

Submission

By



to the

Inland Revenue Department

on

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

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**STREAMING & REFUNDABILITY OF IMPUTATION CREDITS DISCUSSION
DOCUMENT
SUBMISSION BY BUSINESS NEW ZEALAND¹
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1. INTRODUCTION

1.1 Business New Zealand welcomes the opportunity to comment on the *Streaming & Refundability of Imputation Credits* discussion document (referred to as 'the document'). This document is essentially the first step down the path of assessing the nature and role of imputation credits in New Zealand. This is especially relevant given the recent announcements by the finance ministers of New Zealand and Australia concerning mutual recognition of imputation and franking credits for trans-Tasman investment being put back on the table for negotiation.

2. SUMMARY OF RECOMMENDATIONS

2.1 Business New Zealand makes the following **recommendations** with regard to the document, namely that:

- (a) ***The next round of consultation regarding imputation credit streaming and refundability includes one or more possible options going forward that submitters can provide views on (p.2);***
- (b) ***The Government continue to put equal emphasis on a process for imputation outcomes where mutual recognition does not occur. (p.3);***
- (c) ***The issue of differences in marginal tax rates be formally included as an issue that requires consideration when examining future streaming rule changes (p.4);***
- (d) ***Further investigations continue into replacing general rules associated with anti-avoidance with rules that target particular types of transactions and further consideration given to the possible adoption of Australian rules (p.6);***
- (e) ***Going forward, streaming of imputation credits is viewed as a higher priority than refundability (p.8).***

2.2 The document essentially asks for some specific comments relating to issues arising from changes that may occur regarding limited streaming of imputation credits and refunds of credits for tax-exempt entities. No doubt individual companies and groups directly involved with imputation credits will provide specific views on these matters. Instead, Business New Zealand wishes to briefly highlight some broad issues that IRD should take into account before any further steps are taken in what we see as a lengthy consultation process, as well as some more specific issues relating to streaming and refundability.

¹ Background information on Business New Zealand is attached in the appendix.

3. BROAD ISSUES

Setting the Tone for Future Progress

- 3.1 While IRD has provided a useful document to start the process of considering significant issues relating to streaming and refundability, the tone of the document comes across as emphasising risks, rather than opportunities.
- 3.2 The document outlines the Government's view that any future steps regarding imputation issues require a balancing act which involves:
- Ensuring imputation rules do not inhibit legitimate business transactions;
 - Retaining a system for taxing companies that is as close as possible to a fully integrated system;
 - Retaining a source based taxation system is retained; and
 - Reducing incentives for company tax to be avoided by continuing to tax resident shareholders on any unimputed dividends they receive.

The document also states that there is the opportunity for conflict between these objectives that would need to be fully resolved if any recommendations are taken forward. Business New Zealand agrees, as issues relating to imputation credits are often complex to say the least. Some significant conflict is likely, and priorities will need to be established early to guide submitters towards the outcomes Government believes will be more willing to accept.

- 3.3 Also, while Business New Zealand appreciates that the current document sets the scene for future work, it is perhaps unfortunate that there is little to examine in terms of a possible option to discuss. While we accept this may happen in the next round of consultation (provided there is enough support from submitters), the use of a "straw man" would at least have given submitters something to discuss in terms of advantages and disadvantages, and would have helped to guide the Government towards options it should or should not proceed with.

Recommendation: That the next round of consultation regarding imputation credit streaming and refundability includes one or more possible options going forward that submitters can provide views on.

- 3.4 Moreover, it would be fair to say that there is a healthy level of agreement amongst the business community towards reform in this area. However, the document spends a large amount of time looking at the tax avoidance issues and loss to the tax base. While any discussion document should examine possible threats, a truly balanced document should also look at the opportunities in terms of enhancing New Zealand's growth, something which seems lacking in the document provided. The sections below will provide some examples of not balancing out the issues, and Business New Zealand would be disappointed if the potentially long process was dictated by fear,

rather than best outcomes for New Zealand's competitiveness on a global stage.

