Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

Release Document

September 2018

taxworkingroup.govt.nz/key-documents

This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Appendix 3: New Zealand's imputation system

Background Paper for Sessions 6 and 7
of the Tax Working Group

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The Tax Working Group will release its interim report containing its recommendations in September and the views of the Group will be informed by public submissions alongside Secretariat advice.

March 2018

Prepared by the Inland Revenue Department and the Treasury

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Executive Summary

New Zealand has had an imputation system since 1988. Imputation links the taxation of companies and their shareholders. It avoids double taxation of income earned through companies as compared to the same income earned directly. Tax paid at the shareholder level on dividends recognises the taxes that have been paid at the company level. When dividends are paid, it applies the personal tax rates of shareholders to the underlying income earned in the company. Imputation also removes biases that formerly existed under the classical tax system. Under a classical tax system, dividends are fully taxed when received by shareholders. There is no account of tax already paid at the company level.

Internationally, there has been a move away from imputation systems. Australia, which has an imputation system similar to New Zealand's, is considering whether globalisation undermines the rationale for imputation.

The paper provides background on imputation and discusses the implications of an open economy on it. The paper also considers replacing imputation, on the one hand, with a return to a classical tax system; and, on the other, a move to full integration.

Key questions for the Group are:

- Is imputation still a good tax system for New Zealand?
- Do they share Australia's concerns about globalisation and, if so, would they wish to examine any alternatives to imputation?
- Do they believe that either a classical system or full integration should be examined further?
- Are there other issues concerning imputation that the Group would like to have examined?

1. Introduction

1.1 Purpose

1.1.1 Imputation has been central to New Zealand's tax system since its introduction in 1988. The aim of this paper is to provide a concise overview of the key features of the imputation system and its main alternatives by drawing from previous reviews in New Zealand, and the imputation experience globally.

1.2 Content and scope

1.2.1 In order to achieve this outcome, the paper follows the following structure:

- Part one will give an overview of imputation, its purpose, a summary of the findings of past reviews of imputation, and the international experience;
- Part two considers issues with imputation that arise when investments can be made across borders;
- Part three will evaluate whether a return to a classical tax system would be a way to improve the fairness of the tax system.
- Part four examines whether a full integration system would be a viable alternative to imputation.

1.2.2 Imputation has particular relevance to the taxation of closely-held companies. A separate paper analyses issues specific to such companies.

2. The imputation system

1.2.3 Imputation was introduced in 1988 to ensure that, as much as possible, income earned by New Zealanders was taxed at their personal tax rates and that people could not use entities to shelter income from higher rates of personal income tax. Imputation was an important part of a move to try to make tax much less a driver of business decisions, and is still a key part of New Zealand's broad base low rate (BBLR) policy framework.

1.2.4 At the same time as the imputation system was introduced, the gap between the company and top personal income tax rate was closed. In 1987, the company tax rate was 48% while the top personal tax rate was set at 57%; further reform saw the top personal tax rate reduced to 48%, equal to the company tax rate. Rate alignment was designed to remove any scope for companies to be used to shelter income from higher rates of personal tax. By paying dividends companies could ensure that shareholders on lower marginal tax rates were not overtaxed.

1.3 How does imputation work

1.3.1 As income is earned in a company, it is taxed at the company tax rate. When a dividend is distributed it is taxable at the personal level. In order to prevent double taxation, an imputation credit equal to the company tax paid is deducted from the personal taxes that would have been paid on the underlying income. The net personal tax is equal to the difference between the personal and company tax rates applied to the underlying income. If the company tax rate exceeds the personal tax rate then the credit can be used to reduce taxes owing by the shareholder provided that the shareholder has other income. If the company tax rate is less than the personal tax rate of the shareholder, the shareholder must pay the difference. If no taxes have been paid in the company on the underlying income, then full personal tax rates apply.

1.3.2 As an illustration of how imputation works, the table compares the amount of taxes payable on $100 earned directly with $100 earned through a company, assuming that the shareholder is taxed at the top 33% tax rate.

	Earned directly	**Earned through a company**
Income	100	100
Company Tax	..	28
After-tax income (Company)	..	72
Dividend	..	72
Grossed up dividend	..	100
Personal tax on dividend	..	33
Imputation credit	..	28
Net personal tax	33	5
After-tax income (Individual)	67	67

- When income is earned directly, tax is paid at the marginal tax rate of the individual (here assumed to be the 33% top rate);

- When the same income is earned through a company, tax of $28 is paid by the company, leaving $72 of after-tax income.
- When the after-tax income is paid out as a dividend, it is taxed at the personal tax rate of the individual. The dividend of $72 is grossed up by the imputation credit of $28 (which equals the tax paid by the company on the income). The personal tax rate is applied to this amount, for $33 of personal tax. The imputation credit of $28 is deducted from this amount leading to a net $5 of personal income tax being paid. In total the same amount of tax is paid in both situations with the same net income.

