The taxation of business profits and distributions

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I. INTRODUCTION

There is an urgent necessity, even following the report of the Task Force on Tax Reform,[1] for research and legislative reform in many areas affecting the taxation of business and the owners of businesses. The central issues addressed in this paper are the manner in which the business unit (normally a company) and the owners of the business should be taxed (a matter partially examined by the Task Force), international aspects of New Zealand tax law affecting business (a matter not addressed by the Task Force) and recent trends in tax policy affecting business.

II. TAX CRITERIA AND THE BUSINESS SECTOR

Any examination of the tax on business profits or on those who share the profits of business, with a view to charting possible reform, can only be conducted having regard to the context in which business is conducted in New Zealand as well as the wider economic and social goals of the country. A great deal of theoretical analysis has been conducted with respect to alternative tax structures and different methods of taxation having regard to such recognised tax policy criteria as equity, neutrality, efficiency, and revenue, economic, and social goals.

With respect to business profits the relative emphasis on these criteria noticeably changes in contrast to personal income tax. Except to the extent that income from business is taxed to individuals, equity is normally regarded as less important. Thus no attempt is made to tax companies at different marginal rates according to ability to pay. Although small businesses are sometimes taxed at lower rates on the basis that double taxation is more offensive where management and owners are the same, such relief is more likely to be afforded for economic reasons.

While neutrality as between taxable entities is desirable, neutrality does not exist to any great extent in the effects of taxation on the conduct of business. In fact, in tax policy it is usually unrealistic to assume that a business will not base its planning, at least in part, on the manner in which tax law impacts on it and will not take advantage of incentives in the tax legislation. Taxation planning is an integral part of financial planning and in any developed business enterprise it would be exceptional to find that executive or professional services were not allocated to this area.

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1 *Report of the Task Force on Tax Reform* (Government Printer, Wellington, 1982).

New Zealand has a relatively small productive sector. As with any developed nation it is required to maintain a substantial infrastructure of government administration and public facilities. The absence of a large economic and taxpaying base makes it necessary to closely examine the cost of raising revenue as against the cost of collection by the government and compliance by the private sector. It is difficult to contemplate that New Zealand would move away from reliance on an income tax because it is basically efficient, and a skilled administration, though currently under pressure, is in place. On the other hand, any move to introduce a value added tax, for example, which is known to be reasonably complex in terms of collection and compliance, and for which no administrative experience currently exists, must be evaluated carefully in this regard.

The provision of incentives always causes an efficiency problem. Particularly in a country like New Zealand, which must foster growth and export, the trade-off between providing the right type of incentive to the right person without waste requires evaluation of the benefits which are likely to be gained by comparison with the cost of revenue foregone. Economists also refer to the problem of excess burden which measures the financial cost resulting from the tax system interfering with the most efficient business alternative. Regional investment allowances are an example in which the desirability of attracting business to a less popular locality are effective only at a cost to the business. In many cases such allowances do not achieve their goal. An investment allowance to a manufacturer for establishing a production unit in the South Island may have little attraction compared with establishing his or her unit in, say, Auckland, when costs of transportation and the availability of a large domestic market are considered. It is possibly due to its ineffectiveness in the present New Zealand context that the regional investment allowance is to be abolished.

New Zealand must provide incentives, or at least no disincentives, for industrial growth and export. If such treatment is not to be afforded directly to exporters such treatment must at least apply to export related industries. This brings into focus the adequacy of our investment allowances. Are they sufficiently attractive to promote investment in new capital, plant and equipment? By comparison with most countries they are not generous. Are they available to the right persons? It is all very well to attack the transfer of tax benefits by financing mechanisms such as leveraged leasing, but there is no use providing incentive allowances to those who cannot use them (unless in the form of a refundable credit) for example where the recipient of the tax benefit has tax losses. Companies in a loss position may be businesses with the greatest need to replace capital equipment and they would benefit from being able to share tax benefits with a financier to reduce the costs of buying new equipment.

The fact that New Zealand is a capital importing country has important consequences for its tax structure. Our tax system is designed to encourage the investment of loan capital in New Zealand as evidenced by a 15% withholding tax rate on interest but with the probability of exemption under section 61(18) of the Income Tax Act 1976 on application to the Minister. By comparison, equity investment suffers discriminatory treatment. Non-resident withholding tax is levied at the rate of 30% with no opportunity for remission and double tax treaties

negotiated by New Zealand do not normally feature a preferential rate for large ownership participations or an underlying credit for tax paid by the company. New Zealand has no thin capitalisation rules either in its domestic tax law or its treaties requiring a minimum ratio of equity to debt investment. Additionally, an overseas investor cannot purchase an interest of 25% or more in a New Zealand business without the consent of the Overseas Investment Commission.

While foreign investors are not to be discouraged, revenue paid to foreign investors is obviously too important an item to exempt from taxation entirely. The balance between the incentive effect and the requirement for revenue, affects the manner in which source rules are drafted within the Income Tax Act, the level of withholding taxes and the limitation of rates with respect to dividends, interest, and royalties in double taxation agreements. The wide definition of royalties, the manner of taxing reimbursing payments and the Withholding Payments Regulations 1982 all must be assessed in this light.

