

# DISTRIBUTIONS FROM SHARE PREMIUM ACCOUNTS

REPORT OF THE PROPERTY LAW  
AND  
EQUITY REFORM COMMITTEE

PRESENTED TO THE MINISTER OF JUSTICE  
MAY 1982

PROPERTY LAW AND EQUITY REFORM COMMITTEE

REPORT ON

DISTRIBUTIONS FROM SHARE PREMIUM ACCOUNTS

The Minister of Justice.

In April 1979 you referred to this committee for consideration a request from the Trustee Companies Association that the Trustee Act 1956 be amended to authorise trustees, who receive on behalf of the Trust distributions from companies' share premium accounts or other capital revenue accounts, to treat such distributions as income between income beneficiaries and residuary beneficiaries.

After giving preliminary consideration to the problem a working paper was prepared and distributed to all interested parties including the Trust Companies, Public Trustee, and New Zealand and District Law Societies. A good response was received. With little exception, opinion favoured such an amendment. We shall deal in more detail later in this report with the reasons for such support.

The Problem:

The practice of making distributions from share premium accounts in lieu of or partly in lieu of dividends has developed in New Zealand during the last decade and according to information provided to the committee, would appear to be a trend which is likely to continue for some time yet.

Distributions from the share premium account are treated as a reduction of share capital pursuant to section 64 of the Companies Act 1955 and must therefore be treated as capital in the hands of the recipient. In this respect they must be distinguished from other distributions from capital reserves which can only be made by way of dividing profits and thus whether called a dividend or bonus or any other name, are payable to the income beneficiary.

Hill v Permanent Trustees Co. of New South Wales (1930) AC 720 In re Davis, N.Z. Insurance Co. Limited v Davis (1961) NZLR 597.

Where the will, deed, or other instrument creating the trust authorises the trustees to treat distributions from share premium accounts as income for the purposes of the trust notwithstanding that they are capital in nature then the problem facing the trustees in balancing the interests of life tenant and remaindermen is to some extent, overcome. Otherwise it appears that trustees may be faced with the following difficulties.

- (a) Because such distributions are capital they are the property of the remaindermen and not available for the life tenant unless the remaindermen are sui juris and consent to payment to the life tenant.
- (b) Trustees who are required, or consider it desirable, to maintain the income of a life tenant at a certain level, are frequently obliged to elect to receive a dividend, where the company provides the right to make such an election as an alternative to receiving a distribution from the share premium account. Where no such election is available the life tenant is deprived of the benefit of the distribution.

- (c) Trustees can be discouraged from maintaining an investment in a company making distributions from its share premium account in lieu of dividends because of the need to produce an appropriate income for the life tenant.
  
- (e) Corporate trustees operating pool holdings are put to considerable trouble in separating and maintaining individual classifications for their various shareholders, for some of whom it is appropriate to receive the capital distribution while for others an election to be paid a dividend from income, is necessary.

The Solution Proposed:

The working paper suggested that if as the result of the committee's investigations the need for amendment was established, it should be effected by an extension of the powers of trustees under the Trustee Act 1956. The powers should be extended to include the power for trustees in their absolute discretion to pay to income beneficiaries of the Trust distributions from the share premium account of any company in which the trust holds shares. This power should be limited to share premium distributions where, as a term or condition of the authority for the distribution, it is a requirement that a capital replacement fund be provided by the company from revenue sources, or to that portion of the distribution which is subject to the requirement for a capital replacement fund. These conditions are considered necessary for the protection of residuary beneficiaries whose interest in the capital of the company is otherwise diminished by the distribution from the share premium account.

Response:

As stated above, the response from those who considered the working paper was almost unanimously in favour of amendment. Those who considered that there was not a sufficient case for amendment raised the following points:

1. Many trust instruments provide (and draftsmen in the future should ensure that they do so provide) appropriate discretions to the trustees to deal with the problem. The trustees can be empowered to treat capital receipts of this nature as income for trust purposes, and/or can be authorised to lend and advance funds to the life tenant to protect the life tenant's position.
2. Trustees can in most, if not all cases, elect to receive an income dividend rather than a share premium distribution.
3. The investments of the trust can be altered to ensure receipts of an income nature.
4. Where residuary beneficiaries are sui juris and consent capital payments to the life tenant can be made by arrangement.
5. The availability of funds to companies from which to make share premium distributions is likely to diminish.

The committee is of the view nevertheless, that to protect the position of life tenants under trust instruments and to ease administrative difficulties, there is, on balance, a case for amendment.

Recommendation for Amending Legislation:

It is recommended that to protect the position of a life tenant under a Trust, an additional provision be added to the Trustee Act 1956 Part III General Powers, and a draft is attached for consideration.

Taxation Considerations:

It became very clear to the committee from the numerous replies received to its working paper, that most proceeded on the assumption that provided trustees had power to pay a share premium distribution to the life tenant, that distribution, being from a capital source would be free of income tax in the hands of the life tenant. Indeed, this was frequently given as a reason for supporting the proposed amendment.

This committee sees no reason why a life tenant should not receive such a distribution free of income tax, nor for that matter any distribution or dividend from a capital source which is free of tax in the hands of other shareholders. However, the law is far from clear.

