The Five Phases of Company Taxation in New Zealand: 1840–2008

ANNIE CHO*

I INTRODUCTION

This article traces the history of the company income tax in New Zealand from 1840, through its various phases of development, to the modern form of the tax in 2008. A consideration of the taxation of companies also involves consideration of the tax treatment of their shareholders, because, although the company is at law a separate person, it is inextricably linked with its shareholders in an economic sense. As Oliver and Plunket have observed, "a company is not an economic entity in its own right, it is merely a vehicle through which individuals make their investments".[1] This article, therefore, focuses on the inter-relationship between the tax treatment of companies and their shareholders, and also explores the economic, social, and political reasons for particular changes in company taxation. Companies have made an important contribution to New Zealand's economic landscape, but surprisingly little has been published on the history of the ways in which they have been taxed. This article aims to go some way towards filling this gap in the literature.

The history of company taxation in New Zealand falls into five distinct periods. The first phase was from 1840, when New Zealand became a British colony, to 1890. As a new colony, New Zealand adopted the tax system of New South Wales, relying on customs and excise duties. This was the country's first tax system and lasted until 1844 when a tax on property and income was introduced. This was short-lived, however, and was repealed in 1845. Further unsuccessful attempts to introduce an income tax were made in 1864, 1878, and 1879.

In 1891, the Land and Income Assessment Act established a tax on incomes, including corporate incomes, thus marking the beginning of the second phase (1891–1930) of New Zealand's company tax history. The new tax was relatively straightforward: companies were taxed on their profits and shareholders were exempt from tax on their dividends. This simplicity could not be sustained, however, with the advent of World War One in 1914. The financial strain of the war meant that many of the

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1 Oliver and Plunket, "Trends in Company/Shareholder Taxation: Single or Double Taxation? New Zealand Branch Report" in *Cahiers de Droit Fiscal International, vol 88a* (2003) 707.

changes to company taxation implemented during this period (such as the excess profits duty and the "special war tax", introduced in 1916 and 1917 respectively) were geared towards funding the war effort.

In notable contrast to the two earlier phases, the third phase of company taxation in New Zealand (1931–1957) was focused largely on developing more sophisticated company tax rules, as it had become apparent that taxpayers were using companies as a means of mitigating their liability to tax. From 1931 onwards, shareholders' dividends, though still exempt from tax, were deemed to be part of their individual assessable income for the purposes of determining personal tax rates. This was known as the "average rate" system. A new anti-avoidance measure was also introduced that applied to closely-held companies (those with less than four shareholders). The rationale was that such companies were essentially sole traders or partnerships that had converted their businesses into companies to take advantage of the lower tax rates applicable to corporate income. The introduction of "Pay As You Earn" ("PAYE") also changed the way in which the tax system was administered and the basis on which companies paid tax after 1957.

Taxing companies on their profits and leaving dividends untaxed was unsatisfactory because personal tax rates were higher than company tax rates and individuals were reducing their tax burden by conducting their business through companies. The "classical system" of company taxation introduced in 1958 was aimed at alleviating this problem. Under the classical system, company profits and dividends were both subject to income tax, capturing tax revenue that had previously been lost when individuals channelled activities through a company. The implementation of the classical system marked the fourth phase (1958–1987) of New Zealand's company tax history. Prior to this, dividends had always been exempt from income tax, and, thus, when the classical system was introduced, a new problem of double taxation arose. Corporate profits were in a practical sense being taxed twice — once in the hands of the company and again in the hands of shareholders. Two other new taxes, Non-Resident Withholding Tax and Bonus Issue Tax, were implemented in this fourth phase and were both payable by the company.

The double tax produced by the classical system prompted a move to a full imputation system in 1988. This system is still in use today. A company paying a dividend can attach to it a credit, which shareholders can offset against his or her personal tax liability. Thus, distributed corporate income is taxed only once.

II PHASE ONE (1840–1890): EARLY ATTEMPTS

Property Rate Ordinance 1844

When New Zealand became a British colony in 1840, it was made an adjunct of the Colony of New South Wales. The laws of New South Wales were extended to "her Majesty's Dominion in the Islands of New Zealand" on 16 June 1840.[2] This meant that New Zealand adopted, along with much else, the New South Wales system of taxation, which was comprised of customs and excise duties.[3] This was New Zealand's first tax system and remained in place despite New Zealand becoming a colony separate from New South Wales in November that year.[4]

In 1844, however, the Property Rate Ordinance abolished the customs and excise duties regime and introduced a property and income tax in its place. From the preamble of the Ordinance, it appears that the objective of the new property and income tax was to remove the restrictions on trade that had been imposed by the customs duties, and, consequently, to promote "commerce agriculture and general prosperity".[5] Income tax was dealt with in a single section of the Ordinance, which provided that:[6]

> Income liable to the rate hereby imposed shall, comprise the nett yearly profits of any trade, business, or profession, rents arising from real property, interest on money lent, pay, salaries, annuities, pensions, and every other description of income, whencesoever or from whatever source the same respectively may be derived.

The wording of that provision is wide and captures income derived from any source. It would appear, therefore, that profits derived by a company were subject to the tax imposed by the Ordinance. The rate of tax was a flat 1 per cent[7] on all income over £100 and the maximum amount of tax payable was £12.[8] This had the effect of making the tax regressive at income levels above £1,200. A taxpayer with income of £1,500, for example, was liable for £12 in income tax, resulting in a tax rate of 0.8 per

2 Joseph, *Constitutional and Administrative Law in New Zealand* (2 ed, 2001) 37–38.

3 See Harris, *Metamorphosis of the Australasian Income Tax: 1866 to 1922* (2002) 25; Customs Ordinance 1841.

4 The Letters Patent established New Zealand as a separate colony on 16 November 1840. See "Historic NZ Events in November" (2006) NZhistory.net.nz <http://www.nzhistory.net.nz/calendar/11> (at 21 July 2008).

5 Property Rate Ordinance 1844, Preamble. The only clue as to the purpose of abolishing the customs and excise duties and replacing them with a property and income tax lies in the preamble to the Ordinance. There were no official records of debates relating to legislative matters at the time. The New Zealand Parliamentary Debates (Hansard) only became available after 1854 with the establishment of the New Zealand Parliament.

6 Property Rate Ordinance 1844, s 4.

7 Prior to 1967, the currency used in New Zealand was the New Zealand pound adopted from Britain and consisting of pounds, shillings, and pence sterling. Tax rates were thus expressed as shillings and pence in the pound between 1840 and 1967. Decimal currency was adopted in 1967. For ease of understanding and to allow for comparisons between different periods, all tax rates cited in this article have been converted to percentages.

8 Property Rate Ordinance 1844, Schedule.

cent; while a taxpayer with an income of £2,000 was liable similarly for £12 in income tax, but his or her effective tax rate was 0.6 per cent.

The Property Rate Ordinance was repealed in 1845,[9] bringing an end to the income tax system and a return to the former regime of customs and excise duties adopted from New South Wales. It is unclear what factors may have caused this shift.

Subsequent Attempts at an Income Tax

After the repeal of the Property Rate Ordinance in 1845, there were three further failed attempts to implement a system of income tax in New Zealand. The first attempt was made on 13 December 1864 by Edward Stafford (in opposition at the time),[10] who moved in the House of Representatives[11] for the introduction of an income and property tax.[12] Stafford's motion was heavily motivated by the cost of the country's loan, which had been incurred to meet the expenses of the New Zealand Wars between the English and Maori.[13] However, Stafford was unable to gain the support of the other Members of the House and he was forced to withdraw the motion that same day. Some Members had felt that the issue should have been raised earlier in the Parliamentary session, rather than at the end when there was insufficient time to properly debate the issue.[14] It was also thought that an income tax would not be feasible unless it was merely a temporary measure.[15]

The second attempt to introduce an income tax was made in 1878 by the Colonial Treasurer John Ballance.[16] Ballance proposed a joint stock companies duty of a flat 1.25 per cent, which was to be imposed exclusively on the net profits of all joint stock companies registered or trading in New

9 Property Rate Repeal Ordinance 1845, s 1.

10 Edward William Stafford (1819–1901) was Premier of New Zealand on three different occasions: 1858–1861, 1865–1869, and 1872. He retired in 1878. See Bohan, "Stafford, Edward William 1819–1901" in Oliver (ed), *Dictionary of New Zealand Biography* (1990) vol 1, 404–407. The title "Prime Minister" was used in a casual fashion in the nineteenth century and was not officially used until 1900. See "Prime Ministers of New Zealand" (2006) 1966 Encyclopaedia of New Zealand <http://www.teara.govt.nz/1966/P/PrimeMinistersOfNewZealand/TheTitlepremier/en> (at 21 July 2008).