The tax system should raise revenue with a minimum distortion to business. The Task Force report notes the fall in income tax from companies to approximately 14% of total income tax.[2] This is largely attributed to many companies suffering losses. The extent to which such losses are real losses as opposed to tax losses has not been estimated. Obviously, the personal income tax has borne too great a share of the revenue burden in the recent past. But it is also obvious that the tax system should encourage business. Where profit levels of companies decline, so does the level of revenue which may be gained from the business tax.

III. THE BUSINESS UNIT

Most business in New Zealand is conducted through the vehicle of a company. Other business entities such as unit trusts and property syndicates are or will be taxed as companies. Partnerships are not taxation entities as such and depend on the nature of the partners as companies or individuals for their ultimate tax treatment.

IV. THE TAXATION OF COMPANIES AND SHAREHOLDERS

The classical, or separate, system of company taxation, adopted in New Zealand, which imposes a tax on the company and a separate personal income tax on dividends is one of several possible systems, although internationally still the most popular. Other countries currently using the separate system are the United States and Australia. A split rate system which imposes a preferential rate on distributions is used in West Germany and a partial imputation system which credits shareholders with part of the tax payable by the company is in force in the United Kingdom, France and Canada.

In New Zealand the rate of tax is currently 45% for domestic companies and 50% for foreign companies while the tax on dividends received by individuals will be as high as 66% as from 1 October 1982. Dividends received by New Zealand companies are exempt from tax.

2 Ibid. 176.

A significant defect in the separate system is that it involves double taxation in the sense that shareholders are required to pay personal income tax on company profits that have already borne company tax. The total tax borne at the company level and by the individual on the highest marginal rate in force for the year ending 31 March 1983 will be in excess of 79% and in subsequent years in excess of 81%. Thus the separate system is clearly inequitable by comparison with the personal income tax which is the only income tax levied on a sole proprietor. To the extent that distributions are not made and excess retention tax does not apply, company profits may be retained in which case the only immediate tax is the 45% company tax. The deferral for income tax earners on a higher marginal rate than 45% is clearly an unfair advantage as against a sole proprietor. In this case the tax defeats the progressivity of the personal income tax.

The Task Force noted that shareholders of closely-held private companies are in a different position to that of shareholders of widely-held companies, such as listed public companies, in that they are able to reduce, or even escape completely, so-called double taxation by paying all profits out as salaries to full-time shareholder employees.[3] The effect is complete integration at the personal level. So far as other individual shareholders were concerned the Task Force regarded the present system of full taxation of dividends with no offset to recognise the company tax as inequitable.[4]

Apart from equity the present system can be criticised on the grounds that it is neither neutral nor efficient. The present system contains a bias against doing business in corporate form. The argument that the privilege of limited liability should bear a premium in terms of tax obviously has no proper basis in tax policy terms. The separate system favours retention of profits. This is seen by some to be of assistance to small companies with limited access to outside debt and equity financing opportunities. If one were to ignore the impact of inflation and the need for building up reserves, many economists would favour enforced distributions and, in practice, a level of distributions will in most cases inevitably occur. In the absence of specific economic policies favouring distribution or non-distribution, it would appear that neutrality with respect to distributions should prevail.

The separate system is not neutral as between equity and debt financing as interest is deductible while dividends are not. Specified preference shares are an instance where the government has provided for deductible dividends in an effort to support the equity market.

The case for changing away from the separate system has been widely recognised and must be considered in the context of any reform of business taxation.

V. ALTERNATIVE SYSTEMS

Perhaps the most obvious alternative is to treat all profits as having been distributed and to impose income tax only on shareholders and not on the company.

3 Ibid. 181.
4 Idem.

The tax system would be neutral between business entities, equitable as between the contributors of capital and the inefficiencies of double taxation would have been eradicated. The effect of such a system is to tax the company as a partnership.

The principal difficulty with this system is the basis on which profits would be allocated. It could pay no attention to the different rights to profits enjoyed by different classes of shareholders. Difficulties would also be experienced in the treatment of non-resident shareholders. At present a 15% withholding tax is levied on dividends and that rate is generally carried over to the double taxation agreements entered into by New Zealand. The OECD Model Convention anticipates a lower rate where non-resident shareholders own a substantial interest in a resident subsidiary in recognition of the underlying tax paid by that company although New Zealand policy to date has not been to grant the concessional rate. The taxation of a notional total distribution would certainly require renegotiation of New Zealand tax treaties with a withholding tax rate substantially higher than in other countries.

Another system would tax only actual distributions and the annual increase in the value of shares to take account of undistributed profits. Such an alternative is impractical due to difficulties of valuation.

VI. THE SPLIT RATE AND IMPUTATION SYSTEMS

In practical terms it seems that any acceptable reform must proceed on the basis of tax being levied on both companies and shareholders. Two methods which seek to relieve the double taxation burden on shareholders and which are more neutral as between distributed and undistributed profits are the split-rate system and the imputation system.

