TAXATION OF COMPANIES AND SHAREHOLDERS DIVIDENDS FROM CAPITAL SOURCES

An Occasional Paper

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Contents

Foreword: The Institute

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The Institute wishes to place on record its thanks for the time given by members of these committees, and for their contribution to the studies.

Introduction

In his 1985 Statement on Taxation and Benefit Reform the Minister of Finance announced that distributions made by companies to their shareholders from capital sources, which had hitherto been tax-free, were to be taxable. This measure closed a widely perceived loophole by means of which shareholders could extract part of corporate-sources income without incurring the usual personal tax on dividends. The loophole was most commonly exploited in relation to share premiums and realised capital profits.

In the same statement, however, the Minister announced his intention to introduce in 1988/89 a more fundamental reform of company/shareholder taxation. The so-called imputation system will eliminate company tax attributable to income from which dividends are paid to shareholders. Shareholders will be able to credit the company tax against their personal tax on the dividend (grossed up to its pre-company-tax equivalent value). This measure will effectively remove the main incentive to create capital sources for dividends and recognises the distortions created by the second layer of tax on corporate-sources income. It appears somewhat incongruous, therefore, that the Minister decided to close what is less a loophole than an escape hatch in a fundamentally distorted tax system.

The allied problem of distinguishing for legal and tax purposes between "income" and "capital" gains, when both represent economic measure in that they are accretious in wealth, has even more general implications for tax policy. In the

corporate context, the distinction between profits which are income and profits which are capital is enmeshed with the problems created by the legal friction separating companies from their owners, the shareholders.

Prepared prior to the 1985 tax reform announcements, this paper suggests somewhat prophetically how dividends from capital sources ought to be treated for tax purposes on the assumption that the present separate taxation of companies and their shareholders were to continue. Notwithstanding the subsequent policy announcements, the paper aims to clarify the legal and economic substance underlying tax-motivated corporate distributions.

Synopsis

New Zealand currently has a tax system that taxes corporate profits twice, in the hands of the company and then in the hands of the shareholder. Ultimately, it is hard to justify this double taxation on economic grounds. One consequence is that if there is some leakage of corporate profits that logically should be taxed this leakage may do a degree of rough justice to the corporate sector.

On the other hand, if one accepts that corporate profits should be taxed twice, perhaps no leakage should be allowed. If it should not, one should be concerned about corporate distributions debited to certain capital funds, particularly share premium accounts and capital profits. Broadly speaking, such funds can be generated fairly easily if there is need for them. But, again broadly speaking, a company will not usually distribute funds to its shareholders, from capital sources or from anywhere else, unless it can afford to do so. Ordinarily, whether a company can afford to make a distribution depends on its profitability, not on the labels attached to different funds in its accounts. Economically there is no difference between a distribution debited to a capital fund and a dividend debited to revenue. Should there be a difference for tax purposes?

Structure of the Income Tax System

The Income Tax Act 1976 draws a fundamental distinction between receipts of income and receipts of capital. Income is taxable; capital is not.

It is generally agreed by economists that in the last analysis there is no rational distinction between capital and income. However, the distinction is recognised by lawyers and accountants and is maintained in the Income Tax Act 1976. Irrational though they may be, legal and accounting rules do succeed in clearly identifying most receipts as either income or capital. Some of the legal and accounting rules are codified in the Act. Others are modified by the Act. However, ultimately there are a number of types of receipt that fall close to or on the line separating income and capital. Not surprisingly, these items cannot rationally be allocated to either category.

Consequently, there has grown up a considerable body of judge-made law that attempts to make this categorisation. The cases are not readily reconcilable. However, lawyers are well used to lines that are difficult to draw between different legal categories. Consequently, the problem of distinguishing between capital and income is generally put down to the inherently difficult nature of the question. Few lawyers, much less the public at large, appreciate that the question should not be asked at all. Against this background, and bearing in mind that the Income Tax Act is drafted on the assumption that there is a rational distinction between capital and income, reforms are difficult to explain to the public.

Taxation of Profits of Individuals and of Companies

For income tax purposes the business profits of a company are computed in the same way as the business profits of an individual. There are a few immaterial exceptions introduced by parliament for reasons of policy rather than because of the requirements of any relevant general principle of law, accountancy, or economics. Thus, transactions that produce capital for individuals produce capital for companies and transactions that produce revenue for individuals produce revenue for companies. Consequently there are few provisions in the Income Tax Act that apply specifically to the computation of corporate income. They are not necessary. The relatively few rules that are necessary are found in sections 190 to 197 of the Act. Sections 190 and 197 are anti-avoidance provisions. Section 191 cuts through corporate structures to enble groups of companies owned by more or less the same people to consolidate their tax accounts, setting off losses in one company against profits in another. Broadly speaking, sections 192 to 196 prevent companies from treating what is fundamentally equity capital as if it were loan capital. To a company, the advantage of loan capital over equity is that interest on loan capital is deductible in calculating its taxable profits whereas dividends paid on equity shares are not deductible. Apart from sections 190 to 197, certain parts of sections 188 to 189 are calculated to frustrate the exploitation of corporate structures in order to get access to deductible losses.