1.3.3 In effect, imputation means that the personal tax rate replaces the company tax rate (it may be higher or lower); and, income that is not taxed at the company level is taxed when it is received by the shareholder. These effects are deferred until the income is paid out as a dividend.

1.4 Comparison of the classical system and imputation

1.4.1 The imputation credit system replaced the classical company tax system in New Zealand. A classical tax system taxes income earned through companies twice; first when companies are taxed and then a second layer of personal tax when profits are distributed to shareholders. Imputation instead works to tax company profits only once, at the marginal rate of the investor. This single layer of taxation is achieved by attaching "imputation credits", representing company tax already paid, to dividends paid out to shareholders. The credits can then be used to reduce the personal income tax liability of the shareholder. In this sense, company tax can be thought of like a withholding tax for New Zealand resident shareholders.

1.4.2 To understand how this works, consider the following simple example illustrating the operation of a classical system versus a full imputation system. Assume a New Zealand company earns $100 of profit in an income year. It is subject to company tax at 28% under both systems. However, when the after-tax profit of $72 is distributed to shareholders, (assumed in the example to be taxed at 33%), the dividends are treated differently.

	Classical system	**Imputation system**
Income	100	100
Company Tax	28	28
After-tax income (Company)	72	72
Dividend	72	72
Grossed up dividend	..	100
Personal tax on dividend	24	33
Imputation credit	..	28
Net personal tax	24	5
After-tax income (Individual)	48	67

- under a classical system, the dividend is subject to full tax at the shareholders' marginal tax rate of 33%, so a further $24[1] of tax is paid for a net return of $48;
- under a full imputation system, the grossed up dividend (i.e., the dividend plus the imputation credits which equals the pre-tax income of the company) is subject to tax at the shareholders' marginal tax rate; in the example, $33 of tax; however a $28 imputation credit reduces the shareholders' tax liability to $5; so that the net return to the taxpayer is $67, the same as if they had earned the $100 of income directly.[2]

1.4.3 Imputation was designed to reduce the distortions that a classical system can generate. These distortions include:

Distortions to forms of business organisation

1.4.4 Under a classical company tax system there can be major biases over forms of business organisation. For example, in the example provided earlier with a company tax rate of 28% and a personal tax rate of 33%, there was a 52% effective tax rate when a company earns income if the profit is being fully distributed as dividends. This means that an investor would have substantial incentives to earn income directly through an unincorporated enterprise rather than earning income through a company even if there were some real commercial benefits from using a company such as limited liability. Full imputation with close alignment of the company rate and top personal marginal tax rate means that there is little tax difference in earning the income through a company or directly.

Distortions to form of finance

1.4.5 Under a classical system, there is a bias between equity and debt finance. Full imputation means that company income is taxed once at the investor's personal tax rate irrespective of whether the company is financed by equity or debt. There is great simplification achieved by avoiding the need to characterise financial instruments as debt or equity.

Distortions to company retention and distribution decisions

1.4.6 A classical system provides a bias favouring retention of profits in an existing company, ahead of the profits being distributed and reinvested in more productive new firms. Full imputation, even with a gap between the top company and personal income tax rates, helps reduce this bias. Rate alignment would eliminate it entirely.

1.4.7 The biases outlined above alter the way income is earned (through a company or directly; as interest or dividends) or the way capital is deployed, simply to

[1] Figures rounded to nearest dollar; 33% of $72 is$ 23.76.

[2] The effect depends upon the marginal tax rate of the shareholder. If the shareholders' marginal tax rate is higher than 28%, then the shareholder must pay the difference. If the shareholders' marginal tax rate is lower than 28%, the imputation credits can be used to offset tax on other income. Any excess imputation credits are, as a tax credit or as a converted loss ,carry forward to future years.

achieve advantageous tax treatment. These distortions incur unnecessary transaction costs or prevent the allocation of capital to its most productive use. This represents a deadweight cost to the economy. The design of the tax system should seek to minimise these biases wherever possible. As such, the shift to full imputation was aimed at reducing all of these biases.

1.4.8 While New Zealand's company and top personal tax rate are no longer aligned, biases to choice of business organisation, debt and equity decisions, and portfolio choice are likely to be smaller than they would under a classical company tax system.

Avoidance and complexity

1.4.9 On its face a classical system appears to be simpler than an imputation system. Imputation requires the tracking of imputation credits across years and through chains of companies. Complex rules are required to prevent the trading in unused tax credits. No such record-keeping exists for a classical tax system.

