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Policy and Strategy
Inland Revenue Department
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Our ref 151102KPMGsubLossGrouping

2 November 2015

Dear Sir

KPMG submission: Loss grouping and imputation credits – An Officials' Issues Paper

We welcome the opportunity to comment on the Issues Paper and appreciate the additional time for making a submission.

Policy rationale for change supported

Under the current rules, shareholders of non-wholly owned companies have an imputation shortfall when losses are grouped and dividends paid.

The proposed solution aims to bridge this shortfall by allowing imputation credits to be passed from the loss company (which provides the loss to be used for grouping purposes) to the profit company (which makes use of that loss), which can then be attached to a dividend paid by the profit company.

This proposed imputation credit transfer mechanism ensures that dividends from the profit company are able to be fully imputed, including to minority shareholders, to the extent the shortfall relates to use of loss offsets and subvention payments.

We support the policy principles underlying the proposal – to ensure shareholders of non-wholly owned companies are not tax disadvantaged when losses are grouped and dividends paid.

A simpler option is to extend the inter-company dividend exemption

However, the proposed solution is technically complex and has constraints (i.e. does not deal effectively with loss grouping between sister companies, as discussed further below).

The imputation credit transfer mechanism will require companies to keep track of loss groupings, between group companies, for up to four years. The solution also does not work when the company providing the losses and the company receiving the dividend are not the same entity (as there will be an imputation debit in the loss company which will remain outstanding).

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An alternative option is to extend the existing intercompany dividend exemption rule to shareholders that can satisfy the 66% or greater commonality of shareholding test under the loss grouping rule.

In our view, this would be a simpler option and put minority and majority shareholders in a 66% or greater commonly owned group in the same position as a 100% shareholder. They would be in the same after tax position regardless of whether they invest in wholly-owned or non-wholly owned companies (which meets the stated aim of the imputation credit transfer mechanism).

We understand Officials' concern is that extending the existing intercompany dividend exemption rule would raise potential tax planning opportunities – namely, allowing transfers of capital gains tax-free within a less than wholly-owned group prior to liquidation.

We note that the Issues Paper on the closely-held companies review also raised concerns about capital gains being able to be paid out tax-free. We do not believe this is a "distortion" but rather a natural concomitant of New Zealand not taxing capital gains and a corporate tax system which attempts to remove double taxation at the shareholder level through imputation.

There is, therefore, no sound policy reason for restricting access to capital gains prior to liquidation of a company. The current restriction is the "distortion", in our view.

Further, we consider that any concerns around potential tax planning opportunities should be balanced against the complexity of the proposed solution.

If there is a concern around the inter-company dividend exemption being used to shift capital gains, the application of that exemption in a less than wholly-owned setting could be limited to a dividend that is paid from the taxable income of the paying company, including amounts that would be taxable income, but for the use of loss grouping. (This is no different to the information required to be provided to Inland Revenue in order to utilise the proposed imputation credit transfer mechanism.)

The proposed solution needs to work for loss grouping between sister companies

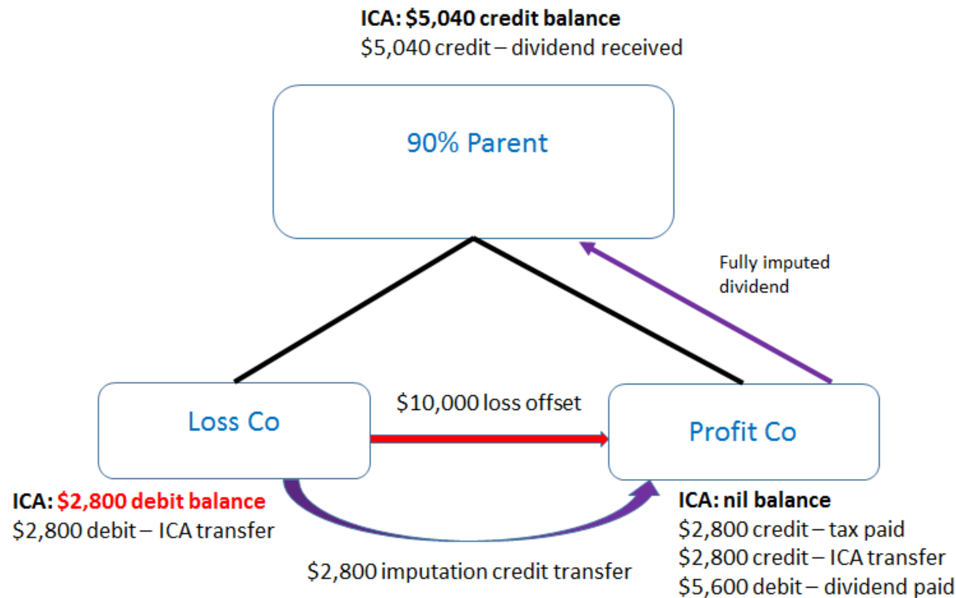
If our alternative solution above is not acceptable, we submit that the Issues Paper proposal needs to deal effectively with the imputation shortfall that would arise if there is an imputation credit transfer from a company that provides losses to another group entity, but there is no direct shareholding between the two.