11 The Constitution Act 1852 set up the first system of elected representative government in New Zealand. Parliament, or the General Assembly, consisted of the Governor, the Legislative Council, and the House of Representatives. The Legislative Council's role was to amend or revise the legislation passed in the House of Representatives. See McLintock and Wood, *The Upper House in Colonial New Zealand* (1987) 16–21. See also "Parliament – House of Representatives 1854–2004" (2004) New Zealand History Online <http://www.nzhistory.net.nz/politics/history-of-parliament/the-house> (at 3 December 2006).

12 (13 December 1864) NZPD 182 (Edward Stafford).

13 The New Zealand Wars (1840–1872) were driven by the confiscation of Maori land by the Crown. See "*The New Zealand Wars*" (2006) New Zealand History Online <http://www.nzhistory.net.nz/war/19thcenturywars-nzwars> (at 21 July 2008).

14 (13 December 1864) NZPD 184 (Charles Brown).

15 (13 December 1864) NZPD 184 (Julius Vogel).

16 John Ballance (1839–1893) joined George Grey's ministry in January 1878 as Commissioner of Customs, Commissioner of Stamp Duties, and Minister of Education, but shortly after became the Colonial Treasurer. He was responsible for introducing the first land tax (Land Tax Act 1878) and the first income tax (Land and Income Assessment Act 1891) in New Zealand. See McIvor, "Ballance, John 1839–1893" in Orange (ed), *Dictionary of New Zealand Biography* (1993) vol 2, 23–25.

Zealand.[17] The joint stock companies duty was part of a package of reforms announced in Ballance's financial statement of 6 August 1878, which also included a land tax.[18] Ballance's principal aim in proposing the joint stock companies duty appears to have been anti-avoidance. He had noted in his address to the House that many shareholders of New Zealand companies were non-residents, who were not liable for tax in New Zealand, and therefore the profits of those companies were being taxed neither in the hands of the company nor those of its shareholders. By imposing a tax on companies, the Government was hoping to prevent the drawing away of profits from New Zealand "without effort or responsibility to other forms of taxation".[19] The Joint Stock Companies Duty Bill was introduced into the House on 20 August 1878, but Ballance fell out with the Premier, Sir George Grey,[20] and this led to the Bill being withdrawn on 8 October 1878.[21] The Bill formally lapsed on 10 October 1878.[22] The accompanying Land Tax Bill, however, was successfully passed.[23]

In July 1879, when Parliament reconvened, Grey's Government proposed a full income tax to counteract the problem facing the "current financial year of a decreased land revenue" from the sale of public land.[24] The Income Tax Bill was introduced into the House on 22 July 1879 but the political troubles of the Grey Government were again to impede the passing of any income tax legislation. On 29 July 1879, a want of confidence motion was passed against the Government and a dissolution followed shortly after.[25]

III PHASE TWO (1891–1931): A NEW INCOME TAX

Land and Income Assessment Act 1891

After three failed attempts, an income tax was finally implemented by the Land and Income Assessment Act 1891 ("the 1891 Act").[26] It was New

17 (6 August 1878) 28 NZPD 88 (John Ballance). The joint stock company was a forerunner to the modern corporation, the public limited company. See Hickson and Turner, "Corporation or Limited Liability Company" in McCusker et al (eds), *History of World Trade since 1450* (2006) vol 1, 164.

18 McIvor, supra note 16, 24.

19 (6 August 1878) 28 NZPD 91 (John Ballance).

20 Sir George Grey (1812–1898) arrived in New Zealand in 1845, assuming office as Governor. He was knighted in 1848. Grey became Premier in 1877 but was defeated in the elections in 1879. See Sinclair, "Grey, George 1812–1898" in Oliver (ed), *Dictionary of New Zealand Biography* (1940) vol 1, 323–331.

21 Harris, supra note 3, 49.

22 The Joint Stock Companies Duty Bill was introduced into the House on the same day as the Land Tax Bill, which imposed a tax on property based on the value of land net of improvements. Unlike the Joint Stock Companies Duty Bill, the Land Tax Bill was passed on 15 October 1878. See ibid.

23 McIvor, supra note 16, 24. The Land Tax Act 1878 was replaced by the Property Assessment Act 1879, which imposed tax on real and personal property.

24 (11 July 1879) 31 NZPD 6 (Governor George Constantine).

25 Harris, supra note 3, 51.

26 See generally Facer, "The Introduction of Income Tax in New Zealand" (2006) 12 Auckland U L Rev 44.

Zealand's first income tax (leaving aside the very short-lived Property Rate Ordinance of 1844) and applied to both individuals and companies. The land and income tax was offered as a substitute for the existing property tax, which had become "grossly unjust in its operation",[27] presumably because it was taxing one source of wealth (property) and not another (income).

1 The Scheme of the 1891 Act

The charging section in the 1891 Act was section 15, which provided as follows:

> Subject to the provisions of this Act taxation shall be levied at stated rates in the pound sterling, in accordance with an annual Act to be passed for that purpose upon ... [a]ll income derived or received in New Zealand from business, employment, or emolument, in the manner provided in the several Schedules C, D, E and F to this Act.

The intention was thus that the 1891 Act would establish the structure for the new tax and annual Acts would set out the rates of tax.[28] The 1891 Act also provided for the administration and enforcement procedures, while the detail of the land and income tax was provided for in the Schedules.[29]

2 Income Tax Applying to Companies

Schedule C of the 1891 Act provided for company income tax — every company carrying on business in New Zealand was liable for tax on the profits derived from such business, but only to the extent that those profits were not distributed to shareholders.[30] A company therefore did not pay tax on profits paid out to shareholders as dividends. At the same time, dividends were exempt from tax.[31] The effect was that the distributed profits of a company escaped entirely untaxed.

In 1892, Schedule C was amended so that companies paid tax on all profits, whether or not such profits were distributed to shareholders.[32] Dividends remained exempt from tax, the rationale being that "the income had already been taxed in the hands of the company"[33] and that to tax the company and the shareholder would amount to double taxation.

The rate of tax for companies was a flat 5 per cent, which was the same as the highest personal income tax rate (applying to income of

27 (16 June 1891) 71 NZPD 66 (John Ballance).

28 Ibid. The first of these annual statutes was the Land Tax and Income Tax Act 1892.

29 The format of the 1891 Act was based on the Taxation Act 1884 (SA), which similarly provided for a land and income tax. See (4 August 1891) 73 NZPD 96 (John Ballance).

30 Land and Income Assessment Act 1891, sch C, cl 1.

31 Ibid cl 3.

32 Land and Income Assessment Act Amendment 1892, s 17(3).

33 Herbert, Adam and Cunningham, *Land and Income Tax in New Zealand* (1 ed, 1933) para 299.

an individual exceeding £1,000).[34] This ensured that persons who had structured their affairs through a company were subject to the same tax rate as wage or salary earners. For example, if the tax rate for wage and salary earners had been 7.5 per cent, and the tax rate for companies 5 per cent, a person receiving income in the form of dividends would have effectively incurred a lesser tax burden (by 2.5 per cent). The company would have only paid five per cent on its profits and the dividends from those profits would be exempt from any further tax in the hands of the shareholder. In contrast, a wage or salary earner would have had to pay 7.5 per cent tax on his or her income.