The split-rate system grants relief at the company level by imposing a lower rate of company tax on distributed profits than on undistributed profits. Integration at the shareholder level is provided for by the imputation system by granting a credit for income tax paid by the company to the shareholder to apply against his or her personal income tax against dividends. In the latter case, full imputation could result in complete neutrality as between the taxation of distributed and undistributed profits but, in those cases where the imputation system has been introduced, such as in the United Kingdom and France, administrative and other reasons have resulted in the introduction of only partially integrated systems in which a credit is given for less than the total corporate tax liability. Both systems are always accompanied by a withholding by the company from distributions at a predetermined rate. At the domestic level the split-rate system can be structured to have an almost identical effect to the imputation system.

The choice between the two has been the subject of consideration by many commissions and tax commentators. The main body of research has been conducted by the European Economic Community which sought a harmonised system amongst its members with a view to achieving the ultimate goal of a free flow of capital

within the community. In an integrated economic alliance, taxes on corporate profits are particularly important because of their direct impact on the profitability and therefore the location of corporate investment. In this regard closer economic relations with Australia, with the prospect of increasing financial interdependence, means that the New Zealand government could be unwilling to move to an alternative basis, which was different from Australia.

Discussions in the United Kingdom leading to the 1972 corporation tax reform were comprehensive in their assessment of the alternative tax systems. Between 1965 and 1972 the United Kingdom adopted a separate system. For reasons of neutrality between distributed and non-distributed income and in the interests of harmonising its position with EEC members, the United Kingdom government decided to move to a partially integrated imputation system. Under that integrated system a standard rate of tax is deducted from dividends and allowed as an offset against corporation tax previously paid.

The difficulties with the imputation system and with the split-rate system are at the international level and would affect taxes paid by New Zealand businesses conducted abroad and by foreign investors. Under a credit system, applied by New Zealand in its domestic law and under its double taxation agreements, a company earning income abroad would be discriminated against, because the foreign tax credit would be limited to the company tax payable in New Zealand which would normally be reduced by the lower rate on distributions (split-rate system) or by the tax credit withheld (imputation system). The foreign tax could not be fully credited and the spill-over would constitute an extra tax burden on the company investing abroad. Such discrimination may be removed by keeping intact the entire amount of company tax for the crediting of foreign tax, by adopting a dividend credit system without withholding the amount creditable (which is not a practical alternative), or by allowing the crediting of foreign tax against the creditable tax dividend. The only point to be made in this regard is that the adoption of an integrated system will not encourage investment abroad, if such encouragement is in fact desired, without suitable modification.

The second aspect concerns taxation of foreign corporations investing in New Zealand. The split-rate system automatically extends distribution relief to foreign shareholders while the imputation system does not. In the case of both the United Kingdom and France credits are extended to foreign shareholders only through double taxation agreements.

In Canada, which adopted an imputation system in 1971, no attempt was made to provide credit to foreign investors. The withholding tax rate of 15% already in force was applied to distributions and a credit of this amount, which is lower than the domestic rate, was applied against corporation tax. The system therefore discriminated against foreign investors.

In summary then, any change to an integrated system will require consideration of the effects at the international level. A New Zealand company operating abroad would be disadvantaged if credit was not allowed for foreign tax, against either the total New Zealand company tax or any prepayment or tax withheld, rather than against the total tax diminished by any tax withheld. A decision would

also be required as to what encouragement should be given to foreign investors investing in New Zealand. Neither of these problems would appear to provide sufficient grounds for not changing to an integrated system.

The Task Force recognised the restriction that the need for maintaining government revenue, particularly from non-resident shareholders, placed on the reforms it might otherwise have suggested. Without this restriction the Task Force stated that it could have been favourably disposed to proposing an imputation system. It noted that such a system would result in a significant reduction in revenue derived from overseas investors and could not be readily implemented in respect of institutional shareholders such as life insurance companies and superannuation funds, the former enjoying a special tax basis and the latter not being taxed at all.

It is obvious that any change to an integrated system would, under present rates, reduce the amount of revenue paid to government. However, with little more than 10% of the income tax presently being paid by the corporate sector and with most dividends not being taxable in the hands of institutions, it would seem to be an appropriate time for such a transition to be made with minimum revenue effect. To compensate for any revenue loss, an increase in the company rate of tax would be required and, for this reason, the transition might not be well received. On the other hand, the resultant decrease in the tax liability of shareholders would hopefully encourage investment in a weak equity market. It is thought that a public inquiry into the revenue effects of implementing a partial imputation system is warranted.

The adoption of an integrated system should not be discouraged simply because of problems in dealing with foreign investors. A discriminatory system against foreign investors, as in Canada, may leave the foreign investors no worse off than at present and raises the prospect of a foreign government seeking to negotiate a more favourable position through tax treaties in return for a concession of value to New Zealand. It would not be the first instance of this kind. The 30% rate of non-resident withholding tax on dividends was introduced expressly to induce the USA to revise its New Zealand treaty. When the United Kingdom introduced its imputation system other countries such as New Zealand were anxious to negotiate credits for their residents.

