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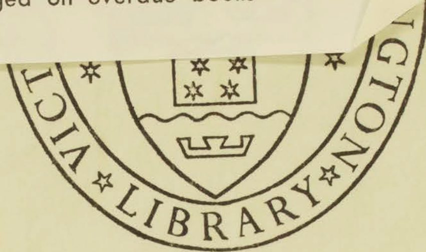

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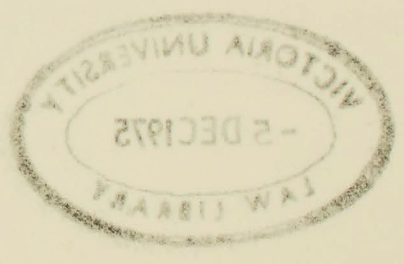
MARK CHARLES DOWLAND

A DESCRIPTION OF THE TAXATION OF COMPANIES IN NEW ZEALAND

Submitted for the LL.M. Degree at the
Victoria University of Wellington



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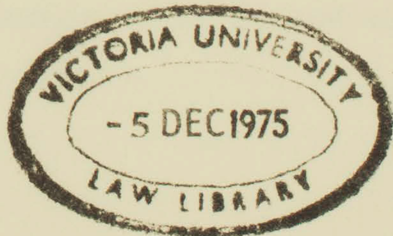

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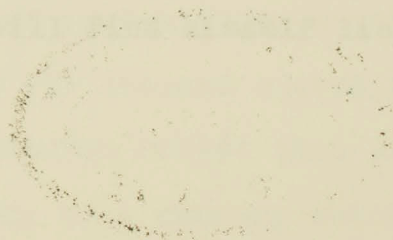

INTRODUCTION

This paper will attempt a description of the taxation of Companies in New Zealand with some attempts to display the rationale behind the particular method of taxation. The taxation relationship between the shareholder and the Company will also be discussed in the light of overseas developments in recent years.

The Company will be examined as an individual entity and in its relationship to the group. The position of a "loss company" in the taxation structure of the group also bears examination.

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PRE-INCORPORATION

A Company does not derive, for the purposes of taxation, any income before incorporation. In the case of a new Company taking over an existing business the income will remain that of the Vendors or become that of the trustee to the Company to be formed. Generally a Vendor would seek to avoid any taxation liability being imposed on him once he has sold the business.

The position of persons acting for a Company to be formed is generally unsatisfactory, the position could arise that while they may have to account for profit before the Company is incorporated they may in fact be liable for taxation.

The rate of taxation may be affected as while in relation to the unformed Company the sums earned would be the commencement of its income, in relation to the trustee the sums would increase his income for the year and be taxed at possibly an higher rate. It is therefore desirable to have the income derived by the Company as soon as possible.

In practice the Commissioner adopts a sensible and convenient solution. Where the period between the times when the trustee begins trading on behalf of the Company and the Company is incorporated is short the Commissioner assessed the whole of the income as being that of the Companys. It is only when the period is extended that a trustee or agent for a company to be formed will find himself liable for tax.

Definition of "Company"

For taxation purposes Company is defined in the Land and Income Tax Act 1954[1] S.2. as:-

"... any body corporate, whether incorporated in New Zealand or elsewhere, but does not include a local or public authority.

On S.153B 2(9) Unit Trusts were included in the definition of "Company". Building Societies, Friendly Societies and Trade Unions are incorporated bodies excluded from taxation as "Companies". The definition is extremely wide and would catch every incorporated society unless excluded from the act. This paper will however, be confined to taxation of Companies incorporated under the Companies Act with reference also to the taxation of the shareholders in those Companies.

Other commonly used words in the Statute are "taxpayer" and "person". On S.2. "Person" includes a company and the definition of "taxpayer" is "a person chargeable with land tax or income tax". There can be no doubt that Companies are intended to be caught by most of the sections in the Act. "Company" figures in other definitions in S.2; a New Zealand Company means a company which is incorporated in New Zealand and not surprisingly an overseas Company means a Company other than one incorporated in New Zealand. The non resident investment company has a section devoted entirely to it[2] which section was included in the Act in 1968. The meaning of such a Company is a company which derives no income from New Zealand except interest and has no other investments or assets except that principal from which the interest is derived, or a company which total assets

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1 Hereafter unless specifically mentioned all sections referred to will be of The Land and Income Tax Act 1954.

2 S.2A

consists of more than half of development investments. Development investments are investments of a nature which by Order in Council are "development investments" for the purposes of the section. Other definitions such as the definition of proprietory company will be considered later.

The Distinction Between the Taxation of Companies and the Taxation of Individuals

While the Company is caught by the definition of "person" in section 2 there are many important differences between the taxation of companies and of individuals. Not always is the taxation of the Company clearly devorced from the individuals taxation as in the case of bonus issue tax the Company in effect pays the tax on what is really income gained by an individual[3]. The relationship between the Company and the individual shareholder in the Company is established for taxation purposes by S.4 but recently in Great Britain and in Australia the relationship has been reconsidered. Since New Zealand included "dividends" in the definition of income only as late as 1958 it is unlikely that any real change will become apparent in this field for some time. However, fiscal statutes are suseptable to rapid change[4] and the fact that a policy was implemented only sixteen years ago does not necessarily indicate that the policy is permanent. Some suggestions for the reform of the relationship between the shareholder and the Company will be found later.

The most obvious difference between the Company and the individual is the rate of taxation. The Company rate varies depending on which type of Company is sought to be taxed. For the 1973/74 income year the basic rates of taxation for resident companies was 20 cents in the dollar for the first $6,250 of assessable income together with a further .002 cents in the dollar for each dollar of that assessable income, as

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3 Bonus issue tax will be considered later.

4 With however, some notable exceptions. The delay in effecting an amendment to S.108 was inexplicably long in the face of clear judicial opposition.

does not exceed $6,250. A flat rate of 45 cents in the dollar is assessable on such amount of assessable income as exceeds $6,250. The non resident company tax rate is basically 5% higher than the resident company tax rate[5]. There are several companies in a specially rated class of taxation. Group companies are assessed on the basis of an aggregated income while Life Assurance Companies pay only 40% on the amount of tax which is usually payable with Life Companies. The rate for resident companies always applies not the rate for non resident companies although the company in fact may be non resident.