The matching rates between companies and individuals meant that it was no more beneficial to conduct business through a company than to do so as a sole trader or as partners in a partnership. In addition, sole traders and partners were entitled to an exemption from tax on the first £300 of their taxable income.[35] Companies, on the other hand, were not entitled to any exemptions from income tax, although a company suffering hardship could apply to the Commissioner for tax relief.[36]

Schedule F of the 1891 Act provided for deductions. In order to be deductible, expenditure had to be:[37]

1. Actually incurred by the company in the production of income; and
2. Not one of the non-deductible items set out in clause 2 of Schedule F.

The non-deductible items included outgoings that were not "wholly and exclusively laid out or expended for the purposes of business",[38] or that were "expended in any other domestic or private purposes".[39] In essence, deductions were allowed for expenditure that was incurred in deriving income and in the course of carrying on business.[40] Allowance for depreciation deductions was introduced in 1894 and added to Schedule F.[41]

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34 Land-tax and Income-tax Act 1892, s 2. For income below £1,000, the rate of tax for individuals was 2.5 per cent.

35 Land and Income Assessment Act 1891, sch D, cl 2.

36 Ibid sch C, cl 3; Land and Income Assessment Act Amendment 1892, s 10(2). The Commissioner could, at his or her discretion, release a company, either wholly or in part, from liability to tax on application by the company suffering hardship.

37 Land and Income Assessment Act 1891, sch F, cls 1, 2.

38 Ibid cl 2(f).

39 Ibid cl 2(i).

40 This is similar to the wording of the present general deduction permission in the Income Tax Act 2007, s DA1.

41 Land and Income Assessment Act Amendment 1894, s 18: "The Commissioner may allow [a] deduction for depreciation of any implements, utensils or machinery ... in respect of diminished value during any year by reason of fair wear and tear...."

A Graduated Company Tax

The flat rate company tax was replaced in 1910 with a graduated scale (although the maximum rate for companies remained the same as that applying to individuals). The rates of tax were as follows:[42]

Total income	Rate of tax
£0–£1,250	5.00%
£1,250–£2,000	5.42%
£2,000 +	5.83%

The change was motivated by the Government's need for additional revenue in order to facilitate a New Zealand contribution to the British Navy. According to Finance Minister Joseph Ward,[43] it was in the interests of New Zealand to support the "maintenance of British supremacy on the seas".[44] The new graduated scale and the contemporaneous increases in personal tax rates were expected to raise an additional £75,000 to £90,000 in revenue.[45]

However, one disadvantage with the graduated scale was that it encouraged shareholders to split income across multiple companies in order to reduce each company's liability to tax. Under a flat rate system, it had been pointless to do so since each company was subject to the same rate of tax. Under a graduated scale, the income of a company falling into a higher tax bracket could be split between two companies so that a lower tax rate applied to both companies, and less tax was paid in total between them. To counteract this, an anti-avoidance rule was introduced in 1923 that applied to groups of companies with substantially the same shareholders, or that were under the control of the same persons.[46] The Commissioner had to be satisfied that the separate constitution of such companies was bona fide for the purpose of more effectively carrying out each company's objects;[47] otherwise the Commissioner could treat those companies as if they were one company for tax purposes.[48]

42 Land-tax and Income-tax Act 1910, s 2(b).

43 Joseph George Ward (1856–1930) entered Parliament in 1887 and became Prime Minister in 1906, but he had difficulty controlling his caucus. Ward's Government lacked direction and he resigned as Prime Minister in 1912 after a deadlock election in 1911, drifting in and out of politics for the remainder of his life. His twenty-three and a half years as a Minister of the Crown remains a record. See Bassett, "Ward, Joseph George 1856–1930" in Orange (ed), *Dictionary of New Zealand Biography* (1993) vol 2, 565–569.

44 (1909) 148 NZPD 56 (Joseph Ward).

45 Ibid.

46 Two companies were deemed to consist substantially of the same shareholders if not less than half of the paid-up capital of each of them was held by or on behalf of the shareholders of the other. See Land and Income Tax Act 1923, s 98(2).

47 Under section 20 of the Land and Income Tax Amendment Act 1939, this purpose was altered to "wholly or partly for the purpose of reducing their taxation", which targeted the rule more clearly at incidences of tax avoidance.

48 Land and Income Tax Act 1923, s 98(1).

World War One and the Great Depression

World War One placed great financial strain on New Zealand and more money was needed to finance the war effort — a situation faced by other countries involved in the war.[49] Countries could fund the war by either taxation or borrowing, which was essentially a choice between taxation in the present or in the future as loans contracted during the war eventually had to be repaid out of tax revenue.[50]

In New Zealand, company tax rates increased significantly — the maximum company tax rate increased almost three-fold from 5.83 per cent in 1910 to 15 per cent in 1917.[51] From 1916 onwards, a "super tax" of 33.33 per cent and an "additional income tax" of up to 5 per cent were added to ordinary tax rates.[52] An excess profits duty of 45 per cent was also implemented in 1916[53] because it was considered that those with surplus should "be called upon to provide a portion of the capital required" to fund the war.[54] The special war tax was introduced in 1917 and was levied on all incomes exceeding £300.[55]

The Great Depression reached New Zealand in 1930 and similarly placed financial pressure on the country. Income tax payable by companies and individuals was increased by 10 per cent in 1930 and by 30 per cent in 1931.[56]

IV PHASE THREE (1931–1957): FORESHADOWING A TAX ON DIVIDENDS

The Average Rate System

In 1931, the tax treatment of dividends changed somewhat. Under the Land and Income Tax Amendment Act 1931, dividends were deemed to be part of a person's assessable income for the purposes of determining which tax rate applied.[57] The actual dividend income, however, continued to be exempt from tax (that is, it was non-assessable income of the individual). To illustrate, a taxpayer with income of £2,000, £1,500 of which was income from wages and £500 of which was income from dividends, was

49 For example, in the United Kingdom, the November 1914 Budget (the first of the War) doubled the basic rate of income tax from 3.75 per cent to 7.5 per cent. See Strachan, *Financing the First World War* (2004) 69.

50 Ibid 61.

51 Land-tax and Income-tax Act 1910, s 2(b); Finance Act 1917, sch 1, part II, r 2.

52 Finance Act 1916, ss 4–5. Both taxes applied to tax rates for companies and individuals.

53 Ibid s 9.

54 (16 June 1916) 176 NZPD 37 (Joseph Ward).

55 Finance Act 1917, s 39. The maximum rate of special war tax payable was 15 per cent.

56 Land and Income Tax (Annual) Act 1930, sch, part II, cl 4; Land and Income Tax (Annual) Act 1931, sch, part II, cl 4.

57 Land and Income Tax Amendment Act 1931, s 6(1).

required to pay tax on £1,500 (being the taxpayer's assessable income) at the rate applicable to £2,000 (being the sum of the taxpayer's assessable and non-assessable income). This was known as the "average rate" system — dividends were included in a taxpayer's assessment, so that an average rate of tax could be calculated and applied to that part of their income that was actually assessable.

This change may have been due largely in part to the additional 1.67 per cent that applied, from 1931 onwards, to personal tax rates for income exceeding £500.[58] Company tax rates were not subject to this additional tax. An individual could, therefore, pay less tax by structuring his or her activities through a company and the average rate system was perhaps aimed at this form of avoidance.

Extending the Definition of Dividends

Prior to 1935, dividends had been broadly defined as "all sums distributed in any manner and under any name among shareholders of a company on account of profits made by the company".[59] In 1935, distributions of bonus shares were added to that definition.[60] In 1939, the definition was replaced by a comprehensive list that captured dividends in cash and in kind, and distributions of income and capital. Items in the list included:[61]

1. Any credit given by the company without fully adequate consideration;
2. The value of any other property of any kind distributed by the company;
3. All amounts received by any shareholder in respect of his shares; and
4. Any money advanced by the company to or for the benefit of any of its shareholders, where such advance was not made as a bona fide investment by the company but was virtually a distribution of profits.