Taxation of Dividends

If the special rules about computing corporate profits are relatively few and, apart from the rules on losses and on corporate groups, relatively simple, the same cannot be said about the rules in respect of dividends. The trouble with dividends is that according to the general law a shareholder's dividend is income in the hands of the shareholder. This is so whatever the source of the dividend: capital profit, revenue profit, or gift. In the general law a share is an item of property and dividends are the fruit of that property. They are therefore taxable.

This general principle is enshrined in section 65(2)(j) of the Income Tax Act, which expressly declares all dividends to be assessable. Moreover, the meaning of 'dividends' is considerably expanded in the Act beyond the meaning of the term in company law. By section 4, virtually any benefit conferred by a company on a shareholder in his or her capacity as a shareholder is taxable as a dividend. This very wide definition is necessary in order to prevent tax avoidance, particularly by shareholders of closely-held companies. For example, a benefit conferred by a company on a relative of a shareholder is generally taxable to the shareholder as if it were a dividend derived by the shareholder.

Exceptions to Align Shareholders with Other Taxpayers

Given that the Income Tax Act does distinguish between capital and revenue, it may be thought unfair that a shareholder should pay tax on a dividend that comes from capital sources within the company. It is unfair if the shareholder must pay tax on a dividend arising from a capital profit. It is even more unfair if he must pay tax on a return of capital. For company law purposes a return of capital is not even a dividend, but it is caught within the general definition of 'dividend' in section 4(1) of the Income Tax Act.

Because of this apparent unfairness parliament has enacted a number of exceptions to the definition of 'dividend' in the Income Tax Act. Broadly speaking, these exceptions provide that dividends paid to shareholders from capital sources are not

'dividends' for purposes of the Income Tax Act. They are therefore received by shareholders tax free.

One difficulty of this broad policy in section 4 is that in many cases whether a company creates capital funds is largely a question of choice. For example, a company can record a capital profit in its books by upward valuation of plant, buildings, and other capital assets. It can then pay a dividend out of this upward revaluation. Of course, the money does not come literally from the upward valuation; it cannot, because revaluation does not create cash. That does not matter. A company can use cash that in fact comes from trading profits or simply from borrowing. So long as the company has profits in its books to which the dividend can be debited the dividend may be paid. It is often, perhaps generally, contrary to good accounting practice for a dividend to be paid from profits that bear no relation to cash transactions but arise simply from upward valuations of capital assets. But this practice is not against company law.

It follows that if there were a general exception in the Income Tax Act whereby payments to shareholders from any capital source were tax free most shareholders would rarely have to pay tax. Where a dividend was desired a company could simply revalue a capital asset and debit the payment to that account. Rather surprisingly, this once was the position in New Zealand. It is remarkable that shareholders ever paid any tax at all. The loophole was closed in 1965. From then profits from revaluations of capital assets have not qualified as sources of dividends that are free of tax in the hands of the shareholder.

Policy Considerations

The story of revaluation profits is only one chapter in a lengthy saga. Year after year, parliament has refined and restricted the definitions of capital funds that qualify as the source of tax-free dividends. For several reasons the legislation is complex and messy. First, provisions that disqualify funds from a tax-free status are usually in the form of exceptions to exceptions. Initially, all dividends are deemed to be taxable. Then there are certain exceptions in respect of some capital funds. Finally, these exceptions are cut back by sub-exceptions. Legislation by double negative is to be avoided.

Secondly, the exceptions and sub-exceptions to the definition of dividends have slowly encrusted the fundamental provisions of section 4 like so many barnacles. As parliament has discovered that yet another type of capital fund can lend itself to exploitation, so there has been an accretion of anti-avoidance provisions. Time does not seem to be available for redrafting section 4 in some more rational form, avoiding the plethora of provisos, exceptions, sub-provisos, and sub-exceptions. One result is that not many people know precisely what section 4 means.