1.4.10 On the other hand, a classical tax system invites arrangements to avoid taxation of dividends. These schemes, some of which are described in the paper on Dividend Avoidance, can be very complex to implement and to prevent. Arguably a classical system would only be possible if full capital gains taxation were implemented, even though that would not deal with all of the problems.

1.5 Previous reviews in New Zealand

1.5.1 Reviews of New Zealand's imputation system have lent support for its retention.

Capital Market Development Taskforce (CMDT)

1.5.2 A 2009 paper to the CMDT explicitly considered whether it would be better to shift away from full imputation to a classical system in order to make New Zealand a more attractive investment destination. The analysis found it would arguably impede the development of domestic capital markets, boost taxes on domestic residents investing in domestic companies and increase taxes on the distributed earnings of non-residents outside of treaty partner countries. It would also result in double taxation as there would be no relief for individuals for tax paid at the company level. At the same time this shift was estimated to allow only a minor reduction the company tax rate of 2% to 4%.

VUW Working Group

1.5.3 The VUW Working Group review considered the advantages and disadvantages of a classical system combined with a reduction in the company tax rate as part of its final report. Overall, the VUW Working Group concluded that the classical system would pose risks to the integrity and fairness of the tax system and recommended the retention of imputation.

EY imputation survey

1.5.4 Support of imputation has also come from the private sector. Accountancy firm EY published a 2015 study that found imputation encourages tax payments in New Zealand and discourages tax avoidance.[3] It was stated that there is

[3] EY (2015), *'Imputation and the New Zealand Dividend Psyche'* at pg. 55.

"overwhelming support" for the imputation system from both corporates and investors because it lowers the cost of capital and is considered to be fair and equitable.[4] The study considered that removing imputation would likely have a significant impact on capital markets, by discouraging domestic investors who could be influenced by a higher effective tax rate and the expectation of smaller dividend pay-out ratios. It argued that, overall, businesses could face difficulties accessing capital.

1.6 Imputation in other counties

Australia's review of imputation

1.6.1 Recent reviews in Australia have suggested that at some stage Australia should consider replacing its imputation system. While Australia's 2015 *"Re:think"* tax discussion paper recognises the value imputation has in removing double taxation and in supporting the integrity of the business tax system, it considers that it makes little contribution to attracting foreign investment into Australia. The role of foreign investment in an open economy is an important issue that is discussed in greater detail in the following section. The revenue and compliance costs of imputation were also considered to be reasons why Australia might want to remove imputation, particularly as the authors considered other jurisdictions achieved similar outcomes using alternative systems.[5] Despite this analysis Australia still has imputation.

1.6.2 The Australian imputation system has a key difference to the current New Zealand system in that imputation credits are refundable credits. For those recipients who are unable to utilise those credits a refund is available. The interplay between the imputation regime and the Australian superannuation rules result in most superannuation funds being refundable to the funds. We understand that this creates integrity issues for the Australian system. These issues primarily arise from the concessionary treatment that superannuation funds enjoy in Australia (primarily being a lower tax rate).

1.6.3 In New Zealand these integrity issues do not arise which makes New Zealand's imputation system more robust and less susceptible to abuse than Australia's.

1.6.4 The implications for New Zealand of the Australian analysis are discussed in greater detail below.

The rest of the world

1.6.5 Many countries provide relief on taxation of dividends to relieve double taxation. It is not uncommon for countries to maintain a form of imputation system – Australia, Chile, Canada, Malta, South Korea and the United Kingdom are examples of countries who do this. Often alternative approaches to relieving the double taxation associated with a classical system are utilised by countries instead of imputation. Examples of these include:

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[4] Ibid.

[5] The Australian Government the Treasury (2015), '*Re:think – Tax discussion paper*', The Australian Government at pg. 73.

- offering shareholder relief through dividend taxation at preferential rates (Japan, Denmark, Poland, Portugal, Spain, Switzerland);
- taxing only a portion of the dividend in the hands of the shareholder (France, Finland, Italy, Luxembourg, Turkey);
- exempting dividends (Estonia, Slovak Republic); or
- exempting the risk free return (Norway).[6]

1.6.6 There has been a shift away from full imputation, particularly within European countries. Notable examples include the United Kingdom (1999), Ireland (1999), Germany (2001), Singapore (2003), Italy (2004), Finland (2005), France (2005), Norway (2006) and Malaysia (2008).

1.6.7 The compelling consideration for EU countries in moving away from imputation was a judgement by the European Court of Justice that imputation systems providing tax credits only to domestic investors are discriminatory. The European Union Single Market rules require that treatment of foreign investors be non-discriminatory.

1.6.8 Generally, countries have removed imputation as one part of a wider reform of corporate taxation. Singapore, for example, reformed its company tax system in reaction to high unemployment and the general impacts of recession on the economy and part of this reform was to remove imputation.[7] The particular reason provided for the removal of imputation credits was that doing so would encourage the use of Singapore as an investment hub and generally reduce compliance costs.