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58 Land and Income Tax (Annual) Act 1931, sch, cl 6.

59 Land and Income Tax Act 1923, s 97(2).

60 "Bonus shares" meant the paid-up value of the shares allotted to any shareholder, to the extent that the paid-up value represented the capitalization of the whole or any part of the profits of the company. The term also included any credit given to shareholders in respect of the amount unpaid on shares not fully paid-up, to the extent that such credit represented the capitalization of the whole or any part of the profits of the company. See Land and Income Amendment Act 1935, s 5. The inclusion of bonus shares in the dividend definition was inconsistent with English tax law at the time, which treated bonus shares as a distribution of capital and not subject to tax. See e.g. *I.R. Comrs v Blott* [1920] 1 KB 114; *I.R. Comrs v Greenwood* [1920] 2 KB 657. Conversely, in a number of Australian cases it was held that bonus shares formed part of the income of the shareholder that was subject to tax. See e.g. *James v FCT* (1924) 34 CLR 404.

61 Land and Income Tax Amendment Act 1939, s 22(1).

Returns of capital by the company were not treated as dividends.[62] The extension of the definition reflected the fact that companies had been distributing profits in increasingly sophisticated ways so as to avoid distributions being treated as "non-assessable income" of the shareholder under the average rate system.

"Proprietary Companies"

In 1939, additional anti-avoidance measures were introduced that applied to companies controlled by not more than four shareholders (termed "proprietary companies"). The shareholders of these companies were assessed for tax as if the company's income were their own.[63] This was to reduce the tax benefit being enjoyed by sole traders and partnerships that had converted into companies.[64] Such restructurings were motivated by the increasing difference between company and personal tax rates.

From 1931 to 1936, the difference had been 1.67 per cent, as a result of the additional rate that had been applied to personal tax rates. In 1936, the additional rate disappeared but was replaced with higher company and personal tax rates.[65] The result was a 3.33 per cent difference between the maximum and minimum company and personal rates.[66] It was therefore advantageous to derive income through a company, rather than directly as a sole trader or partner (given that dividends were still not taxable). According to David Wilson, leader of the Legislative Council, the proprietary company provisions were designed to repair these "holes in the income tax fence".[67]

1 The Mechanics of the Proprietary Companies Regime

(a) Definition

"Proprietary companies" were defined as companies that were under the control of not more than four persons in any income year.[68] A person had control of a company if he or she, either directly or through a nominee, held

62 Land and Income Tax Amendment Act 1940, s 8(b). A dividend was deemed not to include "any payment or other transaction to the extent to which ... that payment or transaction constituted a return to the shareholders of premiums paid to the company in respect of the issue of share capital by the company".

63 This amendment was the result of a special inter-departmental committee report, referred to in a later report by the New Zealand Taxation Committee. See Report of the Taxation Review Committee [1967] AJHR B18, para 149. In 1940, an exemption was introduced for proprietary companies that the Minister of Finance was satisfied had been "incorporated exclusively for the purpose of establishing in New Zealand a new industry and the establishing of that industry [was] in the best interests of New Zealand". Such companies were deemed not to be proprietary companies. See Finance (No. 3) Act 1940, s 2.

64 Herbert, Adam and Cunningham, *Taxation Laws of New Zealand* (3 ed, 1956) para 185.

65 The additional 1.67 per cent tax disappeared from the Land and Income Tax (Annual) Act 1936, presumably because of the higher ordinary tax rates.

66 Land and Income Tax (Annual) Act 1936, sch, part II, cl 3. The minimum rates were 5 per cent for companies and 8.33 per cent for individuals; the maximum rates were 37.5 per cent for companies and 40.83 per cent for individuals.

67 (4 October 1939) 256 NZPD 584 (David Wilson).

68 Land and Income Tax Amendment Act 1939, s 23(1)(a).

more than half the shares or voting rights in the company, or by any other means had control of the company.[69] When shares were held by a partnership, the partners together were treated as one person in applying the control rules. This was the same in the case of several persons who were interested in the estate of a deceased (whether as beneficiaries or as trustees).[70]

(b) Attributing Company Income to Shareholders

Income of a proprietary company was attributed to its shareholders in proportion to their shareholding in the company[71] and the attributed income was the shareholder's "proprietary income".[72] Where the shareholder's proprietary income exceeded 20 per cent of the company's total income in any year, the shareholder was liable for income tax on that amount.[73] Where it did not exceed 20 per cent, the company's income was not attributed to the shareholder at all.

Notwithstanding whether income was attributed to shareholders, the company was required to pay tax on its profits in the usual manner.[74] However, in order to avoid double taxation, the shareholder was allowed a tax credit for the tax already paid by the company in respect of his or her proprietary income.[75] The credit was deducted from the tax payable by the shareholder. This was, in effect, a system of imputation, though the term was not used in the legislation.

2 Rules against Income Splitting

(a) Shareholder-Employees, Directors, and their Relatives

The Land and Income Tax Amendment Act 1939 also introduced rules to prevent income splitting through shareholder-employees, directors, and their relatives. Where a proprietary company paid remuneration to such persons for services rendered, the amount could not exceed what the Commissioner regarded as reasonable.[76] The payment of excessive sums to shareholder-employees, directors, and their relatives had been a means of reducing the total tax payable by a proprietary company.[77] Any amount

69 Ibid s 21(1). The definition of control was amended in 1953 to include persons who, by reason of their shareholding, would be entitled to more than 50 per cent of annual profits at the end of the year, if those profits were distributed by way of dividend at the end of that year.

70 Land and Income Tax Amendment Act 1939, s 23(1)(a). Note that where the shares are the property of the individual partners in a partnership, or of individual trustees and/or beneficiaries of an estate, then the deeming provision does not apply and the shares are treated as being held by separate persons.

71 Ibid s 23(1)(g).

72 Ibid s 23(1)(i).

73 The 20 per cent requirement was increased to 25 per cent in 1953 after a recommendation by the New Zealand Taxation Review Committee in 1951: Report of the Taxation Review Committee [1951] AJHR B8, para 356.

74 Land and Income Tax Amendment Act 1939, s 23(4).

75 Ibid s 23(3)(c).

76 Ibid s 24(2).

77 (4 October 1939) 256 NZPD 584 (David Wilson).

in excess was therefore not allowable as a deduction for the company and was deemed instead to be a dividend paid by the proprietary company to that person as a shareholder.[78]

(b) Multiple Companies

The rules were further extended in 1940 to target the use of structures involving multiple companies. Parent and subsidiary companies were to be treated as a single company and therefore as one single shareholder for the purposes of determining whether a company was a proprietary company.[79] In addition, where two or more holding companies were under the control of the same persons and held shares in another company, the holding companies were treated as one single company if in doing so the other company would be rendered a proprietary company.[80]

These changes meant that the proprietary company provisions now "reduced materially the amount of tax which would otherwise be avoided if the income had been split ... among the proprietor and two or more companies formed as separate entities".[81] Under the old rules, a group of family members could, for example, set up five companies that each held shares in another (potentially proprietary) company. Those five companies, though all related by reason of common ownership, were treated as separate shareholders for the purposes of the proprietary company rules. The company would, therefore, not have qualified as a proprietary company (because it had more than four shareholders) and the income of the company would not have been attributed to each of the family members as their personal income.

Social Security Charge

In 1938, all companies resident in New Zealand became liable to social security charge in addition to income tax. The charge was levied at five per cent on company profits and was payable to the Commissioner.[82] Dividends paid out by resident companies were exempt from the charge in the hands of the shareholder,[83] presumably for the same reasons as the exemption applying to dividends from income tax (that dividends were paid out of an already taxed source).

The purpose of the charge was to fund the new social security scheme, which had been part of the Labour Government's election campaign in

78 Ibid.
79 Finance (No. 2) Act 1940, s 12(1)(k).
80 Ibid s 12(1)(l).
81 Herbert, Adam and Cunningham, supra note 64, para 185.
82 Social Security Act 1938, ss 108(b), 113(1)(c), 125.
83 Ibid s 110. Herbert, Adam and Cunningham, supra note 64, para 641.