That is, the proposed solution needs to be effective for imputation credit transfers arising from loss grouping between two sister companies in a 66% or greater commonly owned group.

While the Issues Paper notes that the *"proposed imputation credit transfer mechanism should also be available to sister companies with a common corporate parent that owns between 66 percent and 100 percent of both the profit and the loss company"*, in practice it will not be used.

The group company providing the loss (and the imputation credits) will have an imputation credit account debit balance following the transfer. However, because the parent and not the group company providing the loss will receive the dividend from the profit company, there will be no imputation credits to offset the debit in the loss company.

To outline the problem, and our proposed solution, we have included the diagram below.



In the above example, Profit Co uses the Loss Co's losses of $10,000 to offset against its income of $20,000. Loss Co can transfer up to $2,800 (i.e. 28% of the loss offset) of imputation credits to Profit Co.

While this then allows Profit Co to fully impute a dividend to Parent (and any minority shareholders), this will leave a debit of $2,800 in Loss Co's imputation credit account.

This in turn raises two issues:

- A debit balance in Loss Co's imputation credit account, at year end, will result in additional income tax and imputation penalty tax having to be paid by Loss Co, unless Loss Co is part of a consolidated imputation group. (Consolidation will not be possible, however, if Loss Co and Profit Co are not part of the same wholly-owned group.)
- The imputation credit transfer mechanism is not effective if Loss Co is not the dividend recipient and does not have sufficient accumulated imputation credits. In contrast, if Loss Co was the dividend recipient, an imputation credit transfer would work, even if Loss Co did not have sufficient imputation credits (i.e. a nil opening imputation balance), as the combined effect of the transfer and dividend on the two companies' imputation accounts would be neutral.

Therefore, unless Loss Co has accumulated sufficient imputation credits to offset any debit created by the imputation credit transfer (i.e. the account will be in credit at year-end), we expect the option is unlikely to be exercised in a sister company scenario, unless an arrangement can be entered into in order to transfer other imputation credits in the group to Loss Co.

We are concerned, however, by comments made by Officials that arrangements to ensure a debit imputation balance does not arise in Loss Co could be subject to challenge under the general anti-avoidance rule (due to imputation shopping concerns).

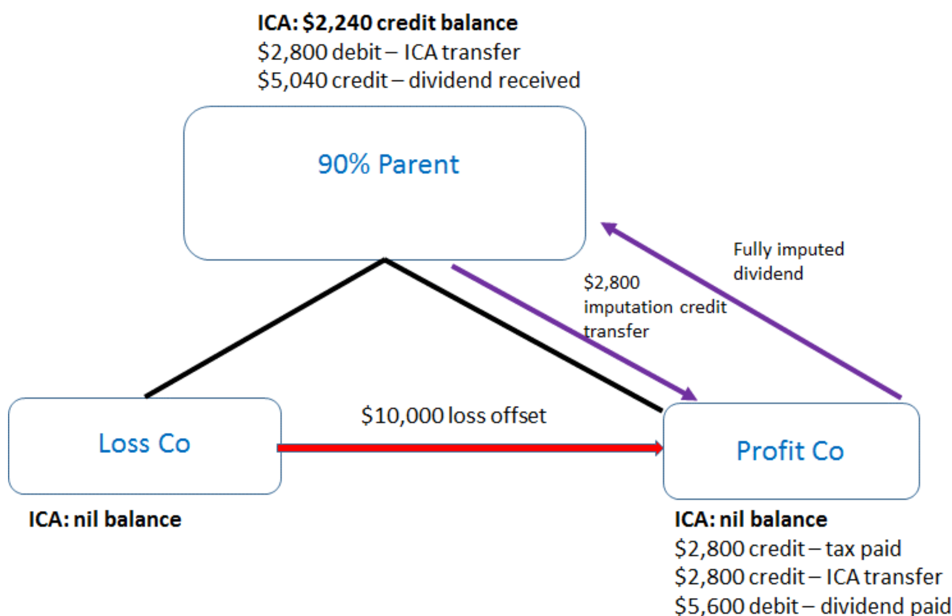
For the avoidance of doubt, in such situations, it would be helpful to have a positive legislative statement on the types of arrangements acceptable to the Commissioner.

KPMG's recommended solution: allow dividend recipient to undertake the imputation credit transfer (on behalf of the loss company in the group)

We consider that the Issues Paper proposal should be amended to allow the dividend recipient (the Parent, in the example above) to transfer imputation credits to the dividend payer (Profit Co, in the example above) equal to the imputation credits that Loss Co would otherwise be able to transfer to Profit Co under the proposal. This would effectively allow the Parent to utilise the imputation credit transfer mechanism on behalf of Loss Co.