1.6.9 Often corporate tax reforms have included a reduction in company tax rate as part of the same package that removes imputation (e.g., in the case of Germany[8], Finland[9] and Singapore[10]).

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[6] The Australian Government the Treasury (2015) at pg. 85.

[7] Ministry of Trade and Industry (2002), *'Restructuring the tax system for growth and job creation'*, Report of Economic Review Committee, Singapore.

[8] Endres, D and Oestreicher (2000), *'2001 tax reform in Germany – Planning for a new era'*, Intertax, vol. 28, pp. 408-422.

[9] Hietala, H and Kari, S (2006), *'Investment incentives in closely held corporations and Finland's 2005 tax reform'*, Finnish Economic Papers, vol. 19, pp. 41−57.

[10] Above, n 7.

3. Imputation in an open economy

1.6.10 It is fair to say that much of the analysis that led to the introduction of an imputation system in New Zealand was based upon considerations related to domestic investment. Australia has recently questioned whether imputation remains an appropriate policy when considerations of international investment are taken into account.

1.7 Australian review

1.7.1 In an increasingly globalised economy, the Australia review, Re:think[11], has questioned whether the complexity of imputation is warranted given concerns that it may not increase investment and therefore productive capacity. Basically the argument goes as follows.

1.7.2 In a capital importing country such as New Zealand, where domestic savings fall short of domestic investment opportunities, the rate of return in the economy is the rate required to attract sufficient foreign investment to fill the gap. Foreign investors make up any deficiency between the savings of domestic savers and the level of investment in the economy. Consider the following example.

1.7.3 Suppose that foreigners demand a fixed rate of return, say 10% on their capital and that foreigners are marginal investors into New Zealand companies. New Zealand is a net capital importer and at the end of the day it won't be able to attract foreign investment unless it provides foreign investors with comparable returns to what they could obtain from investing in other countries. Suppose the comparable return is 10%.

1.7.4 In the absence of any taxes in New Zealand, corporate investments would need to be earning 10% at the margin, to be attractive to foreigners. If, there were profitable investment opportunities earning more than 10%, they would willingly be funded by foreign investors and investment opportunities earning less than 10% could not obtain funding. Moreover, the price of company shares would be determined by what foreign investors demand. A company that was expected to generate revenue of $100 per annum would be worth $1,000.

1.7.5 Because this is the return that foreigners require and because foreigners are the marginal investors, domestic residents investing into New Zealand companies would also obtain a 10% return on their investments before any personal tax. If the government wants to impose a tax on domestic investors of 33% at the personal level (and to make this concrete suppose dividends are taxed at this rate and New Zealand companies are paying out all of their profits in dividends) then New Zealand investors would earn a 6.7% after-tax rate of return on their domestic shares.

1.7.6 Now suppose that the government introduces a 28% company tax rate and has a full imputation system so that domestic residents but not foreign residents obtain imputation credits for company tax that has been paid. In this simple story, the rate of return that New Zealand firms would need to generate would have to

[11] The Australian Government the Treasury (2015), ibid.

climb sufficiently to appease the marginal foreign investors. A marginal investment would now need to earn a pre-tax rate of return of 13.9%. After company tax is levied on this, the after-tax rate of return would be 10% and so investment into New Zealand would continue to provide foreign investors with comparable returns to investing into other countries. Now a company that earned $139 per annum pre-tax would be earning $100 per annum after-tax and be attractive on the margin to foreign investors.

1.7.7 What about New Zealand capital owners? Normally it would be thought that company tax might be a way of taxing New Zealand capital owners who invest into companies. But here we find a result that might at first be surprising. Because the pre-tax rate of return on corporate investments has been driven up to 13.9% and because we have a full imputation company tax system, increasing the company tax rate will be making New Zealand shareholders into New Zealand companies better off. Now New Zealand shareholders will be earning a 9.3% after-tax rate of return on their investments into New Zealand companies. Raising the company rate from 0% to 28% makes New Zealand shareholders better off by raising their after-tax returns from 6.67% to 9.3%. Rather than the company rate leading to higher taxation of domestic capital owners it provides a subsidy.

1.7.8 An interesting question is how this result would change if, instead, New Zealand had a classical company tax system (and no NRWT on dividends). With a zero company tax rate, the pre-tax rate of return on New Zealand companies would be 10% as earlier and New Zealand shareholders would be earning 6.7%. As before a 28% company rate would raise the pre-tax rate of return on corporate investments to 13.9% which would leave a 10% net of company tax rate of return. Under a classical system, when dividends are paid, they are fully taxed, so the 10% dividend becomes 6.7%, after applying the 33% personal tax rate. But now (once more assuming all profits are paid as dividends), the after-tax rate of return to domestic shareholders would remain at 6.7%. Company tax would be levied without subsidising domestic savers who hold shares in domestic companies.