The Task Force's comments with respect to institutional shareholders would appear to have no application in light of the 1982 budget announcement indicating that life insurance companies will in future be taxed on their investment income. Superannuation funds are in no different a position from an ordinary company which receives dividends tax-free and, in as much as most superannuation funds will henceforth be pension funds receipts will be taxable to members of the fund in the same way as shareholders of a company upon eventual distribution.

In lieu of a change to the corporate tax structure the Task Force recommended the introduction of a dividend rebate in the range of 15%-20% of dividends received. While alleviating the effects of double taxation a rebate is more a palliative than a cure. This is because in the absence of integration the company enjoys no benefit from the rebate and hence there is no advantage to the company, as opposed to the shareholders, in distributing profits. In fact, to

the extent that distributions are partially tax free in the hands of shareholders, a rebate system provides an incentive for a company to pay a lesser amount as dividends.

VII. PRIVATE COMPANIES

Currently, shareholder employees are permitted to distribute all profits by way of salary. They are in fact taxed as partnerships. Although the Task Force did not consider them as a special case, commissions in other countries have recommended formalising their partnership status at least as an elective right. The United States has had a system of election for a number of years. This approach has certain administrative difficulties and would be unnecessary under a fully integrated tax system.

Currently, excess retention tax forces distributions of investment income which would otherwise be allowed to accumulate on a tax deferred basis. An excess retention tax is necessary under a separate system but would not be required under a fully integrated system.

VIII. UNIT TRUSTS AND PROPERTY SYNDICATES

A shift to an integrated system of company/shareholder taxation would prevent the government using the double taxation effect as an instrument for forcing certain investors to comply with its economic policy. It would seem wrong in principle that this existing inequity should be used as a penal measure but even more so when it is selective in its application. Contrary to the practice in most developed countries whose tax systems are similar to our own, unit trusts are taxed in New Zealand as companies and as from 1 April 1982, partnerships and syndicates of more than 6 persons engaged in farming, fish-farming, horticultural and property owning ventures will also be treated as companies. The effect in both cases is that contributions to share capital of a partnership will be treated as shares in a company, the profits of the partnership will be treated as company income and taxed at 45 cents in the dollar and any distributions will be taxed as dividends to partners at their individual marginal tax rate.

An initial query, in relation to tax policy, is why the government continues to be offended by larger investment groups and actively penalises them in favour of smaller investment groups. The obvious effect is to discriminate against the smaller investor in favour of the wealthier investor. Investment trusts are a commonly used investment vehicle in many countries but, except to the extent that such trusts fall within the narrow exclusions of section 211 of the Income Tax Act 1976, which taxes unit trusts, they are virtually unknown in New Zealand. It is interesting to note that section 211 was originally introduced as section 153B of the Land and Income Tax Act 1954 by the Labour Government in 1960. The government of the day considered that for practical purposes a unit trust was the same as a company and should receive the same taxation treatment. The National Party Opposition disagreed. It felt that unit trusts had none of the elements of a trust company and saw no reason to distinguish between them and other types of trusts for taxation purposes. To do so, they said, was unfair and would discourage investments through unit trusts.

These two approaches categorise the difference in views expressed in other countries. In the United Kingdom the legality and validity of a unit trust was upheld in the late nineteenth century in *Smith* v. *Anderson*.[5] While an authorised unit trust is treated as a company, tax relief for capital gains tax is granted. On the other hand, in Australia there is no provision in the Income Tax Assessment Act 1936 deeming unit trusts to be companies. Consequently, they are taxed in the same way as other trusts. Such money as is received by the unit holders and has the character of income in their hands is taxable to them at their own marginal rate and not to the unit trust itself. Only non-distributed income is taxed to the unit trust. Public unit trusts arising out of a company reorganisation are taxed as companies but this is a narrowly based exception. The general object remains of preserving unit trusts, particularly those used as a medium of collective investment for investors with a limited amount of capital wishing to spread it over a range of investments.

There seems to be an almost offensive aura of patronage in the New Zealand system which discriminates against the small investor. To the extent that economic reasons, such as inflationary pressures on land prices from large scale, non-managerial investment, exist and it is seen as necessary to discourage such investment, the principle of penalising only the small investor appears to be highly questionable. Even if the new legislation is acceptable as a temporary measure for valid economic goals, the more general issue relating to the appropriate tax treatment of unit trusts remains. Under an integrated system the questionable use of the corporate tax structure in this manner would not be available.

IX. COMPANY DISTRIBUTIONS

Two matters of taxation relating to the taxation of company distributions are of current interest. These are the proposed legislation with respect to tax-free distributions and bonus issues.

Tax-free distributions may be made from realised or other capital profits under section 4(5) of the Income Tax Act 1976. In a weak equity market with declining real profits, companies have made considerable efforts to pay dividends which are tax-free. The Commissioner has by assessment attacked two situations. First, where dividends were generated by a subsidiary and passed through the parent to its ultimate individual shareholders it was claimed that the dividends were not received as capital profits by the parent and were therefore not able to be passed out tax-free. The Court of Appeal rejected this argument in the recent decision of *Smout* v. *C.I.R.*[6] While it was recognised that capital profits do not retain their nature as such in the hands of the recipient and the Act did not expressly provide for the situation, the purpose of the legislature could only be achieved by treating the receipts as capital profits in the hands of the parent and therefore available for distribution tax-free.