Thirdly, section 4 as we now know it is the product of several conflicting policies. There is a general principle that capital should not be taxed by the Income Tax Act either in the hands of the original recipient or in the hands of a shareholder where the capital has passed through the books of a company. Then there is the countervailing consideration that companies and shareholders should not be permitted to avoid tax by contrived transactions. From time to time these conflicting policies have caused some unfortunate results. For example, in 1982 amendments were enacted in order to prevent companies from using as a source of tax-free dividends capital profits that had been 'realised' according to accounting and legal principle but which had little or no substance from an economic point of view. Despite careful and thoughtful drafting this amendment proved to have been painted with too broad a brush. One group of people particularly affected was owners of flats whose ownership depended on their status as shareholders in a company in whose name the flats were registered. Such companies are not trading organisations at all. They are simply a vehicle for enabling people to get some sort of title to flats in blocks.

These corporate titles are far inferior to the unit titles that were introduced by the Unit Titles Act 1972. The difficulty was that after the 1982 amendments to the Income Tax Act people in blocks of flats who wanted to exchange their shareholders' titles for unit titles were faced with substantial expenses. Either their companies sold the flats to the shareholders who already owned them, incurring full stamp duty, or, worse, the flats were transferred lock, stock, and barrel to their owners. In that event, many lawyers and accountants, and the taxation authorities, believed that the difference between the value of the flat when initially acquired by the company and its value when transferred to the shareholder was assessable at full rates

of income tax as a dividend in the hands of the shareholder. This conclusion was said to obtain even in respect of shareholders who had recently purchased their units and had not even been members of the company during most of the appreciation in the value of their flats. The present author did not agree with this view, but the possible consequences were so grave that one could not advise people whose ownership of their flats depended on their status as sharesholders in a company that was the registered proprietor of the land in question simply to take a transfer of their flats from the company and fight out the question of assessability in court.

There is a further policy question that to date has had little influence in this or any other area of corporate or shareholder taxation. However, ultimately it is more fundamental than the others. It is trite to say that the major result of permitting shareholders to receive payments from corporate capital sources tax free is to reduce the overall tax paid by company and shareholders on corporate profits. From the point of view of many economists this is a good thing. Ultimately, one cannot make out a case for taxing companies that withstands economic analysis. Companies are a legal fiction. They are simply a form of business organisation. If one accepts that a tax system should be fair it follows that any particular receipt should be taxed only once. A rich person should probably pay proportionately more tax on the same receipt than a poor person. But it is hard to justify making anyone pay twice for the same item. Nevertheless, that is what New Zealand's corporate tax system does. For legal purposes a company is a person separate from its shareholders, directors, and employees. But these purposes are to do with efficient business organisation. They have nothing to do with tax. A company does not exist physically. Its staff, directors, and shareholders do exist. They should be taxed on their income and usually are. To tax the company is to impose additional tax on both the shareholders and the staff, or to add to costs eventually borne by the company's customers. How the additional burden is spread between shareholders, staff, and customers depends on the workings of the economic system in respect of that particular company. If labour is plentiful and unions are weak the staff of the company will bear the burden of the extra tax by way of reduced remuneration. If labour is strong shareholders' returns are reduced. If the company is well placed in the market, staff and shareholders may combine to pass the cost on to the customers.

The conscientious tax reformer with a knowledge of economics is aware of these considerations. Accordingly, one view that he or she can take of tax-free dividends is that in a rough and ready way they offer some compensation for the economically unjustifiable double taxation of the profits of any business that happens to be organised as a corporation.

Some Sources of Tax-Free Dividends

Over the last twenty years parliament and the parliamentary draftsmen have struggled to refine section 4 of the Income Tax Act into an instrument that exempts what may be described as 'ordinary' capital funds from taxation when distributed to shareholders but that captures within the tax net payments from capital funds the existence of which has been contrived for tax purposes. Given the competing policies that have just been described it is not surprising that there are still major loopholes in section 4. The two most commonly exploited relate to share premiums and to realised capital profits. There are three or four other possiblities but these are rarely if ever used. The reason is that if it turns out that the company is wrong in thinking that a certain capital fund may be distributed tax-free it is the shareholder, and not the company, who must pay the tax bill. Companies are reluctant to place their shareholders in this position. Accordingly, it is customary to obtain clearances from the Inland Revenue Department before telling shareholders that particular payments are tax-free in their hands. It is understood that such clearances are unlikely to be forthcoming in respect of funds of types that have not hitherto been recognised as distributable tax-free. Several of these other possible sources of tax-free dividends are described in J. Prebble, *The Taxation of Companies and Corporate Investors* (1984), pp.27-33.

Share Premiums

The words 'share premium' are terms of company law. Whenever a company issues a share and receives value in excess of the nominal or par value of the shares the extra value is a share premium. Because premiums constitute money or other consideration paid for the issue of shares company law requires

them to be treated on almost the same footing as the capital of the company.