1.7.9 In this case, imputation provides a "savings incentive". Imputation raises the rate of return to domestic savers, with no increase in investment. At most there may be a shift toward more domestic ownership.

1.7.10 Viewed from this perspective, "double taxation" of company income does not deter investment and imputation may reduce the efficient allocation of domestic savings, by providing an incentive to invest in domestic shares rather than alternative instruments.

1.7.11 Following from these observations, the Australian review noted that one possibility would be to eliminate imputation (i.e., return to a classical system) and use the funds saved to reduce the company tax rate. The separate question of whether a return to a classical system (without a company tax rate cut) might be fairer is examined in the next section.

1.7.12 In our view the results are likely to be much too strong. Exactly the same logic would say that the pre-tax rate of return in Australia would be driven up by its company tax rate. Because New Zealanders get credit for New Zealand taxes

but not Australian taxes, the model would suggest that no New Zealanders should be investing into Australia companies and no Australians would be investing into New Zealand companies. This conflicts with the facts. In our view the model might be plausible if returns from shares could be predicted in advance with a high degree of certainty so shareholders could know what the future returns would be (as was assumed in the story given above). The model is much less likely to be plausible in practice given the real uncertainties around returns on shares. The model might also be plausible, if the large bulk of shares in domestic companies were owned by foreigners but is much less likely to be plausible when New Zealanders are also major investors.

1.8 VUW Working Group review

1.8.1 The VUW Working Group review considered the advantages and disadvantages of a classical system combined with a reduced rate of company tax. In that regard is should be noted that eliminating imputation only funds a relatively small company tax rate reduction, in the order of two to four percentage points. The review noted that eliminating imputation while cutting the company tax rate could attract foreign capital and boost labour productivity, while continuing to tax domestic workers and savers at higher personal rates.[12]

1.8.2 However a significant list of disadvantages, (discussed in greater detail below), was also identified, including:

- double taxation;
- higher tax rates on domestic investors;
- reduced incentives to save;
- reduced capital flow to SMEs and increased incentives to invest in assets such as housing;
- biases in entity and financing;
- a requirement for more anti-avoidance measures; and
- administration complexities.[13]

1.8.3 Overall, the VUW Working Group concluded that the classical system would pose risks to the integrity and fairness of the tax system and would be likely to increase administration costs.

1.9 Other considerations

1.9.1 A key question is whether or not we should think of foreign equity investors as being the marginal investors for all segments of the economy. Do they set the rate of return in the New Zealand economy? One way to address this issue is to look at the value that arises for imputation credits that are attached to dividends that are distributed. There have been a number of studies on the issue with a range of results. The EY study (2015) surveyed these studies and the opinions of firms and investors and concluded that credits had a value of 50 to 60% in

[12] Victoria University of Wellington (2010) at pg. 40.

[13] Ibid, at pg. 41.

Australia.[14] The survey results suggested that the value in New Zealand might be somewhat higher, in the order of 70%.

1.9.2 The results are likely to differ by firms. For some New Zealand firms, with an international presence and perhaps listing on foreign stock exchanges, non-resident investors are likely to be an important part of their shareholder base and might in some instances determine their share price and cost of capital. However, for smaller, more local firms, access to local capital may be more critical. For closely-held companies, with a direct relationship between shareholders and their companies, the principle of a single layer of taxation would be very important.

1.9.3 Foreign direct investment (FDI) in New Zealand equity and investment fund shares was $71 billion in 2017. To the extent that FDI is into companies owned entirely by foreigners required pre-tax rates of return derived by these companies are unlikely to depend much on whether New Zealand has a classical company tax system or an imputation scheme (at least if there is no levying of NRWT under a classical company tax system). Portfolio investment in equity and investment fund shares totalled $39 billion.[15] On the other hand, New Zealand households hold some $121 billion in listed domestic shares, with a further $62 billion in investment funds. A further $201 billion is invested in owner-operated businesses.

1.9.4 The key thing is that the large majority of other businesses in New Zealand will not be listed or will be dependent upon local capital sources. In these circumstances, foreign investors are unlikely to be the marginal investors in these firms. Given the current degree of internationalisation of the New Zealand economy, we do not believe that the Australian concerns described earlier provide good grounds for New Zealand to move back from a full imputation scheme to a classical company tax system

1.9.5 There are other important benefits from imputation. It removes a number of biases. Starting businesses can use the company form without incurring an extra layer of taxation. The incentives to issue debt and equity are equalised, and there is a greater incentive to distribute retained earnings to the extent that this is efficient, so freeing up capital.