The second, and more alarming, aspect from the Commissioner's point of view,

5 (1880) 15 Ch.D. 247.
6 (1982) 5 N.Z.T.C. 61, 158.

has been the generation of tax-free dividends by sales of capital assets between companies which are members of the same group. The Commissioner has attempted to distinguish between profits realised from the sale of assets outside the group and those arising from sales between group members. It is obvious from the comments of Cooke J. in *Smout's* case[7] that such a distinction is unlikely to be recognised by the courts. On the other hand, in some cases the Commissioner may be able to attack, as tax avoidance arrangements, transactions involving the establishing of a subsidiary by a parent company followed by the sale to the new subsidiary of capital assets, expressly for the purpose of generating a source of tax-free dividends. Where a realised profit arises in the course of a corporate reorganisation carried out for commercial reasons, the Commissioner would seem to have little chance of success.

The Task Force was also concerned at the growing use of the share premium account which enabled a tax-free distribution to be made under section 4(1). Tax-free distributions under section 4(1) are limited, in the case of share premium accounts arising after 30 July 1976, to premiums paid in cash, which did not arise with respect to the issue of shares in one company as consideration for the purchase of shares in another company and where such premiums were credited to a share premium account in the books of the company making the distribution. The Task Force stated[8] that in general, share premium distributions did not in substance amount to a return of capital to shareholders as in most cases a condition of the High Court approval for these distributions was a transfer of an equivalent dollar amount from retained revenue earnings to a capital replacement fund. The procedure merely results in a washing of retained revenue earnings so that otherwise taxable dividends take on the tax-free nature of share premium distributions. It is by no means clear that the Task Force acted on a correct understanding of the applicable tax law to the extent that it implied that the capital replacement fund continued to supply a source of tax-free dividends in the future. The position would seem to be that the capital replacement fund, even though funded from appropriated profits, would not capitalise those profits in terms of the Income Tax Act and on any distribution from that fund, a taxable dividend would arise.

The Task Force concluded that the current distinction between capital and revenue dividend distributions should not be continued and for tax purposes restrictions should be placed on a company's ability to nominate the source of its dividend distribution. It therefore recommended that legislation should be introduced to provide that while a company has retained revenue earnings, from past or current years, dividends were to be deemed to be paid first from this source and distributions would be recognised as tax-free only after all retained revenue earnings had been paid out.

The principles of tax law do not recognise the proposition that a capital profit in the hands of a company will retain its character when received by a shareholder. Any distribution of a realised capital profit from a shareholder's point of view is

7 Ibid. 61, 159.
8 Supra n.1, 183-184.

simply a return on his investment and is in the nature of a dividend. Accordingly, any decision to continue the favourable treatment for tax-free dividends is based on a policy determination.

The case is somewhat different for share premium distributions. Where a shareholder has actually paid, as part of his subscription to share capital, a share premium, any return of that amount is inherently in the nature of a return of capital and not the distribution of a profit. Case law and company law recognise the nature of the share premium in this light. The current recognition of tax-free status only for the return of cash premiums is an administrative necessity to combat the possibility of inflated valuations of shares resulting in inflated premiums in merger or takeover situations. Also, part of the value of the share which translates itself into a share premium is in fact the capitalisation of the profits of the company whose shares give rise to the premium.

The recommendation of the Task Force, while attempting to ensure that any tax-free distribution will not be refunded directly or indirectly from retained earnings, has practical weaknesses. First, the legislation will benefit the shareholders of unsuccessful companies, in other words, those companies which have no revenue profits. Secondly, to enable tax-free distributions to be made by a parent company, subsidiaries are likely to refrain from paying dividends to the parent and will, instead, accumulate profits themselves.

The 1982 budget has not, at least in the interim, taken up the Task Force's recommendation. It somewhat surprisingly decided to continue with the existing treatment of tax-free dividends but to disallow tax-free dividend status for distributions funded from intra-group sales.

X. INTERNATIONAL ASPECTS

It is regrettable that having regard to the relative importance of international trade to the New Zealand economy the Task Force was not afforded time to examine the international implications of the existing tax structure. With respect to New Zealand businesses trading overseas it is in the interest of the New Zealand government to ensure on the one hand, that tax laws do not provide an impediment to trade whilst, on the other, the government will receive a fair allocation of taxable revenue from business conducted by a New Zealand resident from its world wide activities. Tax laws must likewise ensure that any non-resident conducting business in New Zealand is subject to his or her fair share of tax while, at the same time, not discouraging foreign investment. In fact, in view of New Zealand's relative isolation, size, and the lack of day to day information about New Zealand possessed by overseas businesses, it becomes vital that a stable, well structured tax treatment of foreign investors, having regard to New Zealand's interests and internationally recognised tax laws and tax rates, should be enacted.