Probably the most significant requirement about capital is that it must be preserved. If a company makes no profit but distributes a dividend to its shareholders the effect is that it has encroached on its capital. If shareholders foresee that their company may not be able to pay its debts and cause it to pay back to them the value of their shares the result is to defeat the creditors. Practices like this are forbidden by company law.

On the other hand, companies sometimes find that they have more capital than they need. Perhaps their main business has come to an end and the directors cannot think of an alternative profitable use for the funds of the shareholders. In these circumstances a company is permitted to return unneeded capital to its shareholders. But the law strictly supervises this practice. A company proposing to return a portion of its capital must first obtain the permission of the High Court. It is required to satisfy the court that after the return of capital it will have enough money left to meet the claims of its creditors. Broadly speaking, these same requirements apply to share premiums and to any proposal to distribute part or all of a share premium to shareholders.

Since share premiums are treated as capital by company law it seemed logical to treat them as capital for purposes of income tax. Consequently, the fundamental rule was that distributions to shareholders from a share premium account were not taxable in the hands of the shareholders. Though logical on its face, this rule lent itself to exploitation by tax planners. Consequently, amendments to the Income Tax Act have provided that only certain types of share premium are eligible for distribution tax-free. How this came about, and whether the amendments sufficiently close off the opportunities available to tax planners, should be considered in the context of a discussion of circumstances typically giving rise to share premiums.

Ordinary Cash Premiums

By 'ordinary cash premiums' is meant premiums that are paid on the issue of shares when nothing else is happening apart from

that issue. In particular, there is no takeover or merger in the offing. Leaving aside tax considerations, the typical case of an ordinary cash premium occurs when an existing, successful company wants to raise more capital. Suppose that the shares in the company have a par value of $1, but are currently trading on the stock exchange at $1.75. If the company issues fresh shares at the original par value the issue will be unfair to the existing shareholders. Their shares are now worth $1.75 but new shareholders can buy shares for only $1. Moreover, common sense dictates that when a company sells anything worth $1.75 it will be foolish if it accepts only $1. That consideration applies just as much to shares in the company as to goods or services ordinarily sold by the company.

In practice, when a company proposes to raise capital by a fresh issue of shares it usually pitches the offer price lower than the current market price of those shares and it ordinarily offers the shares first to its existing shareholders, proportionately to their current holdings. The discount on market price ensures that the offer will be successful and giving existing shareholders first option to buy the new shares is a matter of fairness to them. Such an offer is usually known as a 'rights issue'. Share premiums resulting from rights issues like these are eligible for tax-free distribution, subject to the permission of the court to enable the company to raid its share premium account.

The corporate financing reasons for issuing shares at a premium when the issuer is an existing, successful company are clear. There is another type of premium that seldom, if ever, can be justified on the basis of company financing needs. These are premiums charged at the time of new flotations. These days, when shares in a new company are offered for public subscription the almost invariable practice is for the offer to be at a substantial premium. Typically, a share will have a par value of 50 cents and will be offered at $1, including a premium of 50 cents. Such premiums, also, are eligible for distribution free of tax in the hands of shareholders. Generally speaking, creating pools of money available for future tax-free distribution constitutes the sole reason for these issues at a premium. Given the current state of the tax law it might be thought more sensible for companies to issue shares with a par value of one cent and a premium of 99 cents. Promoters of companies seem to refrain from issues like this for two reasons.

First, they may fear that excessive exploitation of the share premium loophole could lead to further retaliatory action by parliament. Secondly, there is the question of satisfactorily explaining a 99 cent premium to the more unsophisticated members of the New Zealand investing public.

Premiums in the Context of Takeovers and Mergers

The words 'takeover' and 'merger' do not have entirely separate meanings. One company may take over another by purchasing the shares in the target company or by purchasing the assets and business of that company. A takeover may be friendly or unfriendly. A merger is often a friendly takeover. Thus, the absorbing company may buy all the shares in the target company by arrangement with and with the approval of the directors and shareholders of the target company. Alternatively, two companies may promote a third company that buys all the shares in the original two companies. In a sense, this process is also a takeover in that the third company takes over the shares in the other two. In practice a literal merger never takes place. That is, one never finds the shares of two companies blended in together to form one larger company. Most company lawyers who think about the question come to the conclusion that a literal merger in this sense is not possible under company law. That conclusion is debatable, but it is unlikely ever to be put to the test. The traditional ways of effecting mergers through what are technically takeovers seem to work and there is no particular reason for adopting a new and untried approach.