1.9.6 As the EY survey indicated, New Zealand businesses certainly believe that imputation is important to them.

1.9.7 This discussion should be seen in the context of the paper on closely-held companies. That paper outlines two possible directions for change. One seeks to shore up imputation for such companies. The second introduces a regime closer to full integration for such companies.

1.9.8 If we attempted to have a classical company tax system for widely-held companies (perhaps those listed on the NZX while allowing closely held businesses to have a more integrated option), there could be some important

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[14] EY (2015), *'Imputation and the New Zealand Dividend Psyche'* at pg. 54.

[15] Stats NZ (2017), *'Balance of Payments and International Investment Position - information releases'*, Stats NZ <http://archive.stats.govt.nz/browse_for_stats/economic_indicators/balance_of_payments/info-releases.aspx>.

fairness and efficiency concerns arising because of the different tax treatments of these different entities. It could, for example, become unattractive for a firm to list on the NZX even if that would be sensible as a way of raising additional capital.

4. A classical tax system and progressivity

1.9.9 A return to a classical tax system, without a cut in the company tax rate could be considered to be a way of increasing the progressivity of the tax system.

1.9.10 Certainly, dividends are concentrated at higher income levels. Individuals earning over $500,000 per year, who receive dividends, receive some $340,000 on average. On the other hand, dividends are received across the income scale.

1.9.11 Switching back to a classical company tax system would not be an effective or consistent way of increasing the progressivity of the tax system. It would increase progressivity for those who end up being double taxed on company earnings but there would be many ways of avoiding this double layer of tax.

1.9.12 For closely-held companies, which are likely to be the source of the larger dividend receipts, there are other ways of ensuring a single layer of tax on company profits such as shareholder salary and bonuses or debt financing. Thus a classical system would not be effective in increasing their tax payable.

1.9.13 The conclusions of the VUW Working Group, that imputation is to be preferred to the classical system, are equally relevant in this situation.

1.9.14 Double taxing income earned through companies would distort the allocation of savings to the extent that domestic shareholders bear a part of the company tax. Thus it is likely to be inefficient.

1.9.15 In sum, reintroducing classical taxation could significantly impair efficiency without being a good way of increasing progressivity.

1.9.16 An increase in personal tax rates is outside the terms of reference for the Tax Working Group but this would be a much more coherent alternative than switching back to a classical company tax system.

5. Full corporate-personal income tax integration

1.9.17 Many discussions of aligning company and shareholder taxation start with a discussion of full integration. Under full integration, income earned in companies is taxed as if it had been earned directly by shareholders. That is, it is taxed at the shareholders' progressive tax rates. Dividends paid out of that income would not be subject to tax.

1.9.18 Imputation, by contrast taxes the incomes at the company tax rate as it earned. When it is distributed as a dividend, the amount of tax is "corrected" to apply personal tax rates of the shareholders to the underlying income. In addition, unimputed income is subject to full personal tax rates.

1.9.19 As a consequence full integration and imputation can have significant differences in application in particular circumstances.

1.9.20 Full integration might be thought to be a way of responding if future governments want there to be a greater gap between the company tax rate (which under a full integration approach would apply only to foreigners) and the top personal margin tax rate. It would be a means of ensuring New Zealand-owned companies continue to pay full New Zealand rates of tax

1.10 Previous reviews and studies

1.10.1 Integration has been advocated by a number of historic reviews including in Canada (1966), the United States (1977) and Australia (1983) but no country has ever implemented a fully integrated system. (A number of countries, including New Zealand, have special regimes for closely-held companies that have a form of full integration.).

1.10.2 A full integration system for New Zealand was explored prior to the introduction of imputation[16]. Since then there have been no reviews that have considered an integrated tax system mainly due to the support that the current imputation regime has received[17].

1.10.3 The work in New Zealand concluded that a system of full imputation was preferable to full integration on practicability grounds. Technology has significantly improved from those years which might help with some of the practical problems but the issues with full integration may still be prohibitive.

1.11 Differences between imputation and full integration

1.11.1 When imputation was introduced it had a number of differences from full integration that went beyond the difficulties in tracking individual shareholder tax rates. These differences were the result of explicit policy decisions.

1.11.2 There are four main differences between our current imputation system and a fully integrated system:

[16] "How to Integrate Company and Shareholder Taxation – Why Full Imputation is the Best Answer", Benge and Robinson, Studies in Taxation Policy, Institute of Policy Studies, Victoria University of Wellington, 1986.

[17] Most recently Matt Woolley, the co-recipient of the Robin Oliver scholarship for 2018, explored the issue as part of his research paper and we understand he will be separately presenting this to the Group in a later meeting.

