Grant Thornton

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Streaming and Refundability of Imputation Credits – A Government Tax Policy Discussion Document

The following is Grant Thornton's submission on the above named Issues Paper.

Grant Thornton New Zealand is a national association of independently owned and operated firms. This submission is made on behalf of those firms.

We would note at the outset that the problems that the discussion document ("DD") sets out are in large part the result of decisions made at the inception of the imputation system that were not in accordance with the fundamental principle outlined in the first bullet point in paragraph 1.5 of the DD that:

> *"keeping the company tax system as close to a fully integrated system as possible – that is, as far 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".*

That is, anti-streaming rules are required because there are certain taxpayers who cannot use imputation credits and therefore it is natural that taxpayers should want to make full advantage of them and direct them towards those who can.

It is also the lack of adherence to this fundamental principle that leads the Government to believe that any changes to the streaming and refundability of imputation credits will lead to a "loss of revenue" or "base maintenance concerns". Of course any such perceived loss is measured against a tax take that we would submit is greater than what it should be if the correct, principled, decisions were made 20 years ago. In coming to the correct policy conclusions it is therefore an irrelevant measure which to consider despite the fact that it may cause some consternation.

We would also make the general observation that many of the so called "integration" issues that are noted in the DD arise because of the imbalance of marginal tax rates between shareholders and between a company and its shareholders. "Classical" tax rates of 30/30/30 would make much of this discussion redundant and allow a sound basis on which to make tax policy decisions.

Specific Comments

Paragraphs 1.1 to 1.6

We consider that the imputation regime should put the shareholder in the same position they would if they held the investment direct, as such we agree with the comment relating to the active/ passive exemption, but double taxation arises when tax is suffered offshore, and then again on distribution. Contrast this with a person who invested "direct" - the Foreign Tax Credit ("FTC") would relieve their personal tax position. The proxy therefore would be to have FTC's to a company give rise to deemed ICs.

Paragraph 2.3

We do not consider that the statement that non-resident shareholders have no income tax to offset imputation credits against is correct. As far as we know non-resident withholding tax that is prima facie deducted from dividends is an income tax. As pointed out in the example that follows non-resident shareholders receive a reduction in the amount of NRWT paid via the foreign investor tax credit ("FITC"), which results in an effective "gain" against what the position would have been minus FITC of $12.50 in respect of a nominal $100 gross dividend. The non-resident shareholder is still effectively paying $22.50 of tax but this would be (for most countries) $45.00 (30c in $ plus $15 NRWT).

Paragraph 2.9

It states here that total tax collected is $55.50 (based on a $200 profit fully paid out as a dividend) and that "this appears an appropriate level under current policy settings". One would have to know what those current policy settings are but the tax take is either appropriate or it is not.

This may be where part of the uncertainty arises – what is the appropriate level of taxation for an overseas shareholder? That is, as has been acknowledged, for domestic shareholders the intention of the imputation regime is that tax is levied on income from a company based on the personal tax characteristics of the ultimate shareholders. Obviously there are exceptions to this general rule, which is the reason for the DD.

What is needed is a policy decision to be made on what is the appropriate level of taxation that should be imposed on non-resident shareholders of New Zealand resident companies.

The FITC regime is also a recognition that the imputation system unfairly disadvantages non-resident shareholders but that itself depends upon the tax regime in the shareholder's country of residence. A number of countries either have a Underlying Foreign Tax Credit or have a exemption from income tax for overseas dividends. Therefore the only tax impediment for non-resident shareholders would in the main appear to be NRWT on dividends.

Be that as it may once a policy decision is made regarding the amount of tax a non-resident shareholder should pay there will inevitably a need for anti-streaming rules as it is almost certain that non-resident shareholders will be able to make as much use (or have the need to make as much use) of imputation credits that a NZ resident shareholder will.

Chapter 4 – Rethinking the refund rules

As noted above if the rules regarding refund of imputation tax credits were made on sound taxation principles 20 years ago refunds of ICs would have been made. The decision was made not to and this was made purely for "revenue" reasons. To therefore argue that the non-refundability should be retained because of "policy" decisions made 20 years ago lacks any merit. Further to state in paragraph 4.9 that "Tax-exempt organisations are, in principle, no worse off under this decision than they were under the dividend system that applied till 1988" is disingenuous as tax-exempt organisations are definitely worse off compared with other shareholders.