Mutual Recognition

- 3.5 As stated in paragraph 1.20 of the document, *"a major issue which is outside the scope of this review is the possibility of introducing a system of mutual recognition of imputation and franking credits between Australia and New Zealand"*. The Australian Government has indicated that it has an 'open mind' towards an agreement of this kind, with the New Zealand Treasury invited to submit on its official review. A final report is expected at the end of 2009.
- 3.6 We agree with the views expressed by the New Zealand Government that for mutual recognition to proceed, complete harmonisation of New Zealand's and Australia's imputation systems would not be necessary, although alignment to the best level possible would be advisable.
- 3.7 However, it would be fair to say that although mutual recognition is now "back on the table", an end outcome that means it will actually eventuate will take a considerable amount of goodwill on the part of Australia, given the costs that country will incur on its introduction, compared with the benefits New Zealand is likely to receive.
- 3.8 Therefore, we would expect the Government to observe a certain level of pragmatism when examining the issue of refundability and streaming of imputation credits in relation to the broader issue of trans-Tasman mutual recognition. While Business New Zealand would expect the Government to put its best foot forward to ensure that mutual recognition occurs due to the significant benefits for the New Zealand economy (noted in paragraph 2.59 of the document), equal emphasis should also be put on imputation outcomes where mutual recognition does not occur, and what options are best going forward.

Recommendation: That the Government continue to put equal emphasis on a process for imputation outcomes where mutual recognition does not occur.

Marginal Tax Rate Differences

- 3.9 In various chapters of the document there are comments on issues relating to high differentials in tax rates that have a flow-on effect in terms of hampering the option of introducing further streaming provisions. In particular, paragraph 2.25 of the document states that *"It is an open question, however, as to how concerned we should be if shares are sold from one person to another on a different tax rate when there is only a minor difference in their rates. These concerns obviously become larger the greater the difference in tax rates or....if imputation credits can be refunded"*.
- 3.10 Generally, the document often states that the costs of change may be too high. The fact that the differential in tax rates plays such a prominent role lies at the heart of the inadequacy of New Zealand's tax system, given the fact we have not gone down the road of a broad based flat tax structure. If we had,

this would have largely eliminated many of the concerns in this area that have been raised. In particular, the increase in the top tax rate to 39% in 2000 created a sizable difference between that rate and the 30% tax rate applying to the second level of wage and salary earners, as well as the company rate and the Trust rate. While this issue is not within the scope of the document at hand, it nevertheless needs to be openly discussed as a significant block allowing streaming options.

- 3.11 In addition, it also needs to be pointed out that the recent introduction of the Portfolio Investment Entity (PIE) regime means the default portfolio rate of 30% takes away the issue of the 39% rate to some extent for many shareholders, thereby allowing more liberal streaming rules to be given consideration.

Recommendation: That the issue of differences in marginal tax rates be formally included as an issue that requires consideration when examining streaming rules changes.

Impact on Capital Markets

- 3.12 In relation to the issue of mutual recognition discussed above, the document points out in paragraph 2.54 that a number of more limited dividend steaming proposals have been put forward in the public arena by foreign owned companies operating in New Zealand as ways of developing and deepening New Zealand's capital markets. The document also states in the next paragraph that New Zealand's imputation system does provide incentives for New Zealand residents to invest at home rather than abroad since imputation credits are provided for domestic but not foreign taxes.
- 3.13 However, to take the view that because of the current home/away imputation credit system, the incentive to invest at home rather than abroad is in the best interests of New Zealand as a whole is an inadequate conclusion. While we would agree that domestic investment allows the Government the opportunity to receive taxes to pay for public services, on a micro basis a system that steers too far towards investment is more or less solely based on an inward looking agenda does nothing to spread risk or seek higher returns from the rest of the world for the individual investor. Given the lack of depth in the New Zealand market, those focusing investment on the companies available domestically will invariably have 'many eggs in a few baskets', which may prove problematic if these companies were to strike financial problems.
- 3.14 The current turbulent financial crisis in the USA has seen significant and well established companies essentially lose their share values overnight, to the detriment of shareholders. Shareholders in the USA typically have an inward looking focus regarding investment, but have a substantial number of companies to invest in, thereby being better able to spread risk. Hence, given New Zealand's shallow market depth, a similar crisis would result in a far worse outcome for the investments held by many New Zealanders.
- 3.15 Last, we believe that the introduction of KiwiSaver with its significant uptake also needs to be factored in to concerns about a move away from domestic