New Zealand, in common with most developed countries, taxes the world wide income of New Zealand resident companies and individuals and the New Zealand source income of non-residents. Unfortunately, the definition of residence as applied to companies which is contained in section 241 of the Income Tax Act is a

mutation with no known overseas counterpart. The residence of a company is defined as its head office which in turn is defined as the place of incorporation or the centre of its administrative management. The terms "centre of management" or "centre of management and control", being the tests adopted in United Kingdom legislation, are fairly well defined by case law. Essentially, they refer to where control at the directorate level is exercised. To date, the New Zealand Commissioner has applied this test. The alternative test, adopted by New Zealand in its double tax agreements, is the place where day to day management is carried on. It has been argued that the domestic test refers to day to day management rather than to management and control. Statutory clarification is required.

In relation to the source rules the question can be raised as to the efficacy and propriety of section 243(2)(p) and (pa) which deem a New Zealand source for payments by one non-resident to another non-resident where those payments are deducted against assessable royalties or rentals derived from New Zealand. The effect is to legislate a New Zealand source for payments made overseas between two non-residents, the recipient of which may have no involvement whatsoever with New Zealand. The difficulty then becomes one of collecting the tax, for even if the royalty paid offshore is deemed to have a New Zealand source and therefore liable to non-resident withholding tax, the immediate non-resident may not be in a position to deduct the tax from any payment to the second non-resident. The extraterritorial extension of New Zealand's tax laws in this way would seem to be repugnant in principle and, while it is easy to sympathise with the difficulty encountered by the Commissioner in assessing the validity of expenses incurred overseas which are claimed in calculating New Zealand tax, a remodelled section 22 which permitted the Commissioner to make an arm's length estimate of expenses in the absence of satisfactory verification by the overseas taxpayer, would seem preferable to the present law.

International businesses have a propensity for attempting to minimise income and increase deductions in countries with relatively high tax rates such as New Zealand. Section 22 is designed to permit the Commissioner to make an arbitrary assessment based either on capital receipts or total purchases of a business carried on in New Zealand which is controlled by non-residents. Tax treaties entered into by New Zealand contain a provision permitting arm's length allocations of income by the Commissioner. Unfortunately, section 22 does not supply the underlying domestic law in respect of certain income to permit the Commissioner to take advantage of the allocation provision in the double tax agreements or to make an arm's length allocation where there is no double tax agreement.

The first weakness in section 22 is the limitation of its scope to a business carried on in New Zealand. Accordingly, where a non-resident receives income from a New Zealand source, but does not carry on business in New Zealand, there is no power for the Commissioner to make an adjustment. The section refers to adjustments of total receipts or total purchase money. The Commissioner does not appear to have power to impute receipts or purchase money which have not in fact been received.

A further deficiency concerns the meaning of the term "control". The three limbs of section 22 relate either to control by a non-resident or control by any persons or a company not resident in New Zealand. To the extent that control is restricted to non-residents the section cannot apply where control is exercised by New Zealand residents. Regard must be had to the definition of "control" in section 7(2). This section provides that a company shall be deemed to be under the control of persons by whom more than 50% of the shares, the nominal capital, the paid up capital, or the percentage of voting power is held; or, who by any other means have control of the company; or who, by reason of the shareholding at the end of the year, will be entitled to more than 50% of the profits if those profits were distributed.

Section 7 is not thought to apply past the first tier of ownership. Thus the general tests of control can be met and the application of section 22 avoided where a New Zealand company owns more than 50% of the shares and that company is in turn owned by non-residents. By having a majority of New Zealand directors, control by any other means will also be in New Zealand.

Another aspect affecting foreign investment which urgently requires examination is the area of foreign exchange gains or losses and the requirements for New Zealand taxpayers to record transactions in New Zealand currency. Section 71 of the Income Tax Act 1976 is the only provision which deals with foreign exchange gains and losses. That section provides for a deduction for any foreign exchange losses on repayments of loan principal. The section is designed to exclude recognition of losses on rollovers of loans but, as currently interpreted by the Commissioner, he requires actual repatriation of New Zealand dollars and the further purchase of overseas currency for any loss to be realised. This can be an onerous and seemingly unnecessary requirement in some situations.

As previously noted, New Zealand tax law favours overseas loan investment in preference to equity investment. An important issue is whether our international tax policy should place some limitation on the use of the interest exemption available for most overseas lenders. In the absence of thin capitalisation rules such as those adopted in Canada, which fixes deductibility on the basis of a specified debt/equity ratio, a New Zealand subsidiary may be financed virtually entirely from loan capital advanced by the parent and deduct the interest against New Zealand income with the interest being received tax free by the parent. This problem is partly policed by the Overseas Investment Commission which may require a minimum debt/equity ratio before approving a foreign loan to the New Zealand subsidiary of an overseas parent.