Clearly any tax system that imputes taxation via a corporate vehicle to a shareholder should either not tax that income or allow for a refund of taxation where that shareholder has no liability for tax.

Our view is that imputation credits should, in the hands of the shareholder, be treated in the same manner as any other withholding tax and able to be refunded.

Taken in conjunction with the comments we have made in relation to non-resident shareholders above it might well be that there is a need for anti-streaming rules but it would appear that this should be limited to companies with non-resident shareholders.

Para 4.10

Prima facie the statement that "refunding tax credits could also create greater incentives for charities to be used in "tax planning" arrangements, contrary to policy" would appear to be debatable and indeed the reverse would appear to be more likely to be true. That is, the current situation would appear to be riper for tax planning opportunities i.e. diverting imputation credits away from charities to tax paying entities that can make use of the credits.

However the authors of the DD envisage, as set out in paras 4.23-4.25, some schemes whereby shareholding would be moved to charities, from tax paying entities, to have the credits refunded. Presumably thereafter there would be some sharing of the tax benefit between the charity and the company to provide a benefit to both. While we acknowledge that this is possible we do not believe that this should be a consideration in making the policy decision as to whether credits should be refunded as such a concern exists with all tax policy decisions and the safeguard against such practices is to rely on the general anti-avoidance rules or introduce specific anti-avoidance rules, such as the current anti-streaming rules, in the interests of certainty. The reality is that nearly all policy initiatives have degrees of risk of being subject to tax planning/avoidance and any reform would undoubtedly stagnate as a result. As an aside we would note that there is nothing inherently wrong with "tax planning" as it is commonly understood it is when it drifts into "tax avoidance" that there is an issue, particularly when it runs counter to the policy intention of the Government. As such it is important that the Governments intention is clearly set out so that taxpayers know the parameters under which they can make their business decisions.

Para 4.15 – 4.17
It suggested that the fact that some taxpayers are able to carry forward unused imputation credits to future years raises a question about whether it is "necessary to refund imputation credits". That is, the benefit is not lost rather it is a "timing" issue.

"Timing" is all important in tax matters, as is evidenced by the Government's harsh use-of-money rules in relation to provisional tax and the comments in the DD appear self serving. Further there is no guarantee that a particular taxpayer will actually benefit from these unused imputation credits in future years as they are converted to a loss and therefore are only of use if the taxpayer ends up in a tax paying position in future years.

As a general principle tax is calculated on an annual basis, which requires an end of year "square up" and we see no reason for any divergence from this general principle.

However in the "timing" becomes permanent for charities and taxpayers whose income earning process has ceased.

Para 4.30
Issues about "fairness" will not arise if a sound tax policy decision is made to refund tax credits to all resident New Zealanders.

Para 4.31
As noted above a policy decision needs to be made on how much tax non-resident shareholders need to pay on earning from NZ resident companies. At the present time they are discriminated against by not being able to use imputation credits and it is hard to see how this is exacerbated by NZ residents having credits being refunded to them. That is, the imputation system is already a domestic based system and discrimination already exists.

Para 4.32
Most non-income tax paying entities are involved with tax is some way whether as GST payers, PAYE payers etc so they are essentially "in the system". Therefore it should be a relatively simple matter to provide them with refunds of credits but even if there are practical barriers these "system" issues should not be allowed to stand in the way of principled tax policy decisions.

Conclusion
The need for anti-streaming rules will depend on policy decisions about the level of tax that taxpayers, residents and non-residents, should pay on dividend income received from New Zealand resident companies and how much that should be reduced by the company tax already paid. This may appear self-evident but there appears to have been little overt decision making about such issues. That is, it appears that the imputation credit system is a domestic based system which prima facie only has value for resident shareholders. However the FITC regime provides an "in substance" method by which non-resident shareholders may access imputation credits. Further if imputation credits were able to be refunded and the same "benefit" was obtainable by both residents and non-residents then there would appear to be little incentive to stream credits between shareholders. (Treat the cause rather than the symptom).

In terms of pure tax policy reasons it is clear to us that imputation credits should be refundable to non-tax paying entities. A policy decision has been made that these entities should not be subject to tax (a decision that has been reviewed many times) and they should not be subject to tax "via the backdoor".

Future there is no valid reason why imputation credits should not be treated the same as all other tax credits and refundable to taxpayers where they are in excess of tax to pay.

Should you wish to discuss any of the issues please contact me.

Kind Regards

Grant Thornton

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