investment to offshore investment via limited streaming proposals. A large number of New Zealanders now have funds they might otherwise have spent on goods or services (thereby attracting a final tax via GST) directed towards investments locked in for a considerable number of years. From these investments the Government will receive an ongoing stream of tax revenue from the years in which there are positive returns. Allowing limited dividend streaming might mean some funds are invested elsewhere, but the additional tax revenue from KiwiSaver will provide a significant buffer to allay concerns.

4. STREAMING OF IMPUTATION CREDITS

Anti-Streaming Rules - Outlining their Current Needs

- 4.1 The document devotes an entire chapter (chapter 2) to examining the issue of what streaming is and why current rules are in place to prevent it. Chapter 3 then considers the current rules on streaming and seeks views on whether these create significant costs or uncertainties for business.
- 4.2 As discussed in 3.1 and 3.2 above, when reading these two chapters the push to 'do nothing' seems strong when it comes to the introduction of regarding possible limited streaming options. While we assume that other submitters who are acutely aware of streaming barriers will provide views on this or later discussion documents, from Business New Zealand's point of view there are some issues that the Government may want to consider that lessen the fear and promote the opportunities.
- 4.3 First, we are not convinced that allowing some form of streaming will cause a knee-jerk change in the basic structures of businesses for tax efficiency purposes. Paragraph 2.13 in the document postulates that assuming one company is owned by a resident and the other by a non-resident, allowing streaming would create an artificial incentive for these firms to merge so that imputation credits could be streamed to the resident shareholder, who is best able to use them. The merging of firms is without significant cost in itself, but the long-term implications in terms of risk and company performance may outweigh any moves to attain further tax efficiency.

Fiscal Cost of Allowing Streaming

- 4.4 Chapter 2 also examines the cost to the tax base of allowing unlimited streaming, putting it at (a very) rough figure of \$3.2 billion given unlimited streaming would effectively allow domestic company tax to be refunded to non-resident shareholders. The document points out that a decrease in revenue of anywhere near that proportion would not be contemplated.
- 4.5 Domestic costs are also estimated in the document. As mentioned above, one of the key drivers for 'costs' from the Government's point of view is partly the consequence of the high differentials in marginal tax rates, although in reality these would be much less than for the non-resident group. Last, there could also be one-off costs resulting from the creation of opportunities for this income to be passed to new shareholders on lower tax rates.

- 4.6 However, what seems to be missing from this examination of total fiscal cost is that imputation credits reflect tax already paid. Therefore, there is no cost to existing Government revenues.