The treatment of Life Assurance Companies was discussed by Quilliam J. in National Mutual Life Association of Australia v CIR [1972] N.Z.L.R. 1021 at page 1029 where his Honour stated,

> "It seems inescapable that the treatment of life insurance companies with regard to the assessment of taxation has been not only special and different but also favourable... It may well be that the reason for this favourable basis of assessment has been the mutual nature of life insurance companies but it is idle to pretend their treatment is not a favourable one".

Counsel for the life insurance company had argued that the special position enjoyed by the company was a recognition of the question of mutuality and not a favourable position. With respect Quilliam J was quite correct in holding that the Life Company was in a generally favourable position. It is

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5 This factor has raised certain problems in the interpretation of double tax agreements, the argument being that non resident companies are discriminated against.

submitted that the favourable position is less a recognition of mutuality than an attempt to find a satisfactory method of assessing tax on a class of Companies in a difficult position. The type of business is unique in that in the early years of formation the income, and in fact the majority of transactions are largely a collection of premiums. If the Companies were assessed at full rates on the collection of premiums then disaster may strike in later years when the time comes to pay out some of the moneys gained by premium[6]. Basically the special treatment appears to be a recognition of the special type of business rather than of mutuality.

Mining Companies also enjoy a tax saving and a non resident mining operator has different treatment attracting tax at the flat rate of 45 cents in the dollar, Non resident investment companies attract a reduced rate of tax while in the proprietary company situation the profit can be imputed to the shareholders. From time to time Government declares by Order in Council that a certain development is a special development and the Company thereby engaged is entitled to some form of tax saving by a special rate.

On the other hand the assessment of the individual is on a graduating scale. For the same period as is mentioned, the rate was 7.85 cents in the dollar up to the first $650 and a maximum of 50 cents in the dollar over $12,000. The rate of tax increased only 9 cents in the dollar from $4,501 to $12,000 which places the greater burden of tax on a "middle income" group. Coupled with the low maximum rate of taxation provides justification for the expression that New Zealand is "a tax haven for the rich".

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6 The most important section as regards this type of Company is S.149

The non resident company can be contrasted to the individual who is absent in that the company is taxed on a special formula. The non resident investment company is defined by S.2A[7] and such Company may in effect be given a special tax rate by order in Council. The attractive situation is not made available to the individual who happens to be absent.

A company can derive non assessable income from dividends on shares. Part of the definition of "non assessable income" in S.2 includes "Dividends derived from companies and exempt from income tax under S.86c. Section 86c (1) provides that dividends derived from any company that is a New Zealand resident company (other than from companies which are exempt from tax) shall be exempt from income tax. The reason is that the dividends are now taxable in the hands of the individual shareholder. A dividend paid to a company is reflected either in the dividend which that company pays to its shareholders or in the amount of bonus issue tax or excess retention tax the company attracts. To tax the company on the dividend would therefore be a form of double taxation. Obviously the example has no application to individuals.

A Company does not have available to it the special exemption enjoyed by the individuals. The Company along with the individual and all other varities of taxpayer can claim a deduction under S.111. The difference between the deduction and the special exemption is firstly that the deduction is universally available whereas the special exemption has to be specifically created by statute. S.111 offers a general and

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7 mentioned above

abstract notion for deduction which is available unless barred by statute. The special exemption is unavailable unless expressly conferred by statute. A deduction may be carried forward into subsequent years while the special exemption expires if it is not taken advantage of in the current taxation year. The special exemptions available to the individual taxpayer are, the personal exemption, the married man/woman exemption, the housekeeper/child care exemption, the dependant relative exemption, donations/school fees exemption, (a company does attract a tax advantage in making a donation but not as a special exemption), life premium/superannuation contribution exemption, absentee exemptions (these are more limited than the resident taxpayer special exemptions) and the trustee exemption.

The tax rebates available under the Act are available to the individual taxpayer. The most widely known rebates are the dividend rebate and the overtime or shift work rebate. On the other hand only a Company enjoys the advantages offered by S112(i)(g)(ii) whereby should one company pay interest to finance the purchase of shares in another company and both companies belong to the same group of companies (as defined by the Act) then the interest so paid is deductable.

The definition of "proprietary shareholder" is limited to companies by S.138(ii). Originally a proprietary shareholder could be either an individual or a company so long as the shareholding of that individual consisted of 25% of the total shareholdings. According to a Departmental spokesman the system was very top heavy and difficult to administer. Difficulties in administration were particularly apparent when credits had to be given for individuals who were assessed as proprietary shareholders. With an ever increasing

number of companies the Department believed that the loss in revenue would be amply compensated by a greater administrative efficiency and accordingly proprietary shareholding was limited to companies.

The Company and the individual are obviously subject to a different test for residence. On S.166 the residence of an individual for taxing purposes is where that individual has his home. On the other hand a Company is deemed to be resident in New Zealand if it is incorporated or has its head office in New Zealand. The Company can never be "absentee".

Group assessment is perculiarily limited to Companies and Companies can only bring forward a loss to subsequent years if there remains a substantial coincidence in shareholder. The provision is designed to inhibit Companies "trafficking" in other Companies which show a loss to gain a tax advantage, Only Companies are liable for bonus issue and excess retention tax. Companies can never be what is known as a "pay period taxpayer"[8].

There are several other differences of a more minor ~~of a more minor~~ nature between the two classes of taxpayers. These deal with tax accounting and returns and other features involving different treatment for individuals and Companies in the same industry[9].

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8 A "pay period taxpayer" is always an individual deriving less than $2,600 from salary, wages or bonuses.

9 e.g. Corporate underwriters are assessed differently to individual underwriters. For a full list of the differences see the Commerce Cleaning House Publication 1974 New Zealand Master Tax Guide 55.

Residence

The "absentee" individual mentioned above is a person whose home has not been in New Zealand during any part of the income year[10]. S.166 states "a person other than a company shall be deemed to be resident in New Zealand if his home is in New Zealand".

Generally the Commissioner uses a period of 15 months in defining the individuals status and persons away from New Zealand for this time are deemed absentee. There are certain exceptions to this, the most common being persons who are away in the service of the New Zealand Government. Persons who are away because of ill health may also escape the classification and seamen may similarly be exempt.