- Under imputation, company tax rates apply to income until it is distributed to shareholders. Under full integration, personal tax rates apply as the income is earned in the company;
- Non-taxable income cannot be passed out to shareholders tax free under the imputation system – this includes capital gains, foreign active income, and other differences between economic income and taxable income;
- Losses made by an entity cannot be used by the investors. These losses are ring fenced to the entity and can be carried forward to future years, subject to various restrictions designed to ensure that those investors who suffered the loss will get the benefit of it; and
- Exempt taxpayers are unable to benefit from imputation credits and thus a level of taxation will apply to these otherwise exempt entities – the main issue lies with charities that have investments in companies.

1.11.3 In principle, the application of personal tax rates as income is earned would be an advantage of integration. This would prevent higher income earners from using companies to shelter their incomes from higher rates of personal tax. When imputation was introduced, the issue did not arise. The company tax rate was equal to the top personal tax rate. If shareholders were on lower tax rates, bonus issues would allow shareholders to have their tax rates apply to the income.

1.11.4 Problems have arisen since tax rates have diverged, particularly for closely-held companies. These issues are explored in detail in the paper on the taxation of closely-held companies.

1.11.5 The principal reasons that pass-through of preferences was rejected were:

- The full taxation of unimputed dividends (out of income that had not previously been taxed) reduced the incentives for companies to avoid or evade tax; and
- The clawing back of tax preferences such as the active income exemption and foreign tax credits was seen as providing incentives for offshore investment that were better aligned with the national interest.

1.11.6 The non-pass through of losses is a consequence of the use of the corporate form and the assumption that companies and their shareholders are separate taxing entities, rather than a function of imputation *per se*. A key reason not to pass out losses is to prevent the trading of losses and loss tax sheltering. It has the effect of restricting loss use to the income from the business. The issue is closely related to the issue of the refundability of losses which raises significant economic and base protection considerations.

1.11.7 The changes to the pass-through of preferences raise significant issues that would require analysis if full integration were to be considered.

1.12 Current integrated entities

1.12.1 New Zealand currently has a number of entities that have characteristics of full integration with their owners and those are:

- look through companies (which are treated as partnerships for tax purposes); and,
- portfolio investment entities (although the investor's tax rate is capped by the company tax rate).

1.12.2 Māori Authorities also have a partially integrated system which uses a reduced tax rate (17.5%) that attempts to approximate the marginal tax rate of the iwi members but a top up on distributions may be required by those on a higher marginal rate.

1.13 Forms of full integration

1.13.1 There are two possible forms of integration:

- The company is taxed on a flat company rate and that portion of income, along with the associated tax credits, are passed to the individual shareholders who return that income and credits on their personal tax return. Any distributions from the company are ignored for tax purposes (the tax credit model);
- The company uses an estimate of the shareholders' tax rates through a prescribed investor rate to calculate tax. Again any distributions from the company are ignored – just like in the case of PIEs today (the PIE model).

1.13.2 Essentially both methods achieve the same result but the latter option has fewer compliance implications for the shareholder as all the tax calculations are dealt with at the company level.

1.13.3 The paper on the taxation of closely-held companies raises the issue of a full integration regime for such companies.

1.14 Implementation issues

1.14.1 Appendix A examines implementation issues and concludes that full integration is impractical.

1.15 Conclusion

1.15.1 Overall we consider that the implementation issues with a full integration system for all companies preclude it.

1.15.2 While some of these issues could be managed through better use of technology, there are still a number that we consider fatal to the adoption of full integration in the New Zealand context and there are no solutions that would result in a better outcome than our current full imputation system.

1.15.3 This has previously been supported by the other reviews of our full imputation system and our view is that nothing has changed to alter the conclusion that New Zealand's full imputation system continues to be fit for purpose.

1.15.4 Nevertheless, changes could potentially be made within imputation depending upon the issues that were a cause for concern.

6. Appendix A: How a full integrated system could work

1.15.5 The table below illustrates the way an integrated system could work. This assumes company income of $100 with one shareholder on a 33% marginal tax rate[18] (the prescribed investor rate is currently 28% for this taxpayer) and the company tax rate is 28%. Income is attributed to the shareholder notwithstanding they may not receive any distributions from the company (this will only be an issue where the shareholder is on a higher tax rate than the company rate).

	Tax Credit Model	**PIE Model**
Company Taxation		
Company Taxable Income	$100	$100
Tax on that (company rate)	$28	NIL
Tax on that (PIR)	NIL	$33
Net available for distribution	$72	$72
Individual Taxation		
Individual Taxable Income	$100	NIL[19]
Tax on that (Indivl rate)	$33	NIL
Tax Credit for Coy Tax	($28)	NIL
Tax payable	$5[20]	NIL

1.15.6 Business transformation may be able to deliver a more accurate marginal rate to companies to allow them to use those to pay tax instead of the blunt PIR setting process which can have inaccuracies for some taxpayers moving between marginal rates.