The Withholding Payments Regulations 1982 would provide a real disincentive for foreign contractors and suppliers of equipment and personnel if their application could not be escaped by putting up a bond for the payment of tax. They require a 15% withholding from the gross amount of all payments and effectively accelerate tax payments, up to over a year in some cases. Such a system is obviously necessary to ensure the collection of tax but may require evaluation in terms of its acceptability to foreign investors after a period.

This brief survey touches on just some of the problems requiring attention in this important area of business taxation. In the context of a totally developed policy other issues also require attention, such as partial taxation of the income of foreign subsidiaries and the use of tax havens by New Zealand investors, both of which, it is suggested, should remain untouched. In this important but much neglected area a total review is needed.

XI. CURRENT TRENDS IN TAX POLICY

For examples of tax policy in action in the business sector one can turn to the 1982 budget. The budget has ostensible objectives of promoting incentive to work by spreading marginal tax rates at the personal level, assisting primary producers by locking investment money into the land and removing inflationary pressures on land prices, and removing certain areas of tax avoidance. The latter category relates to avoidance through the use of incentives and deserves no pejorative connotation. The tax avoidance areas selected simply relate to areas of greatest revenue loss. Any attack on the principle of tax avoidance would have centred on other areas.

The budgetary measures appear to demonstrate a simple revenue gathering objective and do not take a balanced view of all interests affected. Three examples are the local film industry which relied on tax incentives in some form and has no significant future in New Zealand as a result of the budget; leasing, which will, it would seem, no longer be available as a method of financing asset acquisitions; and charitable entities which have no significant tax incentive attached to them other than an estate exemption and have relied on tax exemption for business income for funding large projects.

The point is that while each of these areas could legitimately be the focus of budgetary attention the apparent disregard for the interests of those immediately affected cannot be beneficial either to business or to the attitudes of business in the long term. The measures are therefore questionable tax policy.

A. Film Production

The recent budget announcement covering the intended future tax treatment of film production by investors is, from the industry's point of view, an example of government overreaction. Until recently, film investors were gaining what was clearly an unwarranted benefit through the operation of the tax law. According to general tax principles it was thought that the investment dollar of a partner in a film production partnership applied to the production of a film, was on revenue account and tax deductible. However, an internationally recognised method of financing film production was for a lender to lend money to investors, the only security being over the profits from film sales and with profits being the only source for the payment of interest and principal. The payment of interest and repayment of capital on the loan was entirely dependent on the film generating sales. The effect was that the contributor was able to deduct $2 which for the marginal taxpayer on a 60% rate was equivalent to a total tax benefit of $1.20 for an initial $1.00 expenditure. Accordingly, where the film was not successful

the investor would still make 20 cents return from the tax system. Where the film was successful he or she would be out of pocket from profits to the extent of the loan plus interest, so that the overall effect would be one of tax deferral rather than tax avoidance.

The Commission recently took the position that the contribution of the investor was on capital account and initially permitted a write off of total contributions plus loan money and any deferred fees, over two income years, commencing with the year in which the film was completed. He then decided to disallow a write-off in respect of the investment attributable to the limited recourse loan and any deferred fees.

In order to bring certainty to the industry and to limit the excessive tax advantages originally received by investors, the Commissioner and the Associate Minister of Finance entered into a dialogue with members of the industry and in particular the New Zealand Film Commission. Considerable work and discussion between members of the industry and the Minister resulted in what was believed to be acceptance of an incentive similar to that adopted in Australia. The proposed incentive would have permitted a 150% deduction for the cash contribution only of investors, which in the case of a taxpayer on a marginal rate of 60c would have left 10% of his investment at risk. If the film generated sales, profits of the investor up to one half of his investment would have been tax-free. It was felt that, having regard to Australian experience, the incentive would have attracted investment into the film industry without being unduly generous in terms of revenue foregone. The Associate Minister of Finance publicly indicated that it was the government's wish to preserve investment in the industry.

The statutory scheme, as announced in the budget, provides no incentive which is likely to attract film investment in the future. The new scheme provides for a write-off of the investor's cash contribution over two years from the year of completion of the film. This means that for a person on a marginal tax rate of 60c, 40% of his contribution will be left at risk and the 60% which is deductible will be spread over two years from the date of expenditure. Any leveraging from loans or deferred fees will be deductible against the assessable profits from the film in the year in which they are actually paid.

The budget states that in recognition of the dramatic impact of these measures, a grant of $1.75 million is to be made to the New Zealand Film Commission reducing to nil over 5 years which is to be used to provide initial assistance to film productions. When regard is had to the fact that a typical international feature film currently costs in excess of three million dollars to produce and market, the efficacy of this grant in preserving the New Zealand film industry will be negligible.

Although not economically important in its contribution to GNP, the internationally recognised quality and success of New Zealand films in recent years has generated recognition of New Zealand abroad and enabled New Zealanders to take pride in the success of a local industry. Unfortunately, the high risk, vulnerability and capital intensiveness of film production has required some form of government subsidy through the tax system in almost every country which has a

developed industry of any stature. The abolition of incentives to a point where they become ineffective as an incentive to investment will almost certainly mean that the present momentum in the industry cannot be sustained.