A Company is deemed to be resident in New Zealand on S.155(2) if it:-

"a. Is incorporated in New Zealand; or

b. Has its head office in New Zealand".

S.155(3) provides, for "... the purposes of this Act, the head office of a company means the centre of its administrative management".

The residence of the Company is important for tax purposes as a different rate of tax is attracted by the non resident, being basically a 5% increase. S.165 provides in subsection (2) that while all income derived in New Zealand shall be assessable to tax subsection (3) provides that income which is derived by a person who is not resident in New Zealand and income which is not derived in New Zealand is not liable for tax. Because of obvious problems in collection withholding tax is payable on any non resident

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10 S.76

withholding income. The non resident company does attract some taxation advantages in that it is not liable for excess retention tax unless it is under the control of New Zealand residents, admittedly a very slight advantage indeed.

The non resident also receives a 5% special rebate on its taxable proprietary income and on S.78F enjoy a rebate in respect of income from special development projects. Non resident investment companies may also enjoy concessions which are not available to resident investment companies[11].

It is difficult to conceive of problems arising with S.166 (2)(a) as whether a Company is incorporated in New Zealand will certainly be one of the simplest questions of fact. Questions may be raised, however, under S.166(2)(b) where, in following the definition provided by S.166(3), the company resides in New Zealand if it has its head office, being the centre of its administrative management, in New Zealand.

The definition provided in the section resembles the test for residence for income tax purposes laid down in <u>De Beers Consolidated Mines Limited</u> v <u>Howe</u> 5 Tax Cas 213 in which Lord Loreburn LC said that a company resides for income tax purposes where its real business is carried on and its "real business is carried on" where the central management and control actually abides. "Real business" must be taken to mean something other than the day to day trading of the Company, which may be called its contact with the outside world. The words should be taken to mean the making of decisions which affects the company in its dealings with itself and with outsiders. The normal place for such decisions to be made is the head office. The only other possible

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11 SS74B, 78C

definition of the words "real business" is the day to day activities of the Company which devolve the profit. This would make the head office just one step removed from the factory floor a result which, it is submitted his Lordship would not have intended.

The "administrative management" of the company is open to several definitions. It could be narrowly construed as simply the managing of the daily internal matters of the company, the "domestic" matters as opposed to "policy making" management. The wider definition is that the administration of the company means in effect the control of the company encompassing not only the domestic matters but also policy decisions. The wider definition is the more acceptable. The "administrative management" described in the section is the "centre" which implies the "brains" of the administrative management. From the "brain" stems all major decisions and implies the head office.

The similarity to Lord Loreburn's definition suggests that the view taken by his Lordship may be properly applied to the words of S.166. The wording of the section should not be taken as imposing a limitation on his Lordships test that is merely a different way of wording the same concept. The test in the section may, however, in certain circumstances be easier to satsify. It is well established law that for the purposes of income tax a company may have more than one place of residence[12]. A Company may be found to have more than one place of residence on S.166 with a head office in one place

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12 Swedish Central Ry Co. Ltd v Thompson 9 Tax Cas 342 the principle was called "trite law" by Viscount Simonds in Unit Constryction Co Ltd v Bullock (Inspector of Taxes) (1959) 3 All ER 831 at 833.

and be incorporated in another. The Commissioner it is submitted must assess the company as being resident in New Zealand if one of the two tests are satisfied.

To have confined the head office of the company to the place where the central management and control was carried on would have lent some precision to the section.

The test of control is one of fact. In Unit Construction Co Ltd v Bullock (Inspector of Taxes) [1959] 3 All ER 831 the facts were that the decision making of the three Companies incorporated in Kenya was performed by the Board of the parent company in London. The state of affairs had arisen because the situation of the three companies (being subsiduaries of the parent company) had become so serious that it was unwise to allow them to be managed in Africa any longer. The Special Commissioners found as a fact the real control of the African companies was exercised in London and the African boards stood aside for their London counterparts for all important matters and many minor matters. The situation was contrary to the Articles of Association of the African companies and was "irregular, unauthorised and, perhaps, unlawful"[13] The English parent company sought to deduct subvention payments made to the African Companies on the grounds that the payments were in accordance with S.20 of the Finance Act 1953 subvention payments made to "associated companies". Under that Act a company could not be an "associated company" unless it was resident in the United Kingdom. To secure the deduction the English parent company accordingly had to show that the African companies were resident for taxation purposes in the United Kingdom.

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13 per Viscount Simonds at page 834

Viscount Simonds followed the well known words of Lord Loreburn and went on to restate the principal that a company may have more than one residence. Regarding the issue of ~~xxxxxxx~~ the fact that the direction from the London board was unauthorised His Lordship said[14],

> "Nothing can be more factual and concrete than the acts of management which enable a court to find as a fact that central management and control is exercised in one country or another. It does not in any way alter their character that, in a greater or less degree, they are irregular or unauthorised or unlawful.. The business is not the less managed in London because it ought to be managed in Kenya. Its residence is determined by solid facts, not by the terms of its constitution however imperative."

Their Lordships being unanimous the Appeal was allowed. An importance question was not raised on appeal but is to be found as obiter dictum in the judgment of Lord Keith of Avonholm. It was admitted that there was no authority for the African companies to be controlled by the English company. While all the companies were linked by shareholdings they were all separate entities in law. The control of the African companies came, therefore, from a separate entity. Accordingly no acting of the African companies indicated that these companies resided in the United Kingdom.

The New Zealand section is clear in that the centre of the administrative management refers to the Company by the use of the word "its". In deciding where the centre of administrative management is the Courts will probably not be inhibited from finding that the administrative management of one company is to be found in another company. As one company may for the purposes of proprietary assessment be held to

14 at page 834

control another company then it is not unreasonable to say that the decision making is vested at the place of control. With the precedent of proprietory assessment Courts may not be reluctant to find that the administrative management is vested in another company. The result may be to make the company in question without an head office within the scope of its corporate identity. However, it is quite clear that the head office of the company refers to the head office of the company in question. Phrased in another way the head "office" must be taken as referring to the company in question and belonging to that company. If the head office does not belong to the comapny then it cannot be said to be "its" head office. The fact that control comes from elsewhere is an irrelevancy to the question of where "its" head office is situated. On this argument the head office would be where the most control is exercised within the particular corporate structure

A possible argument to the contrary is that the head office of a company could be in fact another company. It may be that a very large company creates a subsiduary to perform a specified function yet all book keeping, management and the like is retained by the parent company. Assuming that the two are incorporated in different countries then it is possible to argue that the head office of the subsiduary is in fact the parent company. "Its" head office is the whole of the parent company. The word "its" is a possessory pronoun and is used in a proprietory sense. It does not necessarily offer violence to the section, however, to say that the centre of its administration lies in another company.