A typical takeover may occur in the following manner. Suppose there are two companies, each with shares having a par value of $1. At the time in question the shares in both companies are selling at $1.50. The absorbing company may offer to buy all the shares held by shareholders in the target company. To pay for the shares the absorbing company proposes to issue one new share for every share in the target company. If the shareholders in the target company think that the two companies will do better if their businesses are merged than if they remain separate they may well accept the offer.

The new issue must be recorded in the books of the absorbing company. That record must show that for each new share with a par value of $1 the absorbing company receives a share in the

target company that had a market value of $1.50. The par value of the shares in the target company is not relevant for present purposes. Thus, the absorbing company has issued its shares to the former shareholders in the target company at a premium of 50 cents a share. This premium is recorded in the share premium account of the absorbing company and treated as capital for purposes of company law. However, for income tax purposes the premium is not eligible for distribution to shareholders tax-free.

An alternative way of bringing about the takeover of the target company by the absorbing company is as follows:

* The absorbing company borrows enough money to buy all the shares in the target company for cash.

* The absorbing company offers the shareholders in the target company $1.50 for each share they hold.

* The shareholders in the target company accept and the shares are transferred to the ownership of the absorbing company.

* The absorbing company issues enough new shares at $1.50 to repay the loan.

* One group of people well able to buy these new shares are the former shareholders in the target company because they have in hand the cash paid to them by the absorbing company for the shares that they formerly owned.

Like the direct share exchange described earlier, this cash offer creates a premium in the accounts of the absorbing company of 50 cents for every share that is issued by the absorbing company. Whether this premium is eligible for tax-free distribution depends partly on the circumtances of the takeover and partly on the interpretation of a somewhat obscure proviso to section 4(1) of the Income Tax Act.

As regards the factual context there are two extreme possibilities and innumerable variations in between. First, it may be that the absorbing company agrees beforehand with the shareholders in the target company that it will buy their shares for cash but that they will return the cash in consideration for the proposed issue of shares by the absorbing company. At the

other extreme there may be no arrangement at all and the absorbing company may intend to pay for the takeover by using funds obtained in the course of its ordinary fund-raising activities. One possibility would be a rights issue to existing shareholders in the absorbing company. In between, there may be no agreement between the absorbing company and the shareholders in the target company, but it could be that the proposed new issue by the absorbing company will be on such favourable terms that it can reasonably be expected that most former shareholders in the target company will take up the offer. Another possibility is that the scheme confers an option on the former shareholders in the target company to require the absorbing company to issue shares to them at favourable prices should they so desire.

At the second extreme mentioned above, where a cash takeover is funded without help from the former shareholders in the target company, it is clear that any premiums received by the absorbing company are eligible for tax-free distribution. At the other extreme, where there is a prior arrangement for the money to go round in a circle, the intention of the Income Tax Act appears to be to disqualify premiums from tax-free status. At this extreme, that intention is probably carried out effectively by the language of section 4(1). The proviso already mentioned speaks of 'the issue of shares in one company as consideration for the purchase of shares in any other company, whether by one transaction *or a series of transactions*'. Common sense suggests that a pre-ordained circulation of cash probably amounts to a series of transactions that has the ultimate effect of issuing shares in one company for shares in another. But it is doubtful whether the words of section 4 go much further than this extreme case. Perhaps an option conferred on shareholders in the target company can establish the link that converts several separate transactions to a 'series'. Perhaps it cannot. If the objective of the proviso to section 4(1) of the Act is to ensure that premiums arising on takeovers are not eligible for cash free distribution that objective is not achieved, at least not in every case.

Premiums : Tax Policy Considerations

Why does the Act distinguish between premiums paid in cash and premiums that result from the acceptance of shares with a

market value in excess of the par value of the shares that are issued? Why, even when the premium is paid in cash does the Act appear to disqualify it from status as a tax-free source when the premium arose in the context of a takeover or merger, at least in some circumstances? The reason appears to be as follows.

Take the examples considered above. Why are the shares in the absorbing company selling on the market at $1.50 when their par value is $1? No doubt, there are several reasons. The assets of the company may have increased in value since purchase. The investing public may be impressed with the expertise of the directors and management of the company. But most of all the company probably has in its accounts a reserve of profits. Over the years it will have paid some of its profits out to its shareholders as dividends. But other profits will have been retained for working capital and to buy premises, plant, and equipment. The market price of the shares above par may well reflect all three of these considerations, and some others as well. But in many cases the third will be the most important.

These retained profits may well be invested in capital assets. But that investment does not convert the profits into capital. Consequently, if and when the profits are paid out they retain their character as revenue and the dividends are taxable in the hands of the shareholders. In these circumstances, what is the effect of the issue of shares at a premium?

