEPs were the only viable way for companies to offer a tax-free distribution and avoid double taxation.[36] Shareholders took advantage of this opportunity to receive a tax-free distribution, with around 60 to 90 percent reinvested.[37] From October 1988 bonus-issues-in-lieu-of-dividends, including BEP share issues, were classified as taxable income.[38] BEPs no longer offered a clear tax advantage but the introduction of imputation reduced the need for schemes designed to avoid double taxation. Subsequently there has been no economic difference between offering optional dividends through a BEP or DRP, although they still differ in their legal structure and accounting treatment.

Classifying bonus-issues-in-lieu as dividends supported the general objectives of the imputation system. Paying taxable dividends, and the transfer of imputation credits from company to shareholder, became harder to avoid after BEPs became taxable dividends.

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requiring companies to cancel imputation credits on the dividends foregone, and preventing Australian companies offering BSPs on dividends with less than ten percent imputation credits attached.

[34] Similar issues had been identified with Australian bonus share plans and may have contributed to the adoption of DRPs in Australia. See Michael Skully *Dividend Reinvestment Plans: Their Development and Operations in Australia and the United States* (Committee for the Economic Development of Australia, 1982).

[35] To ensure that BEP shareholders were not deemed in receipt of dividends it was necessary for the election to receive bonus shares to be made before the next dividend was declared.

[36] Warren Head 'In lieu of the taxable dividend' (1985, 28 August) Auckland Star C3. Suggests DRPs will be 'put on ice' until the introduction of imputation as BEPs provided a more tax effective optional dividend following the abolition of tax free capital distributions.

[37] See D J Hasseldine *Dividend Reinvestment Schemes: An Examination of their Accounting, Financial and Taxation Implications in New Zealand* (MCom Thesis, University of Canterbury, 1986). Many different labels have been applied to various types of optional dividend, Hasseldine refers to 'dividend reinvestment schemes' based on their description and the timing of the research they are more likely to be BEPs than DRPs.

[38] *Income Tax Act 2007* (NZ) CD7. With straight bonus issues companies can elect to make the bonus issue taxable, optional bonus issues such as BEPs are bonus-issues-in-lieu so must be taxable.

B. *Dividend Reinvestment Plans*

DRPs were first used by New Zealand companies shortly after the introduction of BEPs in the early-1980s. As the dividend is deemed to have been paid before any funds are reinvested there is no tax difference between reinvesting and non-reinvesting shareholders. DRPs do not provide shareholders with an opportunity to avoid tax so there is no need for specific DRP tax rules.

A possible catalyst for the introduction of DRPs was foreign firms using similar plans, particularly in the United States and Australia. However, it was the introduction of imputation and the taxation of bonus-issues-in-lieu-of-dividends that provided the main impetus for the growth of DRPs. With straight cash dividends the imputation ratio causes a company's ability to distribute credits to be limited by its ability to distribute cash. A cash dividend with a DRP option means companies can declare larger dividends and distribute more credits knowing the cash distribution will be reduced by reinvestment. The level of reinvestment and cash required, however, is only partially under the company's influence.[39]

DRPs are compatible with the imputation system in general, but RWT is not fully compatible with DRPs as it limits the amount that can be reinvested. RWT payments are withheld from the dividend's cash component before reinvestment, thereby reducing the maximum amount that can be reinvested.[40] Imputation credits reduce the need to pay RWT, but as the imputation ratio is based on the company tax rate and the RWT rate is currently above the company rate all dividends will have a component that cannot be reinvested.[41]

C. *Profit Distribution Plans*

PDPs combine bonus issues with an offer to repurchase the bonus shares if a shareholder prefers cash. PDPs originally combined a non-taxable bonus issue and a repurchase structured as a taxable distribution, usually with imputation credits.[42] From November 2012 PDPs became a combination of taxable bonus issue and non-taxable repurchase, so all shareholders would be taxed.[43] Seven listed companies used PDPs between their introduction and the changes in November 2012. These companies paid a total of thirty-one

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39 See D J Hasseldine 'Dividend reinvestment schemes in New Zealand' (1988) 6 *Asian-Pacific Tax and Investment Bulletin* 515. Factors influencing reinvestment rates may be grouped into four categories; economic, company, plan and investor. Plan design and company performance are subject to management's influence, but economic factors including the tax environment and investor factors are external.

40 Shareholders on marginal rates lower than the RWT rate may benefit from surplus RWT credits, but the benefit is in the form of a tax refund, not company shares and there is no benefit for companies needing to raise equity capital.

41 There is no RWT when all shareholders have filed exemption certificates, which is possible for closely held companies but extremely unlikely for public companies.

42 Most, but not all, PDPs attached imputation credits to the dividend.

43 *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012* (NZ).