While there is no definitive statement of law on the issue it would appear that because of the facts of <u>Unit Construction</u> v <u>Bullock</u>[15] the Courts may not be reluctant to find the head office of one company vested in another.

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15 supra

The Company and the Shareholders

The shareholders of a Company may be either individuals or other persons. There is no restriction on the quantum of dividend which must be paid to shareholders but to discourage too great a retention of company funds excess retention tax has been developed.

Dividends

The Land and Income Tax Amendment Act (No. 2) 1958 introduced the taxation of dividends in the hands of individual shareholders. S.4(1) of the act provides the widest possible definition of "dividend". The definition includes;

> "All sums distributed in any manner and under any name among all or any of the shareholders of the company"[16].

Also included in the definition is the value of property distributed to the shareholder by the company, amounts received in respect of shares, where the Company sells to the shareholder at a favourable rate the difference between this and the true market price is included and also various forms of interest paid to the shareholder. Moneys advanced by the Company which are not, in the opinion of the Commissioner, a bona fide investment on the part of the company are caught in the web[17]. The expenditure of money by a proprietary company to the benefit of a shareholder or the shareholders spouse or any trust under which the shareholder or his spouse is a beneficiary is also caught by the definition.

Some relief is provided by S.4(3)(a) whereby the distribution of the proceeds from a sale of captial assets is

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16 S.4(1)(a)

17 Providing the advance is made to benefit shareholders

not included as a dividend in the hands of the shareholders. The section recognises the principal that income tax is a tax on income and not on captial but an easy way of circumventing the provisions of the dividend tax are thereby provided. The wording of S.4(3) is;

"Where -

"a. Any capital asset of a company has been realised,... and the Commissioner is satisfied that the whole or any part of any profit arising from any such realisation in excess of the cost... of that asset is subsequently included in any payment or other transaction..."

then the distribution of the profit or gain is not a dividend.

Goodwill is clearly a capital asset which may be written up. In 2 NZTBR Case 3 a company declared a dividend from its capital reserves account. This was subsequently distributed and was held to be exempt from the definition under S.4(3)(a). The section has been changed from the time of that case[18] and no longer includes a specific mention of the writing up of a capital asset. It is submitted that the situation in relation to goodwill remains unchanged. By its very nature the nett value of the goodwill changes from time to time. If at any given time it is sold, perhaps to a subsiduary, then the fact that it has been written up does not alter the fact that a capital asset has been realised. Only if the writing up produces a manifestly excessive figure need the company fear intermention from the Courts.

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18 3 October 1963

The company should be careful that the profits or gains realised from the particular realisation are distributed to the shareholders. The words "from any such realisation" imply that if the realisation only permitted a distribution from another source, and the funds from the realisation were untouched, then the profits distributed do not arise from such realisation.

The "loop-hole" while particularly attractive to small private companies has never been plugged and on invitation is provided for tax avoidance on a minor scale. It should be noted that no benefit will accrue to the Company by the transactions described. Dividend tax is payable only by the shareholder.

Double Taxation and Dividends

It is doubtful if it was ever open to a taxpayer before the passage of the 1958 Amendment to successfully claim relief from paying tax on a dividend on the basis that there was double taxation. The taxpayer would rely on Gilbertson v Fergusson (1991) 7 Q.B.D. 562. In that case a London agency of a foreign company was able to meet all demands for distribution of dividend made upon the company by the shareholders by distribution of its own earnings. There was no reference to the foreign company but the agency was assessed in respect of the dividends paid by it. The Court held that the agency was not ~~paying~~ distributing English profits but rather the profits of the foreign company therefore if part of the income tax payable was paid in respect of both the foreign and the English profits the tax on the English part would be paid twice over.

In Inland Revenue Commissioners v Roberts (1925) 41 T.L.R.

379 the Court was concerned with taxation relief for dividends on the sale of a company. The comapny was sold in September as at the following January and tax was assessed on the profit from the sale. Relief was given in relation to the dividends as it was held that otherwise double taxation would result.

The principle evidenced by the first case is that if the income of a foreign company can be shown (on being traced to its origins) as to some portion to have borne tax in the United Kingdom and if the taxpayer is taxed to the full amount of the companys income which is distributed to him, by way of dividend, double taxation results. The principle is clearly wrong and rests on the erroneous assumption that double taxation is double taxation of the same corpus. Double taxation is really the double taxation of the same person on the same income.

In Canadian Eagle Oil Co Limited v The King, Selection Trust Limited v Devitt[19] at page 509 Lord Russell pointed out,

> "... logically there is no answer to the view that a company's income is one taxable income, and that the profits which, out of its taxed income, are distributed to the shareholders in dividends constitute another and new income, taxable again in the shareholders hands".

The New Zealand Court of Appeal approved the last stated principle of law in Commissioner of Taxes v Luttrell [1948] N.Z.-L.R. 823. It must be concluded that S.4 is not the imposition of double taxation on the shareholder but is statutory correction of what was previously an anomalous situation. Similarly the principle of "mutuality" does not arise as the

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19 1945 2 All E.R. 499

shareholder and the company are distinct entities.

Alternatives to the Present System

While New Zealand has been experiencing taxation of dividends for a comparatively short time events in the United Kingdom and other countries have prompted a consideration of whether New Zealand enjoys the best system of taxation vis a vis the company and shareholder. The New Zealand system is a classical one rate system with no distinction drawn between distributed and undistributed profits, although the actual rate of tax is graduated. The system is inequitable as it results in the low income shareholder bearing a greater burden of taxation than he might otherwise. The most simple of examples illustrates the inequity;

Taxpayer A - a low income taxpayer

Company rate (say)	50%
Taxpayer A (say)	20% at 50% after tax
Aggregate rate of tax	35% 60%

Taxpayer B - a high income taxpayer

Company rate	50%
Taxpayer B rate (say)	60% 50% maximum
Aggregate rate	65% 75%

The aggregate rate of tax suffered by A is 15% higher than his actual rate whereas B's rate is 5% higher. Similarly on a two rate system with a lower rate for distributions the low income taxpayer bears a greater burden of aggregated tax than the rich taxpayer.