The Parent making the imputation credit transfer to Profit Co, with Profit Co paying a fully imputed dividend to Parent (and any minority shareholders), would have a neutral impact on the imputation credit accounts of Parent and Profit Co. Loss Co's imputation credit account would be unaffected.

The imputation credits available would be limited by the formula proposed in paragraph 3.26 of the Issues Paper (i.e. 28% of the losses utilised by Profit Co). The following diagram illustrates our recommended solution:



To address any imputation credit shopping risk, the rule could have a condition that the dividend recipient (i.e. Parent), the loss company (i.e. Loss Co) and the company making use of the losses (i.e. Profit Co), should have at least 66% commonality when:

- the losses are grouped between Loss Co and Profit Co; and
- Parent makes the imputation credit transfer to Profit Co on behalf of Loss Co; and
- the fully imputed dividend is paid by Profit Co to Parent (and any minority shareholders).

We believe the above suggestion would achieve the stated policy objective as well as extending the solution to cover the sister company scenario illustrated above.

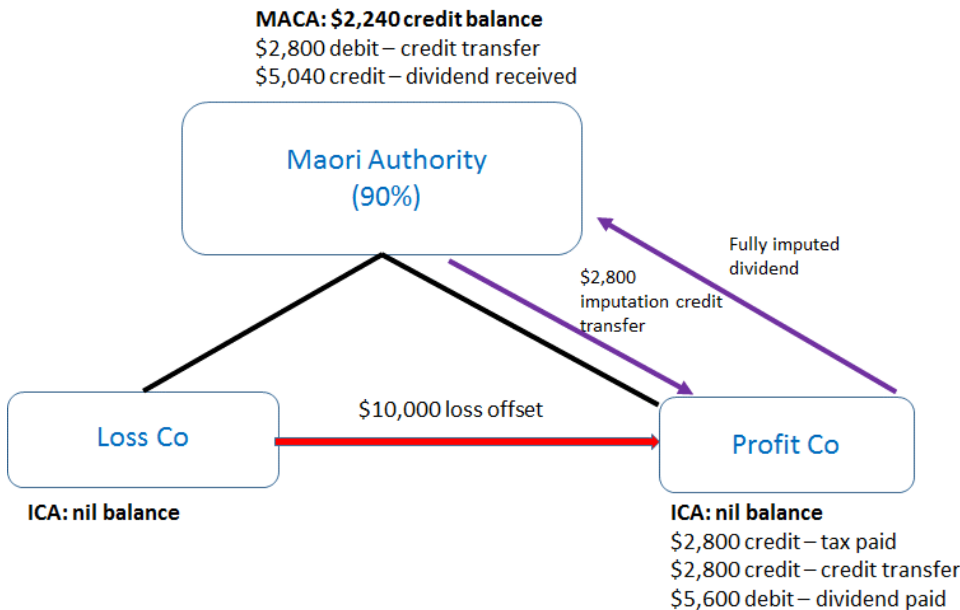
Application to other entities: Maori Authorities

The Issues Paper proposes that the imputation credit transfer proposal should be limited to companies that are eligible to maintain an imputation credit account. We consider that the proposal should be extended to other entities which have similar mechanisms to imputation, as they face similar issues. The proposal should therefore also apply to Maori Authorities.

We understand the specific concern with loss grouping for Maori Authorities is the sister company situation above, where the Maori Authority is Parent and owns 90% of Profit Co and Loss Co. Our recommended solution above should also be applicable to Maori Authorities.

That is, the Maori Authority should be able to make an imputation credit transfer (this would create the relevant debit and credit entries in its Maori Authority credit account) to Profit Co on behalf of Loss Co, equal to the imputation shortfall as a result of loss grouping between Profit Co and Loss Co. This would then allow Profit Co to pay a fully imputed dividend to the Maori Authority and any minority shareholders.

The diagram below illustrates:



Other detailed design features

We support the imputation credit transfer mechanism being optional and subject to agreement of the parties involved.

The Issues Paper proposes requiring an imputation credit transfer to be made within four years of the balance date of the tax return that includes loss grouping. This would require a dividend to be paid at the same time.

We understand the rationale for the four year time limit is to align with the statute bar. This is not a valid comparator. Assuming the minimum 66% shareholding commonality is met between the time of loss grouping and the imputation credit transfer, there should be no time based restriction. Particularly, if both parties to an imputation credit transfer will need to provide information to Inland Revenue about the quantum of the grouped losses, when the loss grouping arose, and imputation credit amounts.

Further information

Please do not hesitate to contact us, John Cantin on 04 816 4518 or Darshana Elwela on 09 367 5940 if you would like to discuss this submission in greater detail.

Yours sincerely

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