PDP dividends. As far as can be ascertained no listed company has used a PDP since the 2012 changes.

Table 2: Reinvestment in Listed NZ Companies through PDPs and DRPs, 2006–2012

	Number of PDPs	Average PDP Reinvestment	Number of DRP Dividends	Average DRP Reinvestment
2006	3	82.08%	30	26.94%
2007	4	65.65%	31	31.51%
2008	7	59.58%	44	23.66%
2009	6	75.23%	52	24.99%
2010	6	77.82%	59	27.01%
2011	3	57.97%	54	29.69%
2012	2	77.32%	52	31.69%
Overall	31	70.09%	322	27.86%

Source: Author's calculations. Reinvestment is calculated as the value of shares issued (net of PDP repurchases) divided by the cash dividend that would be paid if no shares were issued, data obtained from company announcements.

PDPs are designed to provide a high level of cash retention. Table 2 shows PDPs generate over twice the rate of reinvestment found with DRPs. As shareholders only receive cash on application companies may anticipate that shareholder indifference or inertia will result in many shareholders keeping the bonus shares rather than applying for the cash distribution.[44] In the thirty-one PDP dividends the smallest cash payment was around four percent of the total dividend, and the largest payment 75 percent. On average only thirty percent of the total dividend was paid in cash.

The PDP structure was introduced by SkyCity Consolidated Group (hereafter SkyCity). In 2005 they applied for a product ruling on a planned distribution which combined a bonus issue of shares with a simultaneous off-market repurchase of the same quantity of shares. SkyCity's application did not specify whether the bonus issue or repurchase would be taxable or non-taxable. However the size of the share repurchase implied the repurchase should be a taxable dividend as it would not be large enough to qualify as a capital distribution under the bright line tests.[45] The application stated that the PDP would replace their DRP; with the change aimed at increasing the level of reinvestment and reducing cash outflow, to help keep SkyCity's dividend policy affordable.[46]

[44] This is a form of behavioural nudge, see Richard Thaler and Cass Sunstein *Nudge: Improving Decisions about Health, Wealth, and Happiness* (Yale University Press, 2008).

[45] SkyCity stated that the repurchase would be less than 10 percent of the market value of the company's shares, implying the repurchase should be a taxable dividend under the bright line tests.

[46] As the PDP replaced a DRP, and therefore replaced a dividend, it is not clear why PDPs were not classified as using bonus-issues-in-lieu-of-dividends when first introduced.

The resulting product rulings allowed SkyCity to offer its PDP provided the company did not elect to use taxable bonus issues.[47] They were also required to ensure the company had sufficient imputation credits to cover whatever proportion of the bonus issue was not repurchased. The rulings also stipulated the maximum size of the repurchase, to ensure the repurchase was below the bright line tests and therefore a taxable dividend.[48]

Whether the PDP was designed to allow shareholders to choose tax effective distributions is unknown. Simply setting up a PDP does not necessarily mean imputation credits will be directed away from high marginal rate shareholders and towards low marginal rate shareholders. For dividend streaming to occur in a PDP shareholders need to make appropriate reinvestment decisions based on their marginal rates. A PDP would, at most, facilitate such activity.[49]

The product rulings expired in March 2009 and, following public consultation, PDP taxation was changed from November 2012. The consultation process, through an issues paper, identified the main problem with the original PDP structure as the potential for streaming imputation credits. It also stated that any solution needed to consider the benefits of higher PDP reinvestment levels for companies.[50]

To prevent dividend streaming PDPs became taxable bonus issues, so all shareholders received taxable income, with non-dividend repurchases so no shareholders received two allocations of tax credits.[51] Repurchases will no longer be dividends despite being below the levels set in the bright line tests. However, the objective of retaining higher PDP reinvestment levels has not been achieved because listed companies have simply stopped using PDPs. While no company using PDPs has provided a clear reason for stopping, the problems with taxable bonus issues and RWT identified earlier could be part of the reason.

V. Conclusion

Optional dividends are similar to share repurchases in that shareholders are presented with a choice between cash and shares. In both cases the choice to take cash decreases that shareholder's holding relative to investors who choose shares. However; optional dividends

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47 This prevented SkyCity from increasing imputation credit distribution by making both the bonus issue and repurchase income taxable.

48 See Inland Revenue Department Tax Information Bulletin: Vol.18, No.2 (2006) for product rulings 05/07, 05/08, and 05/09, the rulings were issued 5th December 2005 and were valid until 31 March 2009.

49 The product rulings state that SkyCity believed only a very small percentage of their shareholders were likely to be taxable at the 39 percent marginal tax rate, which suggests only limited risk of streaming.

50 'The taxation of distributions from profit distribution plans' An officials' issues paper prepared by the Policy Advice Division of Inland Revenue and The Treasury, June 2009.