B. Charitable Businesses

Under current legislation a charity is exempted entirely from paying income tax on any business profits derived by it. As from the income year commencing 1 April 1984, tax exemption will be restricted to income from business activities which are directly related to the primary purpose of the charity or where the employees of the business are persons for whose benefit the charity was established. This will include such activities as:

(a) Selling religious books and religious materials;

(b) The running, as part of charitable activities, of hospitals or homes for the aged;

(c) The operation of workshops for the blind or disabled and the sale of products therefrom;

(d) The running of church and school fairs and galas.

Investment income of charities, such as interest, dividends and rents will remain tax exempt unless they are profits from the carrying on of a business.

This measure adopts the recommendation of the Task Force. Two reasons for the measure were given in the Minister's speech. First, some businesses carried on by charities enjoy an artificially advantageous position in the market through their exemption from income tax. Secondly, tax avoidance was found to be practised by some individual taxpayers who converted a private business or private company into a charitable trust or a charitable company whose stated object was to conduct a business for charitable purposes. The company could accumulate tax exempt capital and pay the capital by way of salary to the controller of the business.

The potential for tax avoidance could be limited by appointing a government official to supervise charities and requiring the presentation of annual returns. Controls of this nature are a feature of most countries in which charitable trusts or charitable foundations are permitted to accumulate tax exempt funds. Charities are by their nature quasi-public trusts, by definition and as custodians of tax exempt funds. Although an important characteristic of charitable trusts is their private nature which enables them to complement government activities, seen as an important feature in a pluralistic society such as New Zealand, some accountability at the public level is essential. So far the New Zealand government has shown a lack of willingness to accept this responsibility. Coupled with a degree of government control, limits on the ability to accumulate funds should also be imposed.

Where the business activities of charities seriously compete with private industry, various tax commissions have accepted that it is proper to curtail the tax advantage for business activities of charities. In practice, however, there has been a general unwillingness by governments to restrict entirely the business operations of charities in recognition of the valuable and in some cases more effective contribution made

by charities to the public sector, when government itself is unable to fulfil such demands. It is also noteworthy that the tax incentive to charitable donors in New Zealand is very low compared with that in other developed countries which in some cases amounts to a deduction against income for almost the total value of charitable gifts. For charities, the recent budgetary announcement must be seen as a disappointment, due to the scarcity of large private funds available for sponsorship of charitable works, the lack of any real incentive for the owners of such funds to donate them to charity and now, the lack of opportunity for the charitable institution to take significant steps to augment its funding through business activities.

C. Leasing

Leasing has become an important method of financing asset acquisitions. By transferring the benefit of depreciation allowances from the lessor to the lessee, the legislation anticipated by the 1982 budget will substantially curtail the number of leasing transactions entered into in future. The budget indicates that where financial institutions lease equipment, plant and machinery (including motorcars) such leases shall for tax purposes be treated as sales, subject to loans. The effect of the transaction for the lessor is that he is deemed to have lent money, subject to interest; he must accrue, for tax purposes, the deemed interest payment and financial charges made by the lessees, and is not entitled to depreciation. The lessee is deemed to be the owner of the equipment and to have borrowed money to finance the purchase and make lease payments, but only so much as current depreciation schedules allow in relation to the leased equipment together with an amount attributable to interest.

It has been indicated by government spokesmen that while lessors will suffer by not being able to depreciate the leased assets, lessees will enjoy a favoured position from being able to take depreciation plus an interest charge as tax deductible items. This rationale entirely overlooks the financial benefits to the lessee inherent in some leases which result in a significant decrease in financing charges as a result of the depreciation allowances being available to the lessor. The economic implications of this measure will in some instances be quite severe. Acquisitions of new capital assets and the financing of plant for some major projects may possibly not be viable where tax benefits cannot be transferred to an intermediary lessor/financier in order to reduce unacceptably high interest costs currently payable under direct lending. The proposed legislation overlooks the lack of any advantage to an owner or lessee of depreciation allowances where that party is in a loss position, such as in the case of a new business, and will not generate sufficient income to utilise the tax depreciation in the current year or even immediate future.

XII. CONCLUSIONS

Even after the report of the Task Force, the requirement for research, public discussion and legislative reform remains. Existing and intended legislation inadequately deals with some areas both in relation to its scope and its drafting. The

Income Tax Act 1976 does not reflect any coherent philosophy, policy objectives or basis in principle in various areas. It sometimes reflects narrow objectives without attempting to reflect a balance of legitimate interests. Examples are the manner of imposing tax burdens on businesses and their owners; the discriminatory approach in taxing property syndicates; taxing the inflation profit through borrowing in horticulture without any relief for the inflated profit, not attributable to borrowing; the lack of even ad hoc inflation adjustments for business such as stock valuation adjustment or depreciation based on replacement value; and recently announced legislation concerning films, leasing and charitable business. The international aspects of the New Zealand tax system appear never to have been systematically examined and require urgent attention. Significant inconsistencies and omissions in the existing tax legislation must also be addressed.

The best interests of the country and business are served by reasonable, well structured and, to the extent possible, stable tax legislation. We have yet to attain that goal.