On the other hand on the imputation system the corporate tax is paid in advance and is regarded as an advance payment on the shareholders income tax. Where the shareholders income is lower than the rate set he receives a refund. Where it is higher he has to make an additional payment. The French tax

the societes de capitaux (which includes public companies) on the imputation system. In each accounting period the amount available for distribution is ascertained and this is deemed distributed. The Company is responsible for deducting at source the tax from the distributions made and an appropriate adjustment is made in the manner described above.

The imputation system should be developed in New Zealand. It offers the most equitable system for the collection of tax. Some administrative energy should also be saved by reducing the total number of persons filing returns. The tax distributed at source would be available to the company for the accounting period. At the present time, the sum is widely dispersed to the shareholder and being fragmented is of little real economic advantage.

A system of rebates was introduced in New Zealand along with dividends tax. These are now abolished except for persons on small incomes and while the system may be made more equitable by a proper use of rebates administration is made more complicated and the tax money being distributed to the shareholders at source results in the loss of a source of company financing.

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Proprietary Assessment

Section 138 is designed to prevent companies trading together in a group splitting the assessable income or retaining the profits within the group structure. The section empowers the Commissioner to assess the proprietary shareholder on what is deemed to be that shareholders income from the proprietary company. The section contains a number of definitive ~~xxxxxxxxx~~ clauses which are essential to an understanding of the operation of tax. The result of the tax is in effect to brush aside the corporate entity and assess the shareholders as if they were part of an incorporated partnership. As is mentioned above only a company may be a proprietary shareholder but it is unlikely that the tax would ever be assessed to any body other than one under the Companies Act.

history of s138

Definitions

A proprietary company is a company which at the end of the income year is under the control of not more than four persons[20]. The definition of shareholder for the purposes of the tax contains no surprises but it should be noted that "debenture holder" refers only to persons holding debentures on which the rate of interest is not specifically determined but is determined by reference to the devidend of the company or "by any means howsoever"[21]. An ordinary proprietary company is one which consists wholly of ordinary shares each paid up to the same extent and ranking equally providing however, the company has not issued the type of debenture described in S.142[22].

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20 S.138 (1)(a)

21 S.142

22 S.138 (1)(a)

The definition of the appropriate incomes while raising few issues in themselves are central to the assessment of the tax.

The term "residual taxable income" in relation to any proprietary company and any income year, means the amount by which the taxable income of the company for that year (including taxable proprietary income/but not the partial exemption enjoyed by life assurance companies and the partial exemptions on interest from debentures accruing to non resident life assurance companies) exceeds the total amount in respect of income derived by it during the year; provided that when a proprietary company is non resident the income is, for the purposes of calculating the proprietary income in that year derived by any shareholder who is resident in New Zealand, taken as being derived solely in New Zealand[23].

"Total income" is the total amount of the residual taxable income and non-assessable income of that company for the year[24]. The total income derived in any year by a proprietary company is deemed to be income derived in that year from the company by the shareholders of the company[25]. Where the proprietary company is "ordinary" the income is deemed to derive in direct proportion to the number of shares held by that shareholder. Where the company is other than "ordinary" the income is derived in such a manner as may be prescribed by refulations or if these are not made or do not extend far enough as the commissioner thinks fit. "Proprietary

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23 S.138 (1)(f)

24 S.138 (1)(g) Non assessable income includes dividends paid to the company.

25 S.138 (1)(h)

income" means the income deemed to have been derived by a shareholder from a proprietary company in every case where that income together with any other income deemed to be derived by that shareholder during the income year in not less than 25% of the total income of the company[26]. The effect of the definition is to catch persons who may not hold the requisite 25% of shares in their own right, but, who through holding shares in another company which may be a proprietary shareholder of the first company, or by having a beneficial interest under a trust are interested in toto in not less than 25% of the total income of the company.

The provisions of the section would be easily avoided by a proprietory shareholder forming other companies to rank alongside it as shareholders each company holding not more than 12%. This point has been met by S.138 (1)(i) which invokes a constructive situation whereby a number of companies in the same group holding shares in a company are taken for the purposes of the section to be one company. Similarly holding companies under the control of the same person will be considered one company for the purposes of the section and the company they hold shares in will be deemed to be a proprietory company[27].

It is noteworthy that the statute does not attempt a definition of "proprietary shareholder" but leaves this term to inference. A proprietary shareholder must, therefore be a shareholder in a proprietary company to which in the particular income year has been imputed whether in its own right or by construction not less than 25% of the total income of the

26 S.138 (1)(i)

27 S.138 (1)(m)

proprietary company. A further point of notice in the proprietary assessment situation is that losses cannot be brought forward or offset.

The Meaning of "Control"

As mentioned the proprietary company is one which is under "the control" of not more than four persons. The definition of control over a company is provided by section 3. The definition also applies to group assessment and the carrying forward of losses.

A company is deemed to be under the control of persons by whom more the one half of the shares, or nominal capital, or paid up capital, or voting power is held or who would be entitled to more than one half of the profits if these were distributed. The preceeding are all questions of fact which should be able to be answered without unduly taxing the inquisitioners. The only remaining ground of establishing control is rather wider;

> "who have by any other means whatsoever control of the company,"[28].

The provision is very wide and on the face of it may include persons who exercise a control over the companys affairs such as a mortgagees stipulation that he control the companies operations. There is no New Zealand decision on the point but English decisions hold that control means control by the articles of association and not by any other means. The English cases offer interpretation for the words "a controlling interest" which are considerably narrower than the New Zealand provision.