What has happened is that some of the revenue profits have for practical purposes been transformed into capital. This conclusion is practical rather than theoretical. On paper the revenue profits still remain within the company. They will presumably be distributed eventually when at last old age makes it desirable to wind the company up. But in the case of most companies this winding up will not take place for a very long time. For practical purposes the current shareholders and employees of a company can ordinarily regard its existence as more or less permanent. In the short and medium term the company goes on and the shareholders will expect some return on their capital. Distributions may be paid from retained profits or from share premiums. From the point of view of the company the source does not matter very much. If the company can afford to make the distribution it may make it, if not, not. Here, a company where the books are full of share premiums is better off than a company with no sources of tax-free dividends.

If a company can pay its shareholders from sources that render the payments tax-free in their hands it can keep its shareholders happier with a lower gross outlay. Thus, by debiting distributions to shareholders to a share premium account a company can at least effect a deferral of tax payable by the shareholders and, for practical purposes, may be able so to structure its operations so that the tax is never payable.

It is presumably becaue these considerations are brought into particularly sharp focus where non-cash premiums are concerned that parliament has singled out these premiums and denied them status as a source of tax-free distributions. However, when one probes more deeply it becomes evident that the same considerations apply to virtually any share premium. The case of shares issued for cash in the context of a takeover is reasonably obvious. One way or another the economic effect as far as the absorbing company is concerned is much the same. By and large, the fact that there is a share premium at all is caused in part by the existence of profits retained within the absorbing company. In the case of new issues and of issues by an existing company not in the context of a takeover similar considerations apply, but less obviously.

Where an existing company makes a cash issue at a premium that premium no doubt reflects retained profits. In the case of new flotations at a premium the company is simply creating its sources of dividends in reverse order. At flotation, the company expects to make profits. How much better to be able to distribute those profits to shareholders tax-free. Take a new company whose promoters decide $10 million of capital is needed. For tax reasons, instead of issuing ten million $1 shares the company issues ten million 50 cent shares at a premium of 50 cents. But if the company truly needed ten million dollars in the first place it will not be able to distribute that share premium until it has earned some profits. Suppose that a year or two after flotation the company is doing well. The directors decide that there are sufficient funds to pay a dividend. At this point, it is cheaper for the company to resort to the share premium account than to retained profits. Generally speaking there is no other significant consideration. Accordingly, one applies to the court for sanction to make a distribution from the share premium account. Ironically, at this point the accounting entries often reflect rather accurately what is going on. When a company applies to the court to approve a distribution from the

share premium account the chief concern of the court is to ensure that creditors' rights are protected. One way of ensuring this protection is for the company to set aside from retained revenue profits a sum equivalent to the proposed premium distribution. If such a sum is taken from revenue profits available for distribution and given a label like "share premium replacement reserve" the assets available to creditors are the same before and after the reduction of the share premium account. Thus the court's consent may be expected to be readily forthcoming. Establishment of such a replacement reserve is not compulsory; it is simply often convenient. The court may just as well be satisfied that creditors are protected by studying the accounts of the company or by letters from creditors consenting to the proposed reduction.

Denial of Tax-Free Status to All Share Premiums

It was mentioned in paragraph 14 that a system that taxes corporate profits twice, in the hands of both the company and the shareholder, is hard to defend on rational economic grounds. However, if one ignores logic and does exact two slices of taxation, as New Zealand does, different coniderations obtain. In these circumstances, bearing in mind the matters discussed above, it is hard to escape the conclusion that no distributions from share premium accounts should be tax-free. However, such a policy does have some internal inconsistencies.

The fact that a company can issue shares at a premium depends on the performance of that company. The shares will command a premium because of retained capital profits, apparent managerial expertise, perceived advantages in the sector of the economy where the company resides, retained revenue profits, and one or two other matters. Some, but rather few, of these factors are matters of capital. Most are matters of revenue. Income profits clearly fall into this latter category, as do staffing issues. Tax law generally regards questions relating to staff as revenue matters. Redundancy payments are an example: they are deductible in computing assessable income. Thus the influence of public faith in managerial expertise should probably be categorised as a question of revenue. (Even here there are problems. What about managements who are particularly clever at making capital profits?) A good position of a company within the economy is probably a matter of revenue because this position

will be reflected by increased income in the future. The only obviously non-revenue item is capital profits.

Logically, therefore, to the extent that a share premium represents capital profits perhaps it should be distributable tax free. To the extent that the premium represents revenue matters it should not so qualify. One problem is that this distinction is equally relevant in the context of the current rules, but is ignored. All share premiums arising otherwise than in cash are disqualified as sources of tax-free dividends. There is no exception for premiums, or portions of premiums, that reflect capital profits.