51 *Income Tax Act 2007* (NZ) ss 7B, 23B. The changes have effect from November 2012; references to 'bonus-issues-in-lieu' are now to 'bonus-issues-in-lieu and PDP share issues.' PDPs are defined as schemes involving one or more steps including the issue of shares and an option to have those shares repurchased.

increase shares outstanding while with a repurchase there is a decrease. Repurchases only involve transactions with selling shareholders, whereas dividend plans involve all shareholders in at least one transaction. There is a very fine distinction between arguing that BEPs, PDPs and DRPs are sufficiently similar to necessitate similar tax treatments, and arguing that repurchases are distinctive enough to allow different tax treatment.

Taxing economically equivalent transactions equally helps maintain a fair and equitable tax system, minimising distortion and avoidance. However, this objective alone does not explain why BEP and PDP taxation was brought in line with DRP taxation. For that it is necessary to recognise that BEPs and PDPs aided a form of dividend streaming and therefore were a threat to revenue. Furthermore, aligning the taxation of BEPs and PDPs with DRPs supports the operation of the imputation system.

The aim of reducing dividend streaming in PDPs is easily bypassed as streaming is still possible through off-market repurchases. As the taxation of stand-alone share repurchases was not changed, companies can simply use off-market repurchases without issuing bonus shares. Preventing the streaming that occurs through repurchases is a much harder issue to solve. A possible solution is to only allow off-market repurchases as part of a PDP, which would ensure all shareholders received taxable income in proportion to their holding.[52]

Although the introduction of DRPs predates the imputation system, the rationale for using optional dividends was strengthened by New Zealand's dividend imputation system. Imputation created an incentive for companies to find efficient means to distribute imputation credits.[53] DRPs, PDPs and taxable bonus issues separate the distribution of credits from the distribution of cash, allowing more credits to be distributed. There are problems with calculating RWT on taxable bonus issues, and therefore PDPs which incorporate taxable bonus issues under the new rules. Furthermore, when RWT is paid by the company, there is direct cash cost in offering a PDP which partially offsets the increased reinvestment PDPs provide. Overall these problems mean PDPs are not currently viable instruments in corporate dividend policy. Instead DRPs remain the standard form of optional dividend despite suffering from low and variable reinvestment levels, limiting their usefulness for companies needing equity capital.

Listed companies are required to treat shareholders equally but shareholders are not equal in their wants and needs. Corporate actions that suit some will not satisfy all. Some companies responded to this dilemma by offering their shareholders a choice between different distributions, designing a dividend policy to meet the needs of as many

[52] An exception to this rule would be needed for small selective repurchases, for example when companies want to buy out small shareholders holding less than a marketable parcel of shares.

[53] Conversely the need to maintain tax revenues provides an incentive for Government to keep such schemes within reasonable bounds, particularly by preventing companies from streaming dividends and imputation credits to those shareholders who gain the most value from them. PDPs did not allow companies to direct dividends to specific shareholders but they did facilitate streaming by allowing shareholders to accept or avoid dividends in line with their individual tax position.

shareholders as possible. All shareholders are offered the same choice so they are treated equally, but those who value one alternative over another can choose the distribution that best meets their needs. This, in turn, led tax authorities to modify the rules applying to dividend choices; balancing the aims of maintaining revenue with having a fair and equitable system. However, these changes affected the viability of different optional dividend plans resulting in less choice available to shareholders.

The disappearance of PDPs after the tax changes is unfortunate as PDPs provide companies with much higher levels of reinvestment. PDPs could serve a useful corporate purpose and facilitate the operation of the imputation system by increasing cash retention while allowing companies to distribute imputation credits. However, until they become easier to administer they are unlikely to be used. One solution is to change the RWT calculation for bonus issues to the gross-up approach used for other non-cash dividends. This will resolve confusion about how RWT is calculated and paid, although it is not certain this will be sufficient to bring back PDPs.

The objective behind dividend imputation was to reduce the influence the tax system had on company policy. The neutrality of the tax system would be improved if disincentives for using taxable bonus issues and PDPs were removed. This can be achieved through two policy changes; aligning tax rates and changing the RWT calculation for taxable bonus issues. The viability of PDPs would be improved by re-aligning the top personal, company and RWT rates. That would allow companies to use PDPs with fully imputed dividends without needing to pay RWT or impose taxable bonus issues on high marginal rate individuals with insufficient tax credits attached. Changing the RWT calculation for taxable bonus issues would make it easier for companies to use them, and PDPs, when the distribution is not fully imputed. The underlying purpose of the imputation system is to integrate company and personal taxation, aligning tax rates and providing a wide range of viable optional distributions simply helps the imputation system work.