1936.[84] The objective of the scheme was to set up a fund that citizens could contribute to according to their means and draw from according to their needs.[85] The scheme would provide universal superannuation and medical care benefits,[86] and replaced the non-contributory pension scheme in operation at the time.[87] Companies were liable to pay the social security charge not because they would benefit directly from the scheme, but because the additional revenue was needed.[88]

World War Two

World War Two had a similar effect on company taxation as World War One.[89] The lowest company tax rate increased from 5 per cent in 1936 to 12.5 per cent in 1940 and the highest company tax rate from 37.5 per cent in 1936 to 43.75 per cent in 1940.[90] A "super tax" of 15 per cent (later 33.33 per cent) was added to those rates.[91]

New taxes were also introduced during wartime. The excess profits tax was imposed from 1940 to 1946,[92] and the national security tax from 1940 to 1947.[93] In introducing the national security tax, the Minister of Finance, Walter Nash, said:[94]

> Everything that we prize including our social security system is dependent on winning this war and maintaining our national security. In the grave state of emergency that exists I feel sure that every one will gladly make his contribution to this tax. It will be paid by everyone and every one will know that he or she is paying it.

National security tax was collected in addition to, and on the same basis as, the social security charge. This meant that while companies paid national

84 See Oliver, *Ideology, the Slump, and the New Zealand Labour Party: A Study of the Ideology of the New Zealand Labour Party in the 1930s* (MA Thesis, The University of Auckland, 1981) and Hellaby, *Funding a Legacy: Taxation under the First Labour Government* (LLB (Hons) Dissertation, The University of Auckland, 2006).

85 "Social Security" (2007) 1966 Encyclopaedia of New Zealand <http://www.teara.govt.nz/1966/S/ SocialSecurity/ ScopeOfLegislationOf1938/en> (at 6 August 2008).

86 Oliver, supra note 84.

87 Ibid.

88 "Finance, Public" (2007) 1966 Encyclopaedia of New Zealand. <http://www.teara.govt.nz/1966/F/ FinancePublic/SocialServices/en> (at 21 July 2008).

89 For a discussion of the costs of the war to New Zealand, see (27 June 1940) 257 NZPD 303–304 (Walter Nash). Walter Nash (1882–1968) became the Minister of Finance in 1935 and Deputy Prime Minister in 1940. He was elected as Labour's new leader in 1950 and continued as leader of the opposition until 1957 when, at the age of 75, Nash became Prime Minister after Labour won the narrowest of election victories. See Gustafson, "Nash, Walter 1882–1968" in Orange (ed), *Dictionary of New Zealand Biography* (1998) vol 4, 371–373.

90 Land and Income Tax (Annual) Act 1936, sch, part II, cl 3; Land and Income Tax Amendment Act 1940, sch, part A, cl 3.

91 Land and Income Tax (Annual) Act 1940, sch, part II, cl 3. The supertax was increased to 33.33 per cent in 1942. See Land and Income Tax (Annual) Act 1942, sch, part II cl 2.

92 Excess Profits Tax Act 1940, s 3; Land and Income Tax Amendment Act 1946, s 7. See generally Hyde, *Excess Profits Tax Act 1940* (LLB (Hons) Dissertation, The University of Auckland, 2004).

93 Finance Act 1940, s 16(2); Finance Act 1947, s 11.

94 (27 June 1940) 257 NZPD 306 (Walter Nash).

security tax, dividends were exempt because the funds from which they were being distributed had already been subject to the tax.

End of World War Two to 1957

1 Changes to the Proprietary Company Rules

When the proprietary company rules were enacted in 1939, they applied to both companies and individuals with a minimum shareholding of 20 per cent.[95] In 1955, those rules were amended so as to apply only to shareholders that were companies.[96] Shareholders who were natural persons were therefore exempt from the rule that attributed income of a proprietary company to them. It is unclear what factors may have prompted these amendments.

2 PAYE, Provisional Tax, and the Implications for Companies

PAYE and Provisional Tax were introduced in 1957.[97] The new system provided for the payment of tax on income in the year in which it was derived, rather than on income in the year after it was derived. Companies incorporated on or after 26 July 1957 paid tax on this new provisional basis, while companies incorporated before 26 July 1957 continued to pay income tax in the year after it was derived.[98] PAYE also affected companies in their capacity as employers of wage and salary earners. Employers were required to deduct income tax payable by their employees from their wages or salary; that is, tax was deducted at source.[99]

V PHASE FOUR (1958–1987): THE CLASSICAL SYSTEM — A NEW ERA

1958 — Tax on Dividends

1958 was a significant year in the history of company taxation in New Zealand: for the first time, dividends were taxed in the hands of the shareholder. This was a major new feature of the New Zealand tax system.

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95 This was changed to 25 per cent in 1953. See text accompanying supra note 73.

96 Land and Income Tax Amendment Act 1955, s 14(1) inserting subs (11) into s 138 of the Land and Income Tax Act 1954: "This section shall not apply so as to affect the assessment or liability for tax of any taxpayer who is not a company."

97 The objective of PAYE described in the Budget announcement was "to provide a better system of income tax collection during the fiscal year. PAYE is not in itself a method of providing taxation relief or of altering the incidence of taxation. It is merely machinery for collecting tax as income is received by taxpayers." See (25 July 1957) 312 NZPD 1187 (Jack Watts).

98 Income Tax Assessment Act 1957, s 42(1).

99 Income Tax Assessment Act 1957, s 7.

Previously, tax had only been imposed on corporate profits. The shift in 1958 to a "classical system" of company taxation meant that both the company's profits and the dividends received by the shareholders from those profits were subject to tax. Rather than treating the company and its shareholders as economically linked, the classical system treated them as separate entities and taxed accordingly.

As part of its review of the income tax system in 1951, the New Zealand Taxation Committee had considered the merits of a dividend tax in New Zealand.[100] The Committee itself had been split 6–6 on its final recommendation,[101] but Arnold Nordmeyer[102] introduced the new regime in his "Black Budget" of 1958.[103]

1 The Driving Forces behind the Dividend Tax

There were three primary objectives in implementing the dividend tax. First, the newly elected Labour Government faced "a severe and fast-developing balance of payments crisis, triggered in large part by a collapse of butter prices in London".[104] Secondly, Nordmeyer believed the tax was necessary to "ensure that equity [was] preserved as between one section of the community and another".[105] Under the existing regime, dividends were exempt from tax and thus a person earning part of his income from dividends paid less tax than the person earning the same income from wages or salary. The tax system discriminated between different sources of income and a tax on dividends was aimed at ameliorating this. The final motive for the new regime was anti-avoidance. Many companies were being formed to enable the payment of tax-free dividends to their owners and to take advantage of company tax rates, which were lower than personal rates.[106] This had become especially prominent following the changes to the proprietary company provisions in 1955, which meant that individuals channelling their activities through a company no longer had the company's profits attributed to them as their personal income.[107]

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100 The New Zealand Taxation Review Committee was commissioned by the Government in 1951 to inquire into the land and income tax system in all its aspects, and, in particular, to consider what alterations needed to be made. See Report of the Taxation Review Committee 1951, supra note 73, para 1.

101 For the full comments of the Committee in favour and against the tax, see ibid paras 362–388.

102 Arnold Henry Nordmeyer (1901–1989) was elected to Cabinet in 1941. He was originally given the health portfolio but became the Minister of Finance in 1957 when Labour won the election. See Brown, "Nordmeyer, Arnold Henry 1901–1989" in Orange (ed), *Dictionary of New Zealand Biography* (2000) vol 5, 373–375.

103 Along with the dividend tax, the Nordmeyer Budget produced significant increases in indirect taxes, particularly on cars, petrol, tobacco, and alcohol, and so became known as the "Black Budget". Nordmeyer himself said that the dividend tax "excited a great deal of controversy in the commercial community". See (24 July 1958) 317 NZPD 866 (Arnold Nordmeyer).