Australia's Anti-Streaming Rules

- 4.7 Chapter 3 of the document includes an outline of New Zealand's current anti-streaming rules, and asks about the level of concern in regards to the existing rules. Also, it asks whether there should be any moves towards making the rules more consistent with Australia, especially given the separate investigation into trans-Tasman recognition also underway.
- 4.8 The document rightly points out that, "*any consideration of moving towards the Australian rules, however, should recognise New Zealand's different tax environment*". A sticking point will obviously be the lack of a capital gains tax on the sale of shares in New Zealand compared with Australia, which would lead to significant integrity measures (i.e. stronger anti-streaming rules) to avoid any unintended manipulation of the rules.
- 4.9 In the interests of possible moves towards mutual recognition, the adoption of certain rules from Australia for consistency would certainly not be out of the question from Business New Zealand's point of view. This is especially when there are precedents to see how the rules in Australia have worked out to ensure their policy aims have been achieved. However, as always, a high level of care needs to be taken when looking to transfer the particulars of one regime to another, given the different mix of policy settings that is part of any economy.
- 4.10 Regarding general anti-avoidance rules, previous comments from the private sector have focused on interpretation difficulties for both taxpayers and IRD, especially when the taxpayer(s) take the view that the arrangements in question have legitimate commercial purposes. Overall, there is currently too much confusion, as well as a degree of inflexibility with the current rules.
- 4.11 The document proposes two general solutions. One involves replacing the general rules with rules that target particular types of transactions. We believe this has merit, and should be investigated further. The other option is to adopt some of the Australian provisions which, as stated above, should be approached with caution. Weighing up the cost of adopting any Australian approaches against the possibility of mutual recognition in the future will require careful balancing.

Recommendation: That further investigations continue into replacing general rules associated with anti-avoidance rules that target particular types of transactions continues. Also, possible adoption of Australian rules is further considered, although coupled with caution.

5. REFUNDABILITY OF IMPUTATION CREDITS

- 5.1 The other major element of the document relates to the issue of refund rules, given that the current imputation rules do not provide refunds for imputation credits that cannot be used. This typically applies to tax-exempt organisations such as charities.
- 5.2 However, as outlined in the document, any possible changes in this area may provide more problems than solutions. One issue relates to the 'fiscal cost' of refundability, which is estimated to be \$400 million based on the 2006 and 2007 income years.
- 5.3 The second issue relates to 'fairness', whereby if final policy decisions are made that take into account tax planning and/or fiscal cost, decisions in terms of including/excluding persons or organisations from any refund mechanism will add complexity to any rules compiled. There are also issues regarding discrimination. Business New Zealand agrees. An important aspect of any scheme will be ensuring its simplicity, and minimising complexity to make easy compliance possible. Given a number of tax exempt organisations, and in particular charities, do not have adequate resources to comply with often complex tax structures, there may be a gap that cannot be filled or paid for.
- 5.4 However, of potentially greater importance will be the discrimination factor. At worst, this could become a substantive issue not only for IRD, but also for the relationship between tax-exempt persons or organisations that find themselves on either side of the eligible refunding criteria.
- 5.5 At a practical level, it is also important to note that current rules provide tax exempt organisations such as charities with the incentive to choose investments that pay a before-tax return (i.e. interest) instead of investments that provide an after tax return, such as dividends. Although this will not be the case in every instance, many charities typically take a risk averse position by default. Therefore, the issue may not currently be so significant for charities as to warrant the potential costs outlined.
- 5.6 From a best principles point of view in terms of policy, if there is to be full integration at the marginal tax rate of the shareholder then all imputation credits should be refundable. However, the justifications for exemptions may create problems significant enough to limit any further progress in this respect.
- 5.7 While Business New Zealand is sympathetic to the issue of tax-exempt persons and organisations, the problems associated with providing some form of refundability may be significant. Instead, going forward, we would want streaming of imputation credits to be the higher priority.

Recommendation: That going forward, streaming of imputation credits is viewed as a higher priority than refundability.

APPENDIX

6. Background Information on Business New Zealand

- 6.1 Business New Zealand is New Zealand's largest business advocacy organisation.
- 6.2 Through its four founding member organisations – EMA Northern, EMA Central, Canterbury Employers' Chamber of Commerce and the Otago-Southland Employers' Association – and 70 affiliated trade and industry associations, Business NZ represents the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.
- 6.3 In addition to advocacy on behalf of enterprise, Business NZ contributes to Governmental and tripartite working parties and international bodies including the International Labour Organisation, the International Organisation of Employers and the Business and Industry Advisory Council to the Organisation for Economic Cooperation and Development.