1.16 Implementation issues with full integration

1.16.1 However, there are a number of issues that arise with full integration and some of these we consider continue to support a full imputation system over full integration.

1.16.2 These can be summarised as follows:

Classes of Shares

1.16.3 This is perhaps the "deal breaker" for a full integration system. Under a full attribution system the owners of a company are essentially deemed to be the

[18] The current maximum PIR is set at 28% which is the maximum rate at which an investor on a 33% rate pays within a PIE. There is no reason why this reduced rate should apply in the case of an investment in a company. The reasons the PIR was capped at 28% in the PIE example may not have application in a full integration model and therefore we have assumed the maximum PIR will be the top marginal rate.

[19] The PIE model leaves the taxation at the company level with no attribution to the individual shareholders.

[20] In the current imputation system this 5% differential is addressed by resident withholding tax.

owners of the assets and liabilities of the company. They are also therefore attributed their share of the income and expenses of the company in proportion to their ownership share of the company.

- The allocation of income and expenses to owners is a simple task where there is one class of share, as in the SME example. However, when you overlay all the corporate complexities of preference shares, options, convertible notes, and rights issues it becomes complex because, for a full attribution to work, each shareholder's earnings needs to be tracked or different pools of retained earnings need to be maintained to allocate to those shareholders.
- This is to prevent income that has been taxed under the PIE model at a 17.5% rate being distributed to a shareholder who has a 33% tax rate. In the tax credit model the apportionment of the income to various shares with different rights is also problematic in that those should be apportioned in respect of the rights to income that the particular class of share holds. Again, the valuation issue here is extremely complex.
- Unlike a PIE where each investor has their investment fund where the income is neatly divided, the complexities of ownership rights is vastly more complex in an active company example.

Measurement Day

- Not only must the income be attributed to shareholders based on their ownership share, the attribution of income and expenses to shareholders requires a time at which the ownership interest of each shareholder is measured. This "measurement day" would create opportunities for taxpayers to choose whether to receive attribution of the company income, or not, without robust anti-avoidance rules.
- A measurement day allows low or high tax rate shareholders to manipulate their income by buying or selling shares just prior to, or after, the measurement day. It also complicates the tax calculation by having shareholders enter and exit the company on a daily basis. While we do not consider this to be a deal-breaker, it is likely to increase the complexity of the regime. Shares in a large, publicly listed company can change frequently and in significant volumes. Again this is avoided in the PIE situation by daily unit pricing which is relatively simple for a PIE to undertake. For an active business this is not possible.

Foreign Shareholders

1.16.4 There are two issues that arise with foreign shareholders of New Zealand entities that would be subject to a full integration system. Firstly, there is a question as to what rate the foreign shareholder should be taxed at. Currently for non-portfolio investors in a New Zealand company their tax rate would generally be capped at the company tax rate of 28%.

1.16.5 A secondary issue arises where the tax credit mechanism is used as to whether non-residents would be required to return and square up any tax liability on the income (which should not arise if the rate is set at the company tax rate).

1.16.6 Finally any adoption of a full integration system would need to consider the application of New Zealand's double tax agreements and the application of the OECD[21] hybrid proposals which addresses mismatches in treatment of entities between countries. Specifically it addresses the situation where an entity is treated as a look-through in one country and not another.

Tax Adjustments

1.16.7 Under full integration any adjustments to prior years' company income can be problematic in terms of allocation to shareholders. In theory, any adjustments made to a company in a prior year should be allocated to the shareholders of the company in that prior year. This adds complexity to the system, particularly if the shareholder has since sold their holding in the company. An alternative to this may be to allocate adjustments to the shareholders in the current year which may not be a fair outcome for those shareholders as they have not, and may never, have benefited from that under-taxation in prior years.

Losses

1.16.8 Under a full attribution system where an entity makes a loss this should be attributed back to the shareholders, as it currently is in look through companies and, in limited circumstances, the PIE regime, however, this could have implications for the overall tax base given previously those losses would be trapped in the entity and carried forward to future years (essentially ring fencing those losses to the company).

1.16.9 The full attribution of losses raises issues of tax sheltering and increases risks that unexpected loopholes in the business tax area could put personal income collections at risk.

Transitional Issues

1.16.10 There are significant transitional issues in the adoption of a system of full integration. The treatment of retained earnings of companies upon entry to full integration would need to be considered and as full integration has the potential to alter expectations on earnings and returns of an entity which will, in turn, potentially affect the share price of companies there are commercial considerations of integration.

[21] The Organisation for Economic Co-operation and Development.