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28 S.3(1)(b)

In the British American Tobacco Co Ltd v Inland Revenue Commissioners[29] the facts were that the Appellant company held shares in eleven companies operating outside of the United Kingdom. In four companies the Appellant held 50% of the votes and in the other seven it held 50% of the votes in conjunction with another company. The argument was raised that "interest" in the context meant an interest of a proprietary nature and the section would only be satisfied if it could be shown that the Appellant itself owned sufficient shareholding in another company to controllit. Viscount Simon L.C.[30] held,

> "I find it impossible to adopt the view that a person who by having the requisite voting power in a company subject to his will and ordering, can make the ultimate decision as to where and how the business of the company can be carried on, and who thus has, in fact, control over the companys affairs is a person of whom it can be said that he has not in this connection got a controlling interest in the company".

A similar approach was taken by the House of Lords in IRC v J. Bibby and Sons Ltd[31]. The issued capital of J. Bibby and Sons Limited was 750,000 preference shares with no vote and 500,000 ordinary shares with one vote each. Eight Directors held 209,332 ordinary shares between them and these of the Directors were registered as joint holders of 57,500 ordinary shares as trustees. The issue before the Court was whether the

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29 [1943] 1 All E.R. 13

30 ibid 15

31 [1945] 1 All E.R. 667

shares held on trust could be added to the other shares to give a controlling interest. If the answer was in the affirmative the company would be able to increase its capital under the Finance No. 2 Act, 1939 (U.K.) S.9 by 10% instead of 8% as it would be "a company the directors whereof have a controlling interest therein".

Lord Russell of Killowen affirmed the decision of the Court of Appeal holding that controlling interest is the extent to which individuals have vested in them "the power of controlling by votes the decisions which will bind the company in the shape of resolutions passed by the shareholders in general meeting"[32]. Even though a vote may be made in breach of trust the position is not affected. Lord MacMillan took a similar view in holding that the voting control of the company resides in the voting power of its shareholders and the question of whether the Directors have control of the company by their voting power as shareholders can be conclusively determined by the Memorandum, Articles and register of shareholders. Lord Simons was of the same opinion holding that those who control a company by their votes do not the less control it because they may themselves be amenable to some external control.

Their Lordship's would not ascribe the phrase a meaning which would impose the duty to seek out a beneficial interest behind a maze of legal forms.

In Barclays Bank Ltd v Inland Revenue Commissioners[33] the Court held that since the deceased was in the position to secure the passing of a resolution of the company at a general meeting he was in control of the company. The words considered

32 ibid 669

33 [1959] 3 All E.R. 140

in that case were "the control of the company".

The courts in the cases cited look for actual, not potential control. The persons who hold actual control on a day to day basis are the majority of shareholders. A creditor may acquire some potential control over the company but this will be subject to the shareholders allowing the exercise of that control. External considerations are ignored and the Courts will confine themselves to the public record. In light of the restrictions placed on the word "control" it seems unlikely that a New Zealand Court would be prepared to go behind the register of shareholders. Accordingly despite the wide wording S.3(1)(b) must take flavour from its attendant subsections and to establish control of a company for taxation purposes reference must be made to the Articles,

Control of Proprietary Companies

Section 3.(2) is confined to proprietary companies and provides that a proprietary company is deemed to be under the control of not more than four persons if there is one group of four persons (or less) who control it notwithstanding that there may be another group of not more than four persons who, on the definitions in subsection one, could also be said to be controlling the company. The Commissioner may therefore select any group if there is more than one and make a proprietary assessment on that basis. Some Australian cases[34] had held that it was not competent for the Commissioner to select one group and therefore the section would apply to cases where there was only one group.

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34 See Adelaide Motors v Commissioner of Taxation (1942) 66 C.L.R. 346 and F.C.T. v West Australian Tanners and Fellmongers Ltd (1945) 70 C.L.R. 623

The Mechanics of Assessment

There is a relatively restricted number of assessments made as proprietary assessments because when a shareholder achieves $\frac{2}{3}$ of the total holdings in the company group assessment may come into operation.

Where proprietary income is derived two assessments are made. The proprietory assessment includes the taxpayers ordinary income as well as his proprietary income for the tax year. The non proprietary assessment does not include any proprietary income but also include dividends from Companies to which the taxpayer is a proprietary shareholder. Section 138 (2)(b) provides that the taxpayer shall pay income tax on which ever assessment is the greater which reveals proprietary tax as solely a rate lifter.

Where an assessment is made which includes a dividend paid by a company from which the taxpayer has paid proprietary income in the preceeding four years there is deductable as a rebate the additional tax payable under proprietory assessment made in respect of income derived by the tax payer in one or more of those income years, to the extent that it does not exceed the additional tax payable by its inclusion[35]. The additionaltax represents the whole of the rebate available to the taxpayer if he is subsequently assessed under a non-proprietary assessment. The rebate is available for use once only[36]. The shareholder does however, receive a credit for the income tax paid by the proprietary company[37].

35 S.138 (7)

36 S.138 (8)

37 S.138 (3)(c)

Non Resident Proprietary Assessment

A dividend received from a proprietary company by a non resident company is subject to withholding tax. To avoid double taxation a rebate equal to the amount of non resident tax is permitted which ensures that the non resident tax is not charged on proprietary income derived by a non resident company from a New Zealand Company.

In CIR v United Dominions Trust Limited[38] proprietary income was held not to be encompassed by the New Zealand - United Kingdom Double Tax Agreement. The agreement was confined to profits arising from the conduct of trade or business and the laibility for proprietary assessment was held not to arise from the conduct of trade or business but rather by operation of the statute. The Article in question was not intended to offer relief against taxation levied because of a shareholding in a New Zealand Company but rather for income derived from the carrying on of a trade or business in New Zealand.

The position of an overseas company was earlier considered in CIR v Assoicated Motorists Petrol Co. Ltd[39] A.M.P. being wholly owned by Europa Oil Limited - held one half of the shares in Pan-Eastern Refining Co. Ltd. It was common ground that Pan-Eastern was an overseas Company and not subject to the revenue laws of New Zealand. For the Commissioner it was argued that Pan-Eastern was a proprietary company within the meaning of S.138 with the result that A.M.P.'s half share in the profits constituted proprietary income and were subject to income tax.

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38 [1973] 2 N.Z.L.R. 555

39 [1971] N.Z.L.R. 660 (J.C.)