104 Brown, supra note 102, 374.

105 (24 July 1958) 317 NZPD 866 (Arnold Nordmeyer).

106 (18 July 1958) 317 NZPD 746 (William Fox).

107 (1 July 1958) 316 NZPD 361 (Walter Nash).

2 *The Scheme of the Dividend Tax Provisions*

Under the Land and Income Tax Amendment (No. 2) Act 1958 (the "1958 Act"), dividends derived by individuals were to be treated as assessable income of the taxpayer and subject to tax.[108] This resulted in double tax because the company had already paid tax on its profits, and then tax was imposed again on those profits distributed to shareholders. Dividends derived by companies were not, however, subject to tax and continued to be non-assessable income of a company.[109]

To limit the extent of the double tax on dividends derived by individuals, a "concessional ceiling rate"[110] of 35 per cent applied. This was the maximum rate payable by an individual on his or her dividend income and a rebate was given for any tax paid in excess of 35 per cent.[111] The effective tax rate paid on dividends, when taken together with the company tax rate, was thus no higher than the maximum personal rate of 67.5 per cent.[112] This ensured equity between different sources of income. A taxpayer was not at a disadvantage for having received part or all of his income from dividends.

The concessional ceiling rate method was abolished in 1970, leaving dividends subject to tax at the full personal rates, although low income earners (individuals earning less than $4,000 per annum) could still qualify for a rebate of up to 10 per cent on the tax paid in respect of their dividends.[113]

Excess Retention Tax

The Government also introduced Excess Retention Tax ("ERT") at the same time as the tax on dividends. ERT was payable by companies making less than the required level of distribution to its shareholders: that is, an "insufficient distribution".[114] An insufficient distribution arose where the "distributable portion" of a company's income was more than the amount of dividends paid by the company. A company's distributable portion was calculated according to certain definitions provided for in the 1958 Act, which effectively amounted to approximately 40 per cent of a company's net income.[115] Thus, where the dividends paid out by the company were

108 Land and Income Tax Amendment (No. 2) Act 1958, s 6. Between 1931 and 1958, dividends had been treated as non-assessable income of an individual or company taxpayer.

109 Land and Income Tax Act 1954, s 2(c).

110 Report of the Taxation Review Committee 1967, supra note 63, para 322.

111 Land and Income Tax Act 1954, s 5.

112 Report of the Taxation Review Committee 1967, supra note 63, para 322.

113 Land and Income Tax Amendment Act 1970, s 5(1). The low-income earner threshold was adjusted in 1972 to those persons earning less than $8,000 per annum. See Income Tax Amendment (No. 2) Act 1972, s 3. The rebates were abolished by the Income Tax Amendment Act 1979, s 12.

114 Land and Income Tax Act 1954, s 172E as inserted by Land and Income Tax Amendment (No. 2) Act 1958, s 15.

115 Ibid s 172B.

less than 40 per cent of its net income, the company was treated as having made an insufficient distribution, and was liable to pay ERT at a rate of 35 per cent on the amount of that insufficient distribution.[116] In effect, companies were entitled to retain up to 60 per cent of their net profits without incurring liability to ERT.

The ERT provisions were a necessary corollary to the dividend tax, intended to discourage shareholders from retaining profits in the company so as to avoid the tax. As Nordmeyer stated, "[a]ny form of dividends tax requires some form of retention tax".[117] However, it was recognized that a company might need to retain profits for legitimate purposes such as future capital investment. As such, companies were allowed to retain up to 60 per cent of their net profits without incurring ERT liability, thus enabling them to fulfil "normal expansion and asset replacement purposes".[118] In addition, the Commissioner also had power to release a company wholly or in part from its ERT liability if the company could show that the amount of its insufficient distribution was committed to existing liabilities or development expenditure.[119]

From 1961 onwards, ERT applied only to proprietary companies. This change was prompted by the concern that the continued broad application of the tax might inhibit desirable growth and expansion in New Zealand companies.[120] ERT was finally abolished in 1991.[121]

Non-Resident Withholding Tax

Non-Resident Withholding Tax ("NRWT") was introduced in 1964.[122] The tax was at a flat rate of 15 per cent on dividends, royalties, "know-how" payments, and interest.[123] NRWT was deducted at source: companies making dividend payments to non-resident shareholders were obliged to deduct NRWT at the time of payment. In the case of non-cash dividends, the company was required to pay an amount equal to the NRWT deduction to the Commissioner before any payment of the dividend could be made.[124] NRWT deducted from dividends was a final tax and dividends

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116 Ibid s 172E; Land and Income Tax (Annual) Act 1959, s 5.

117 (25 July 1958) 317 NZPD 868 (Arnold Nordmeyer).

118 (26 June 1958) 316 NZPD 287 (Arnold Nordmeyer). The National Party had opposed the ERT because of concerns that it made it impossible for companies to build up reserves for future expansion. See e.g. (1 July 1958) 316 NZPD 347 (Keith Holyoake). Keith Jacka Holyoake (1904–1983) was the leader of the opposition at the time. Knighted in 1970, Holyoake continued in politics until 1980. Wood, "Holyoake, Keith Jacka (1904–1983)" in Orange (ed), *Dictionary of New Zealand Biography* (2000) vol 5, 373–375.

119 Land and Income Tax Amendment (No. 2) Act 1958, s 15. This section was later replaced by a new provision, which extended the special allowance to the acquisition, erection, installation, or extension of fixed assets. See Land and Income Tax Amendment Act 1964, s 46. The release from ERT liability could either be for the relevant tax year or any other period that the Commissioner thought was appropriate.

120 Land and Income Tax Amendment Act 1961, s 9; (21 July 1960) 322 NZPD 807 (Arnold Nordmeyer).

121 Income Tax Amendment (No. 3) Act 1991, s 19.

122 Resident Withholding Tax was not introduced until 1989. See Income Tax Act 1976, s 327C as inserted by Income Tax Amendment (No. 2) Act 1989.

123 Land and Income Tax Act 1954, s 203S as inserted by Land and Income Amendment Act 1964, s 17.

124 Ibid s 203V.

were accordingly not included in the annual tax assessment of the shareholder.[125]

Bonus Issue Tax

Bonus share issues became subject to Bonus Issue Tax ("BIT") from 1965 onwards. The tax was at the flat rate of 17.5 per cent and charged on the nominal value of bonus shares issued or credits given for uncalled capital.[126] Bonus issues of shares had formerly been treated as dividends and included in a shareholder's assessable income. This was unsatisfactory because shareholders did not actually receive cash with a bonus issue. Thus, having to pay dividend tax in respect of the issue presented difficulty.[127] BIT meant that bonus issues were no longer taxable in the hands of shareholders; instead, tax was payable by the company making the bonus issue.[128] BIT, therefore, transferred the tax burden from the shareholder to the company.

BIT was abolished in 1982 as a result of a recommendation from the Task Force on Tax Reform,[129] which had concluded that the tax hindered the capital market.[130] As an anti-avoidance measure, returns of capital within ten years of a bonus issue became subject to tax.[131] Any component of the return applying to the bonus issue was treated as a dividend and taxed accordingly in the hands of the shareholder.[132] A company could not, therefore, make tax-free distributions to shareholders by issuing bonus shares and then making a capital return to its shareholders within ten years of the issue.

A Return to a Flat Rate Company Tax

In 1976,[133] a flat tax rate was reintroduced for companies, at a rate of 45 per cent.[134] A flat rate had previously been in place from 1891 before it was replaced with a graduated scale in 1910. The conversion back to a

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125 Ibid s 203Z.

126 Land and Income Tax Act 1954, s 172P as inserted by Land and Income Amendment Act 1965, s 3.

127 (10 June 1965) 342 NZPD 356 (Harry Lake). Harry Robson Lake (1911–1967) served as the Minister of Finance from 1960–1966 in Holyoake's Government. See Easton, "Two Economic Lieutenants: 1960–1972" in Clark (ed), *Holyoake's Lieutenants* (2003) 63.