This lacuna is not surprising, How can one realistically calculate what portion of a share premium relates to revenue matters and what to capital matters? Bearing in mind that premiums are dictated to some extent by share price on the market, and bearing in mind that market prices reflect only very inaccurately the asset backing of shares, a precise calculation must generally be impossible. Another difficulty is that practically speaking what is truly represented by a share premium account, and particularly by a distributed from share premium account, can change from year to year. The typical example is a company with fifty cent shares issued at a fifty cent premium. In year one the premium is clearly a capital item. In year five, when the company is cash-rich from revenue profits, a distribution that is technically from the share premium account may in substance be from retained income. As far as the present law is concerned, one can say that probably the larger portion of most premiums reflects revenue matters rather than capital. Consequently there is less injustice in denying tax-free status to non-cash premiums than in allowing it. It perhaps follows that cash premiums should be treated in the same way.

Causes of the Problem

Given that both company law and income tax law make earnest endeavours to distinguish between capital and revenue, why is it that the problem of share premiums, which, after all, occur rather frequently, is so intractable? Fundamentally, the reason is the unreal distinction made in both law and accounting between capital and income. When an investment analyst evaluates a company, if it were not for tax there would seldom be any point

in categorising items in the accounts as revenue or as capital. What one wants to know is how rich the company is. Whether a company is rich because its shareholders have contributed a great deal of money, or rich because it has made and saved a great deal of income, is beside the point. The capacity of the company to maintain its present operations or to expand them depends ultimately on how much money it has, not on the labels that it gives to that money.

Despite these rather obvious truths the law insists on distinguishing between capital and income. With a view to protecting the creditors of a company the law tries to prevent it from depleting its capital, but allows the company to distribute its profits. Anyone with knowledge of corporate failures will confirm that this policy has met with mixed success at best. For a variety of reasons the protection afforded to creditors by capital maintenance is minimal. Many companies have very low share capital and high debt capital. Even if there is initially a high share capital its real worth is eroded by inflation. Moreover, as the company expands and retains its profits the portion of its total undertaking represented by nominal share capital steadily declines. Nevertheless, the law feels it must do something and, anyway, it always has protected share capital on behalf of creditors. Therefore, the division between capital and income remains.

Rules about share premiums did not form part of the original company law. Without the existence of tax reasons there was no point in floating a company at a premium and in the nature of things it took some time before companies appreciated that they could issue fresh shares at a premium. Once premiums were discovered it was necessary for them to be categorised as capital or income. Since premiums were paid in return for the issue of shares it seemed logical to call them capital. Also, it gave the law another fund that could be controlled by the courts for the benefit of creditors. One suspects that little thought was given to the fact that the ability of a company to charge a premium for its shares generally depends in large measure upon its revenue profits, past or future. Given the firm categorisation of premiums as capital by company law it is not surprising that the basic thrust of income tax legislation was to treat them as capital.

Realised Capital Profits

Share premiums are not a capital profit: they are a capital fund. Like other capital funds, in principle, corporate capital profits are also distributable tax-free to shareholders. However, capital profits if anything admit of even greater manipulation than share premiums. As mentioned in paragraph 8, a company can easily create a capital profit by upward valuation of a capital asset and this profit may be distributed to shareholders as far as company law is concerned. Because of their ready propensity for abuse capital profits from revaluation of assets are not eligible for tax-free distribution. However, there are some capital profits that do remain eligible. Of these, the most important are profits realised on the disposal of a capital asset.

In leaving this class of asset eligible for tax-free distribution parliament no doubt thought that the requirement of realisation should ensure that there was a true profit. Companies, it was thought, could not engineer a profit that ex hypothosi had to be realised.

This approach ignored the ingenuity of tax planners. Companies desiring to create sources for tax-free distributions developed the practice of creating a subsidiary and selling capital assets to that subsidiary at a profit. It did not matter that the subsidiary had nothing with which to pay for the asset. According to accounting theory and legal principle the profit was realised even though the price might remain owing indefinitely. Having realised a capital profit the parent company could distribute that profit to its shareholders tax free.

This practice was brought to an end in 1982 by an amendment to the Income Tax Act. Broadly speaking, the effect of the amendment is that if a company sells a capital asset to another company with which it is significantly connected, or even to a shareholder with whom it is significantly connected, any profit realised on the sale is disqualified from tax-free status. This was the amendment mentioned in paragraph 12 that caused difficulty to owners of flats in corporately-held blocks.