Lord Wilberforce stated the central issue in the case as, "whether as a matter of construction of S.138 in the context of the Act as a whole, and considering the interrelation between the calculation of the proprietary income of the shareholder on the one hand and the prescribed calculation of the total income of the company on the other hand, the conclusion ought to be reached... that the shareholder in overseas proprietory companies were intended to be within the grip of this section."[40]

The Court of Appeal was upheld on the argument that as an overseas company has no total income it was impossible to apply the provisions of S.138.

The statute subsequently was amended the final result being S.138(1)(f) whereby it is provided that in calculating the proprietary income of a New Zealand resident shareholder in an overseas proprietary company the residual taxable income of that company shall be the amount which would have been taxable income if all the income had been derived in New Zealand.

40 ibid 665

Group Assessment

Closely associated companies were previously assessed under a joint assessment which vested considerable powers in the Commissioner by way of exercise of discretion. The situation was regarded as unsatisfactory and this concern resulted in the present S.141 which removes virtually all discretion from the hands of the Commissioner. Once the provisions of the statute are found to apply then the Commissioner is bound to apply a group type assessment. The aim of the old section was to regularise what would have been an obvious loop hole and the philosophy of the section remains unchanged. The only obvious difference in the mechanics of the section is that the new section provides for a loss company within the group, a facility which was unavailable under the joint assessment provisions.

The effect of group assessment is to impose a liability fo for tax on the total incomes of the companies in the group, which ordinarily has the effect of raising the rate of tax to be paid by the company, Double taxation is avoided in that dividends paid intra group are not included in the assessment. The group however, enjoy the facility of being immediately able to write off a loss.

Relationship with Proprietary Assessment

Group assessment applies to both the parent/subsiduary type of group arrangement as well as the "sister" company type of arrangement. Proprietary tax is limited only to the "vertical" parent/subsiduary and is confined to the case where the shareholders are themselves companies. The group assessment provisions are very much wider but the proprietary situation will apply where $\frac{2}{3}$ common control between two companies cannot be established and there is a 25% shareholding in one company by the other. It should not be forgotten that proprietary

assessment is tax assessed to the company as a shareholder whereas a group assessment is the assessment of the company itself.

Where a company in a group derives proprietary income from another company within the same group the income is disregarded for the purposes of a group assessment as double taxation could thereby result. There is no similar consideration where the proprietary income is derived from a company outside of the group. Where under S.140 the Minister of Finance declares a company not to be a proprietary company the same temporary relief to allow the establishment of a new industry applies to the group situation[41].

Definitions

Section 141 clearly saves the other provisions in the act and the scheme of group assessment cannot be taken to be an exhaustive code. The saving words are,

> "... every company included in a group of companies shall be assessable and liable for income tax in the same manner as if it were a company not included in a group of companys".

A company is one of a group where it is one of any two or more companies where the aggregate of the "prescribed proportions" is two thirds or more of:-

(a) the paid up capital; or

(b) the nominal value of allotted shares; or

(c) the voting power; or

(d) the entitlement to profits.[42]

The prescribed proportions mentioned means the lowest proportion

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41 probiso to S.141(2)

42 S.141(2)

of paid up capital or the lowest proportion of nominal value, voting power or entitlement to profits[43]. There will be no group if the prescribed proportion does not achieve the necessary two thirds. The tests of a group are separate independent criteria but the same test must be satisfied across all the companies before the group situation arises. While the Commissioner can select any test to apply he cannot satisfy one test with one company and another test on another company. If however, a test should fail there is nothing to prevent him from trying alternative tests.

The Land and Income Tax Act may be compared to the Companies Act 1955 S.158 where 50% control is required. The tax act is more concerned with who controls the distribution rather than who controls the company and in a taxing statute the control of the dividend is the more important aspect.

Shares held by a nominee are deemed to be held by the person entitled to the shares[44] and shares in one company held by another company are deemed to be held by the shareholders of the last mentioned company.

The rate of tax is established in subsection four which provides that a company in a group will be assessed to tax at the rate which would be assessable if that company had derived an income equal to the amount of the total income derived by the group. In effect it is the group that is assessed but the subsection recognises that assessment is made on each individual company within the group.

Losses Within the Group

In 1971 a specified group concept was introduced with the

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43 S.141(3)(e)

44 See S.141(3)(d) for definition of nominee. Quaere whether under a discretionary trust with the parent as a trustee to pay to one of two children in his discretion the trustee is a nominee as either child could be excluded.

requirement being that the same persons hold either the paid up capital or the allocated shares at the end of the income year. Where under section 137 there is a loss, the loss shall be deducted from the assessable income of each of the companies within the specified group in proportion to that companys contribution to the total income of the specified group.

The deduction is of right and results is an automatic cross-crediting of current and past losses incurred by one of the companies in the specified group. The case of a company not divided into shares is covered by subsection 7 as is the case of a company with no share capital (an incorporated society would be for the purposes of the section, a company with no share capital).

The requirements of S.137 must be satisfied with the same persons holding not less than 40% of the allocated shares and.or the same proportion of the paid up capital in the relevant income years. The provision is designed to prevent "trafficking" in loss companies.

A danger to be avoided in juggling with losses was demonstrated in XCO Pty Limited v F.C.T. (1971) 45 A.L.J.R. 461. The case turned on the Australian equivalent of S.88(c). The twosections are almost identical, the relevant words being in the Australian S.26A,

> "any property acquired by him for the purpose of profit making by sale, or from the carrying on or carrying out of any profit making undertaking or scheme"

Section 88(c) reads in part,

> "or if the property was acquired for the purposes of selling or otherwise disposing of it... and all profits or gains derived from the carrying on or carrying out of any undertaking or scheme entered into or devised for the purpose of making a profit".

The New Zealand section is slightly wider than the Australian section in that the taxpayers intention is introduced. Despite this the sections display such a degree of similarity that for the present purposes authority in Australia has weight in New Zealand.

The facts were that a holding Company purchased 60% of the shares of Kenneth Wright Pty Ltd which had incurred losses of $290, and owed debts of $260,000. The 60% shareholders protected themselves against the 40% shareholders demands for a share in the future profits by taking an assignment of the debts and paying or threatening to pay the debts to the assignee.

XCO (the holding company) received an assignment of the debts in consideration of $4,000 which it borrowed from its two shareholders.