128 The definition of dividends was amended accordingly so as to exclude bonus share issues. See Land and Income Amendment Act 1965, ss 5, 10.

129 Income Tax Amendment (No. 2) Act 1982, s 40.

130 (5 August 1982) 445 NZPD 1774 (Robert Muldoon). The Task Force on Tax Reform was established to examine the system of central government taxation. Sir Robert Muldoon (1921–1992) became the Prime Minister and the Minister of Finance in 1975. He served as Prime Minister for three terms until 1984. Muldoon was well known for his market interventions during his time as Prime Minister. "Former PMs" (2003) Official Website of the Prime Minister of New Zealand <http://www.prime minister.govt.nz/oldpms/1975muldoon.html> (at 21 July 2008).

131 Income Tax Amendment (No. 2) Act 1982, s 4(1).

132 Ibid.

133 The Land and Income Tax Act was separated in 1976, for the first time, into two separate Acts: the Land Tax Act and the Income Tax Act. Both Acts were consolidated at the same time.

134 Income Tax Act 1976, sch 1, part A, cl 7.

flat rate removed the tax benefit of splitting corporate profits across several companies. A graduated scale continued to apply to individuals, however, with 19 tax brackets starting at 20 per cent for income not exceeding $2,000 and rising to 60 per cent for income over $22,000.[135]

VI PHASE FIVE (1988–2008): FULL IMPUTATION

The Introduction of Full Imputation in New Zealand

In 1988, the classical system was replaced with a full imputation system,[136] marking a new phase of company taxation in New Zealand, which continues today. The imputation system was an integrated approach to the taxation of companies and their shareholders: tax credits were attached to shareholders' dividends, representing the amount of tax already paid by the company in respect of the profits out of which dividends had been distributed. There was therefore relief from the double tax that had been a consequence of the classical system.

1 Objectives of the Full Imputation System

As part of the 1987 Budget, the Finance Minister, Roger Douglas,[137] announced that the Government intended to implement a full imputation system for the taxation of companies and their shareholders, and that a Consultation Committee would be formed.[138] The motivations for the imputation system were two-fold. First, it would remove the problem of double taxation:[139]

> The basic principle is that everyone will pay tax once on their income .... Previously, many people paid no tax at all. However, others, perhaps because of the scale of their business or the specialised nature of it, paid tax twice – once in the hands of the company, and again, on the residue, in the hands of the shareholder. That will become a thing of the past.

Secondly, the system would mean that income earned through a company

135 Ibid sch 1, part A, cl 10; ibid sch 1, part B.

136 Income Tax Amendment (No. 5) Act 1988.

137 Sir Roger Douglas (1937–) became the Minister of Finance in 1984. Sir Roger is most well known for the radical economic reforms he made during his time as the Minister of Finance, which involved the privatization of many of New Zealand's public assets. The term 'Rogernomics' has been used to refer to Douglas's policies during the 1980s. See "Biography" (2006) Roger Douglas <http://www.roger douglas.org.nz/biograph.htm> (at 21 July 2008).

138 The first official statement by Douglas suggesting that a full imputation system might be introduced appeared in his 1985 Statement on Taxation and Benefit Reform. See Consultative Committee on Full Imputation and International Tax Reform *Consultative Document on Full Imputation* (1987) i.

139 (21 September 1988) 492 NZPD 6833 (James Sutton).

would be taxed at the marginal tax rates of the shareholders of the company.[140] An imputation system would thus remedy the inherent deficiencies of the existing classical system.[141]

The design of the imputation system was adopted from the "franking account" system used in Australia.[142] The alternative option had been to implement a compensatory tax system similar to the Advance Corporation Tax ("ACT") system used in the United Kingdom.[143] Under the ACT system, companies paying dividends also paid an amount of ACT equal to the credits given to shareholders in respect of their dividends.[144] The ACT paid was then deductible from a company's "mainstream corporation tax bill"; that is, it was set off against the company's ordinary income tax liability.[145] The second reading of the Bill[146] suggests that the Australian model was preferred because having uniformity between the two countries would assist the drive for closer economic relations.[147]

2 The Scheme of the Full Imputation Provisions

The core sections of the imputation system were provided for in the Income Tax Amendment (No. 5) Act 1988.[148] All companies resident in New Zealand were required to maintain an imputation credit account ("ICA").[149] The ICA recorded the opening balance of imputation credits of a company for each year, and the credits to and debits from the account as they arose.[150] When a company paid income tax, that tax payment constituted a credit in its ICA.[151] It could then attach those credits to dividends paid to shareholders and these payments would constitute a debit in the company's ICA.[152] Both the dividend and the imputation credits were included in the shareholder's gross income for the year, but the shareholder would be allowed a credit against his or her income tax liability of an amount equal to the imputation credits attached.[153]

The effect was that shareholders on a marginal tax rate equivalent to

140 *Consultative Document on Full Imputation*, supra note 138, 1.
141 Ibid 4.
142 Ibid 7.
143 Ibid. For an analysis of the major differences between the two schemes, see ibid 6–17.
144 Ibid 6–7.
145 "A Modern System for Corporation Tax Payments: A Consultative Document" (1997) HM Revenue & Customs <http://www.hmrc.gov.uk/consult/consult_2.htm> (at 21 July 2008).
146 Income Tax Amendment Bill (No. 6) 1988.
147 (21 September 1988) 492 NZPD 6827 (Trevor de Cleene). De Cleene's view was that New Zealand's imputation credit account system would be very similar to the Australian system.
148 Income Tax Amendment (No. 5) Act 1988, s 55.
149 Income Tax Act 1976, s 394B as inserted by ibid.
150 Ibid s 394C.
151 Ibid s 394D.
152 Ibid s 394F as inserted by Income Tax Amendment (No. 5) Act, 1988, s 55. It was not compulsory to attach imputation credits to dividends — section 394F uses the word "may". The permissive wording was to allow for distributions to non-resident shareholders that could not have imputations attached.
153 Ibid s 394ZE.

that of the company rate of 28 per cent[154] would not need to pay tax on their dividend income if they had the maximum imputation credits attached. Shareholders with a tax rate higher than 28 per cent received a credit of 28 per cent and were then liable to pay the difference between their personal rate and 28 per cent. In the case of shareholders on a marginal rate lower than 28 per cent, there would be surplus credits that could be carried forward and offset against their tax liability in subsequent years.[155] The surplus credits could not, however, be treated as losses, so the taxpayer did not receive a tax refund for the surplus. This was essentially an anti-avoidance measure.

Other rules were also developed to prevent abuse of the imputation system.[156] First, a company could not have a debit balance in its ICA at the end of the year. A debit balance would indicate that the company had passed on more credits than the amount of tax it had actually paid. In such circumstances, the ICA balance had to be returned to zero by the payment of further tax.[157] The company also incurred a penalty tax for the debit balance of an amount equal to ten per cent of the further tax that had to be paid.[158]

Secondly, where a company was entitled to a refund of income tax, the amount of the refund could not exceed the amount of the credit balance in the company's ICA.[159] An amount of refund in excess of the ICA balance was set off against income tax payable by the company for the year in which the entitlement to the refund arose.[160] Any residual amount of the refund thereafter was retained by the Commissioner (and not treated as a loss).[161]

Changes since Full Imputation

As at 2008, the full imputation regime continues to be in use as the system of company taxation in New Zealand. Relatively few major changes have occurred in the two decades since the implementation of the imputation system but the more notable developments during this period are discussed in the sections below.

1 Resident Withholding Tax ("RWT")

The RWT regime commenced on 1 October 1989 and required the deduction of withholding tax from interest and dividends paid to New

154 Income Tax Amendment (No. 2) Act 1988, s 22(d). The company tax rate was increased to 33 per cent. See Finance Act 1989, s 11(f); Income Tax Act 1994, sch 1, part A, r 5; Income Tax Act 2004, sch 1, part A, r 5.

155 Income Tax Amendment (No. 2) Act 1988, s 22(d). The taxpayer must supply the Commissioner with his or her shareholder dividend statement or any other evidence in writing of the imputation credit.