The difficulty with the amendment is that it has been only partially successful. Most large companies have considerable assets. From their point of view it is often not very important

whether they own the assets or rent them. Accordingly, if a company finds its sources for tax-free dividends are running dry it can simply select an appropriate building or other capital asset and sell it to an investor. Frequently the purchaser is the staff superannuation fund of the vendor. Unless it has a very substantial shareholding in its company a staff superannuation fund is unlikely to be sufficiently closely connected with the vendor for the transaction to be caught by the 1982 amendments. From the point of view of the revenue authorities a transaction like this hardly even looks like tax planning. After all, superannuation funds must invest in something and it will often make sense for them to buy property from the employing company, if only to save the vendor's commission.

Since these transactions are on their face unexceptionable it may be questioned whether the author is correct to categorise them as tax planning. After all, there is a genuine, realised capital gain. However, from the point of view of the company concerned the economic effect of a sale of a capital asset to a superannuation fund or to another investor may be nil. If the company pays the same amount for all of its capital, whether by way of dividends, interest, rent, and so on (each adjusted for tax) it should not make any difference for the company to switch from ownership of property to rental. Of course, the premise is wrong. Companies do pay different amounts for capital depending upon its form. Nevertheless, the hypothesis serves to make the point that even some apparently utterly genuine transactions cannot withstand scrutiny. They are pointless except in terms of tax planning. Indeed, from an economic point of view a company can afford to take a modest real loss on the transaction overall because it is more than compensated by the cheaper dividends that it can pay to its shareholders. By 'real loss', one does not mean that the asset may be sold for less than its cost. Rather, supposing that market conditions are such that a company is better off to own its building rather than to rent it, if the company does sell the building to an investor it will be worse off. That loss, a real loss but not a legal or an accounting loss, is more than compensated by the company's ability to pay cheaper dividends. Otherwise, the transaction will not be undertaken.

'Genuine' Capital Profits

By 'genuine' capital profits is meant profits that would have been made without tax considerations at all or, perhaps, profits where tax implications are incidental rather than essential. As has been explained above, the 1982 amendments have failed in many cases to prevent the generation of tax-driven profits. There are not many ways to plug this loophole without disqualifying all capital profits from tax-free status. But there are genuine profits. An example is the farmer who has been sufficiently ill-advised as to put his land into a company. Over the years the value of the land appreciates. Eventually the farmer retires. One way to transfer the land to a new owner is for the company to sell it. The capital profit is 'genuine' as the word is used here. In the context of New Zealand's present tax regime it would be unfair to tax the farmer on this profit when the company distributes it to him. Like other farmers, throughout his working life he has no doubt accepted a modest income return on his capital expecting on retirement to derive a non-taxable capital gain. His colleagues who own their farms personally will achieve that result. He may not.

In point of fact, the position is not like that. The 1982 amendments, particularly as modified in 1985, do provide for exceptions calculated to ensure that people can wind up private companies pregnant with capital profits and extract those profits free of tax. These provisions cover not only the case where the company sells its capital assets to an independent party, but also cases where the assets are sold to a shareholder or his connections. One solution to the problems identified above is therefore to deny tax-free status to all capital profits except where they are distributed on the winding up of a private company. Possibly the exemption should extend to public companies. The 1985 amendments cover both public and private companies but the 1982 amendments are restricted to private companies.

A provision like this would result in some injustice. One example is the case of a farming company with more than one major shareholder. It may be advantageous for one shareholder to withdraw but not the other. The shareholders will be reluctant to be forced to wind the company up because they face a large accrued tax liability in respect of livestock. Therefore, the result could be that a farmer who was the sole shareholder in his

company could readily extract his land from it, but two farmers owning shares together in a company might find it too expensive to allow one of them to withdraw.

An Alternative Approach

If it is accepted that there should be some change to the law in respect of share premium and capital profit accounts, rather than disqualifying them atogether from tax-free status an alternative is to permit companies to resort to capital profits or to share premiums only when they have exhausted revenue profits that are available for dividend. In many ways, a rule like this would carry the policy of company law across to income tax law more effectively and more correctly than is now the case. As has been mentioned above, the whole point about capital in company law is that it should be preserved. It is therefore somewhat ironical that in modern times corporate treasurers spend a good portion of their time trying to find or generate capital funds that can be distributed before revenue profits. The status of capital profits, and perhaps more particularly of share premium accounts, as tax-free funds stems from their status in company law as capital accounts. It may not be unfair to a company to require it to distribute those funds last. An amendment along these lines would probably cope with the position of small companies desiring to wind up both better and more elegantly than the present rules because, on winding up, corporate distributions would reach and dispose of capital funds in any event.