In the year in question the loss company was put in funds and paid $5,000 to the holding company in satisfaction of its debts.

The Commissioner maintained this was income (The Court held in fact that only the difference was to income) Gibb J. held that XCO purchasing debts which it knew would shortly yield $5,000 was carrying out a scheme. The judgment may be criticised in that his Honour so held irregardless that this was part of a wider scheme. On the definition of scheme, the scheme of XCO was a very small scheme in the light of McClelland v F.C.T. (1970) 120 C.L.R. 487. Barwick CJ's view was that to be caught in a scheme the taxpayer has to be engaged in something which might almost be characterised as a business.

While the case is of a limited persuasive value only it is to be hoped that it remains as an isolated case otherwise problems may be experienced in the carrying forward of losses after the purchase of a loss company.

Subvention Payments

A subvention payment is a payment in the nature of a subsidy between one company and another to offset or reduce a loss incurred by the payee company. The payment is relatively uncommon as the provisions of carrying forward a loss under section 137 seem to be preferred. However, under the section 137 situation the loss company has to be injected with an income earning capability which may not be easy.

Furthermore, it is an advantage to set off the loss immediately as a subvention payment. Where the group is not wholly owned problems may arise as to whether a subvention payment is ultra vires the payee company. Where there are minority shareholders these persons should be satisfied and a subvention agreement should be drawn under S.141(8)(a). When contrasted with subsection 6 and 6A it is apparent that where the group is wholly owned by the same persons the set off of loss is of right.

The essential features of subsection 8 are:-

(a) the companies must be included in the same group;

(b) there must be an agreement to make a subvention payment;

(c) the loss must be a normal deductable loss;

(d) the payment must be made not later than twelve month after the accounting period of the payee company, and

(e) full disclosure is made in the accounts of both companies.

Once these criteria are met the payment is deductable by the paying company and assessable income by the payee company. The facility is also available to a wholly owned group but would not need to be used.

As a final point under group assessments it should be noted that a company may if it wishes apply to the Commissioner to be assessed jointly. It is understood that the Commissioner acceeds to any reasonable request.

Excess Retention Tax

Excess retention tax is not aimed at producing revenue but rather to prevent large scale withholding of dividends. The tax is attracted at a flat rate of 35 cents in the dollar, but a relief is granted to new companies for up to 6 years and excess distribution may be set off against subsequent assessments.

SS.172B to 172N provide the code for assessment of the tax which originally applied to both public and private companies. In 1961 it was confined to private companies. It is difficult to see the need for the tax in the public company as the shareholders would probably exert more pressure for a distribution than the possibility of the tax. In 1966 the tax was narrowed to proprietory companies which had previously attracted the tax and is now limited to proprietory companies carrying on the business of investment. The last mentioned type of company has a greater incentive to withhold income and reinvestment than other companies.

The tax is assessed on the "insufficient distribution of the company". The insufficient proportion is calculated by ascertaining the difference between the total income and:-

(a) income tax payable; and

(b) any preceeding excess retention tax; and

(c) the retention allowance being 60% of the amount by which the income of the company exceeds income tax payable; and

(d) bonus issue tax; and

(e) dividends received by the company on the winding up of another company in which it was a shareholder.

Bonus issues are treated for excess retention tax purposes as dividends[45] which precludes the company from distributing the fund as a bonus issue and as a dividend to avoid excess retention tax. The company does not have to pass on bonus issues which it derives as S.172B provides that a dividend being received by a company means dividend as defined in S.4. Bonus issues are excluded from S.4.

Bonus Issue Tax

A bonus issue was previously regarded as a dividend in the hands of the shareholder[46]. The effect of a bonus issue is illustrated in IRC v Blott (1921) 8 T.C. 101 where it was held that a company can decide on whatever it wants to do with its accumulated profits and can if it wishes convert them as against the whole world. The bonus issue was held not to give an immediate right to a larger amount of the existing assets but simply to confer title to a larger proportion of the surplus assets if and when a general distribution is made.

In Eisner v Macomber 1920 252 U.S. 189 it was held that a stock dividend evincing merely a transfer of accumulated surplus to the capital account of the corporation takes nothing from the property of the corporation and adds nothing to the shareholder. To derive a gain from capital something of exchangable value must be severed from the capital. The Court noted that without selling the shares the shareholder did not have the means to pay the tax which clearly indicated to the Court that it was a tax on capital.

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45 Although excluded from S.4

46 Since 1965 bonus issue have been excluded from the definition of dividend.

With respect the Court is correct in its opinion however, bonus issue tax is desirable to plug on otherwise attractive avoidance to private companies by reducing capital and paying a bonus.

Bonus issue tax is levied by section 172(p) and is assessed at the rate of 17.5 cents in the dollar. The tax is levied solely on the distributing company.

Conclusion

This paper has not sought to exhaustively describe company taxation in New Zealand but has indicated the salient features thereof. Broadly speaking a company is assessed in the same manner as an individual excepting that the rate is different. A reform is indicated in the relation of the company to the shareholder in that on the present system of assessing company and dividend rates the less advantaged shareholder bears a disproportionate burden of tax, accordingly an imputation system is proposed.

Proprietary income tax enjoys a narrow scope and is limited to companies. The tax was narrowed several years ago mainly because of difficulties in administration and with the great increases in the number of companies in recent years the Commissioner may again be running into problems of administration. A tentative suggestion for consideration may be to abolish proprietory tax and to lower the limits on group taxation to say 50%. While some small loss in revenue is inevitable this would almost certainly be offset by the savings in the administration expenses of a complicated tax. Not only the Departments administrative load would be lightened but also that of the thousands of accountants and advisors who are called upon to consider the tax each year. Unfortunately the Department of Inland Revenue,is, at the time of the writing of this paper unable to indicate the proportion of Company taxation receipts assessed on a proprietary basis.

Bonus issue, excess retention and group assessments are desirable in that avoidances are prevented. It is interesting to note that apart from the simple aasessment of the individual

company and isolated exemptions the majority of the company tax law is formulated to counter avoidance through ever increasingly sophisticated company structures. It is expected that the sophistication of the assessment provisions will develop alongside company law and the taxing statutes will become even more incomprehensible.

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