156 Section 394B of the Income Tax Act 1976 dealt more generally with avoidance arrangements.

157 Ibid s 394L as inserted by Income Tax Amendment (No. 5) Act 1988, s 55.

158 Ibid s 394N.

159 Ibid s 394M(1).

160 Ibid s 394M(4).

161 Ibid.

Zealand residents.[162] The tax is essentially the domestic equivalent of Non-Resident Withholding Tax ("NRWT"), which was introduced in 1964. It is imposed at source: that is, deducted by the company at the time the dividend income is paid. The tax deducted is credited against any final income tax liability of the shareholder.[163]

2 *Qualifying Company Regime*

The qualifying company regime was introduced in 1992 following a report by the Valabh Committee in 1990.[164] The Committee's view was that the imputation rules were too complex for many small companies and that a new regime with "a few, relatively simple, rules" would make compliance easier.[165] The qualifying company regime was an elective one. New Zealand resident companies with not more than five shareholders could elect to become a qualifying company if its shareholders and directors resolved unanimously to do so.[166] Under the regime, qualifying companies were treated in a similar way to partnerships. The company and its shareholders were deemed to be one entity for income tax purposes.[167]

A qualifying company could either be a loss attributing qualifying company ("LAQC") or a non-LAQC.[168] The net losses of an LAQC were attributed to shareholders in proportion to their shareholding in the company, while non-LAQCs were required to carry their losses forward.[169] A qualifying company paid taxable dividends to the extent of the amount of imputation credits available in its ICA.[170] Thereafter, the dividends paid by the qualifying company were exempt from income tax.[171]

3 *Rewrite of the Income Tax Act*

The rewrite of the Income Tax Act ("the Act") occurred in four stages. The first stage was the reorganization of the Income Tax Act 1976 ("the 1976 Act"), which resulted in the enactment of the Income Tax Act 1994. The Act was restructured into various parts: Part B provided for the core provisions, Part C dealt with income, Part D with deductions, and so on. The cumbersome numbering system of the 1976 Act (for example, sections

162 Ibid s 327C.

163 Ibid s 327K as inserted by Income Tax Amendment (No. 2) Act 1989.

164 The Valabh Committee was the short name for the Consultative Committee on the Taxation of Income from Capital. It received the name Valabh Committee from its chairman, Arthur Valabh. For the Committee's recommendations in respect of the qualifying companies regime, see New Zealand Consultative Committee on the Taxation of Income from Capital, *The Taxation of Distributions from Companies* (1990) 22–35.

165 Ibid 22.

166 Income Tax Act 1976, ss 393B–393D as inserted by Income Tax Amendment (No. 2) Act 1992, s 48.

167 Ibid s 393H.

168 Ibid s 393N.

169 Ibid s 393P.

170 Ibid s 393M.

171 Ibid.

394ZZM and 394ZZN) was replaced with a numbering system that reflected the relevant part and subpart of a rule (for example, section CA1).

The second stage of the rewrite involved a revision of the core provisions of the Act and was completed in 1996.[172] The third stage was the rewrite of Parts C to E and resulted in the Income Tax Act 2004. The final stage was a revision of Part F to the end of the Act, resulting in the Income Tax Act 2007. The objective of the rewrite exercise was to remove the unnecessary complexity of the former statute and thus make it easier for taxpayers to follow by using plain language.[173] It was thought that clear legislation was important in promoting voluntary compliance with tax laws.[174]

4 Rewrite of the Dividend Definition

Up until 2004, the definition of dividends had been a long list of arrangements between the company and shareholder that constituted, for tax purposes, a distribution of the company's profits.[175] The value of these arrangements was then subject to tax in the hands of the shareholder. Naturally, as companies and shareholders developed more sophisticated arrangements between them that fell outside the definition of dividends, the list expanded in an attempt to capture these new incidences of avoidance.[176] The definition of dividends had, therefore, become progressively more complex over time.

In 2004, the list approach was replaced with a new definition that reflected the concept underlying each of the arrangements in the list — the transfer of value from the company to its shareholders.[177] A dividend was defined as any transfer of value from a company to a person if:[178]

1. The cause of the transfer was a shareholding in the company; and
2. The transfer was not one of the exclusions in subpart CD of the Act.

Exclusions from the definition included returns of capital via both off-market and on-market share cancellations,[179] distributions of capital upon liquidation,[180] and non-taxable bonus issues.[181] It was intended that the

172 Policy Advice Division of the Inland Revenue Department, *Income Tax Bill: Commentary on the Bill* (2006) 1.
173 Ibid.
174 Ibid.
175 The list approach had been adopted in 1939.
176 Inland Revenue Department, *Tax Information Bulletin, vol 16, no 5* (2004) 55.
177 Ibid.
178 Income Tax Act 2004, s CD 3.
179 Ibid ss CD 14, 16.
180 Ibid s CD 18.
181 Ibid s CD 21.

rewrite would achieve clarity and simplicity, but that there would be no change to the substantive law.[182]

5 New Company Tax Rate

The company tax rate was lowered from 33 per cent to 30 per cent in 2007 as part of the business tax reform package announced in the 2007 Budget.[183] The new rate applied from the beginning of the 2008/2009 tax year and resulted in associated amendments to the imputation rules.[184] In particular, the tax credit ratios for shareholders were adjusted so that the company paid less tax on its profits, and shareholders with a personal tax rate of either 33 per cent or 39 per cent paid more tax on their dividend income. The company tax rate was reduced to allow companies to keep a greater share of their profits and thus stimulate domestic investment.[185] In addition, the new rate aimed at making New Zealand more internationally competitive in tax terms, particularly with Australia.[186]

VII CONCLUSION

This article has examined the history of company taxation in New Zealand through five distinct phases. Each phase has represented a different approach to the taxation of companies and their shareholders.

What remains to be seen is whether the imputation system will continue in New Zealand as the system of company taxation. Certainly, in a number of other jurisdictions, and in particular the European Union, there has been a move away from the use of imputation systems and a return to classical systems.[187] In the past, classical systems have been regarded as less favourable than imputation systems, because of the double tax that arises. In addition, it has been commonly perceived that classical systems result in economic distortions such as the retention of profits by companies to enable the avoidance of tax on dividends by shareholders.[188] However, these theories fail to view company taxation from an international perspective, and, instead, focus on the domestic implications of the two systems.[189] Imputation systems may work well at a domestic level, but they give rise to

182 Inland Revenue Department, supra note 176, 55.

183 Taxation (KiwiSaver and Company Tax Rate Amendments) Act 2007, s 50.

184 "Company Tax Rate Change: Questions and Answers" (2007) The Treasury <http://www.treasury.govt.nz/budget/2007/btr/pdfs/b07-btr-comp-qa.pdf> (at 28 July 2008), 2.

185 Ibid 1.

186 Ibid.

187 Ilhi et al, "Trends in Company/Shareholder Taxation: Single or Double Taxation? Dividend Taxation in the European Union" in *Cahiers de Droit Fiscal International, vol 88a* (2003) 73.

188 Vann, "Trends in Company/Shareholder Taxation: Single or Double Taxation? General Report" in *Cahiers de Droit Fiscal International, vol 88a* (2003) 23–24.

189 Ibid 24.

cross-border issues. In particular, the credits attached to dividends under an imputation system are unable to be used by non-resident shareholders to offset against their own tax liability. In this way, imputation systems favour investors who are resident in the same jurisdiction as the company in which they hold shares. Conversely, classical systems are perceived as being more neutral in the treatment of resident and non-resident investors in companies.[190] The international tax considerations of the two systems may explain the shift, in some countries, away from imputation.

With increasing globalization of capital markets, it will become more difficult for New Zealand to ignore international trends in company taxation and continue with a regime that favours domestic investors. New Zealand adopted the imputation system in 1988 to align its company tax regime with that of Australia, but it can no longer afford to look only at Australia as its sole competitor. New Zealand is, after all, competing with countries other than Australia for international capital, and its tax rules have an effect on how successful it will be in this.

190 Ibid.