It is not, of course, within the scope of this committee to consider or recommend amendments to fiscal legislation, but because this aspect arose so directly in our consideration of the matter before us it was necessary to give it some attention. The lack of clarity in the legal position, and in the application of it, is usefully summarised by Dr John Prebble in a series of three articles in 25 N.Z. Current Taxation and particularly in Part III N.Z. Current Taxation No. 8, at pages 168 to 171.

We further recommend, therefore, that the Income Tax Act, 1956 should be amended to clarify the income tax situation in respect of distributions from capital sources.

Section 4(1DA) Trustee Act 1956 (as inserted by the Trustee Amendment Act No. 2 1977):

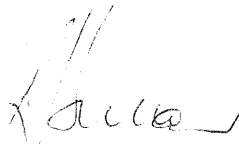
This provision enables share premium distributions to be treated as dividends for the purpose of qualifying a company as a trustee investment. It is closely linked with the reform proposed in this report and the Committee has given some thought to its present form, in view of the problems we have encountered in defining what is a qualifying distribution for the purposes of our own proposed legislation. We found section 4(1DA) defective in that it requires the transfer from revenue sources to a capital replacement fund in the financial year of distribution. This can prove very difficult for a trustee to check. We suggest that a trustee should be able to rely upon the certification of the secretary of the company making the distribution, as to compliance with the requirements of the legislation. A provision similar to the attached draft section 25A should also apply in the case of section 4(1DA).

If section 4(1DA) is to be re-examined, then we draw to your attention a further drafting difficulty with the section. It applies not only to share premium distributions but also to payments from other capital sources. As it is worded, it can have the effect of requiring a capital replacement fund for capital dividends as distinct from share premium account distributions. This was the subject of comment in submissions made to the Committee, and it is difficult to see any justification for such a restriction. This is a matter which might be given attention in any future legislative reconsideration of section 4(1DA).

Pennsylvania Rule:

On 27 August 1980 the Deputy Secretary for Justice with your approval, referred to this committee for consideration the question of capital profit distributions generally, and in particular the implementation of a provision similar to that adopted in some states in America and known as the Pennsylvania Rule. Having given preliminary consideration to this matter, the committee is of the opinion that much more extensive investigation is required, and is proceeding accordingly. However, the question of distributions from share premium accounts, is a specific area which warrants more immediate attention and can be dealt with in accordance with the recommendations contained in this report.

For the committee



Chairman



Members:

Professor R. J. Sutton (Chairman)

Miss J. M. Potter

Mr R.G.F. Barker

Mr A. J. Forbes

Mr W. B. Greig

Miss J. M. Finnigan (Secretary)

APPENDIX I

TRUSTEE AMENDMENT

ANALYSIS

A BILL INTTTULED

An Act to amend the Trustee Act 1956 by giving trustees a discretion to treat distributions from share premium accounts as income under certain conditions.

BE IT ENACTED by the General Assembly of New Zealand in Parliament assembled, and by the authority of the same, as follows:

1. Short Title and commencement - (1) This Act may be cited as the Trustee Amendment Act 1982, and shall be read together with and deemed part of the Trustee Act 1956\* (hereinafter referred to as the principal Act).

(2) This Act shall come into force on the        day of        19   .

2. Power to treat share premium account distributions as income - The principal Act is hereby amended by inserting, after section 25, the following section:

\* Reprinted 1977 Vol.4, p.3607

"25A. (1) In this section the term "Court order", in relation to any distribution by a company from its share premium account, means the order of the Court made under section 77 of the Companies Act 1955 (as applied by section 64 of that Act) confirming the distribution.

"(2) Notwithstanding any enactment or rule of law to the contrary, a trustee of any stocks or shares in a company may in his discretion treat the whole or any part, not exceeding the maximum permitted fraction, of the proceeds of any distribution made to the trustee by the company from its share premium account as income for the purposes of the trust.

"(3) The maximum permitted fraction, in relation to the proceeds of any such distribution made to a trustee, is -

$$\frac{y}{x}$$

where x is the total amount of the distribution paid by the company to the holders of its stocks and shares; and y is the total amount required by the Court order to be transferred by the company, by reason of the distribution, from revenue reserves or profits to a capital replacement fund (however described) that is not available to holders of stocks or shares otherwise than in pursuance of a reduction of the capital of the company duly confirmed by the Court or in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

"(4) For the purposes of this section, a trustee may act upon a certificate by the secretary of the company as to -

- (a) the terms of the Court order; and
- (b) the total amount distributed or to be distributed by the company pursuant to the Court order, and the total amount transferred or to be transferred to a capital replacement fund, in compliance with or in addition to the requirements of that order."

## APPENDIX II

Replies to the working paper were received from the following:

Pyne, Gould, Guinness Ltd

The South British Guardian Trust Company Limited

New Zealand Law Society

N.Z. Trustee Companies Association

The New Zealand Insurance Company Limited

Hawkes Bay District Law Society

Auckland District Law Society

New Zealand Society of Accountants

Mr C. E. Lloyd (Anderson Lloyd Jeavons and Co.)

Canterbury District Law Society

Hamilton District Law Society

Mr P.G.S. Penlington Q.C.