Regulatory Impact Statement: Deductibility of co-operative company dividends

Coversheet

Purpose of Document	
Decision sought:	*Agree to a temporary extension of deductibility for dividends on co-operative company shares*
Advising agencies:	*Inland Revenue*
Proposing Ministers:	*Minister of Revenue*
Date finalised:	*8 August 2023*

Problem Definition
A recent change in the constitution of Fonterra affects its ability to utilise an existing income tax provision to deduct distributions paid to its shareholders. It will result in those deductions significantly reducing, leading to potentially lower distributions and effective over-taxation of distributions for Fonterra shareholders. This RIS considers the options, including a legislative response, to help ensure Fonterra's shareholders are taxed appropriately following this constitution change.

Executive Summary

Background

Fonterra utilises a provision that allows it to choose to deduct distributions to its shareholders rather than the typical treatment of non-deductible dividends which have imputation credits attached. For most shareholders this provides an equivalent after tax treatment. Fonterra has historically required its shareholders to hold one share for each kg of milk solids they supply to Fonterra. This provides a proportionate link between their supply and Fonterra's profits. For example, a farmer supplying 5% of Fonterra's milk would also own (approximately) 5% of its shares and receive 5% of its distributions.

Change in constitution

Fonterra has recently changed its constitution so that farmers are only required to hold one share for each three kg of milk solids they supply to Fonterra. This allows, but not requires, farmers to hold fewer shares than under the previous constitution. However, it also reduces the linkage between supply and ownership. For example, one farmer supplying 5% of Fonterra's milk might own 5% of its shares and receive 5% of its distributions while another might also supply 5% but following the constitution change have sold off some of their shares and now only own 2% of Fonterra's shares and receive 2% of its distributions.

Inland Revenue has considered this scenario and concluded that distributions on shares that previously were required to be held but are now voluntarily held will no longer meet the deductibility provision so that compared with previous distributions, only one third will now be deductible. Also due to the interaction of the Income Tax Act 2007, the Companies Act 1993 and Fonterra's constitution, Fonterra will be unable to attach imputation credits to their dividends. This places Fonterra and its shareholders in a worse position than a regular company as its shareholders will effectively be double taxed on the distributions they receive that the company has not been able to deduct – i.e. once as a tax on Fonterra's profit and again when that profit is distributed to the shareholder.

Time constraint

Officials agree that it would be inappropriate for Fonterra shareholders to face a higher effective rate than equivalent income earned through another structure. We also consider this should apply from the 2022-23 income year, being the first year covered by the revised constitution. This provides a constraint on the analysis as any law change required to achieve this would need to be added to the Taxation (Annual Rates for 2023-24, Multinational Tax, and Remedial Matters) Bill. That Bill is currently being considered by the Finance and Expenditure Committee and is expected to be enacted shortly before the final date for filing an income tax return for the 2022-23 income year (31 March 2024). This time constraint means, while we have consulted with Fonterra, there is insufficient time to consult with Fonterra's shareholders. This has limited the options considered to ones that will be universally beneficial to shareholders as other options considered out of scope will benefit some shareholders more than others.

Options and preferred option

This RIS considers retaining the legislative status quo which would still leave Fonterra the option of changing its constitution to allow imputation credits to be attached to non-deductible dividends. However, a constitutional change could not be completed before the 2022-23 year distribution is confirmed in September 2023 and paid in October 2023. Furthermore, officials need more time to consider the appropriate tax treatment of Fonterra's distributions, so are not seeking to encourage a constitutional change until it is determined whether a future law change, which would make a constitutional change unnecessary, is a better long-term solution.

Instead, officials prefer a temporary law change covering the 2022-23 to 2024-25 income years to restore deductions on distributions to levels that would have been available had Fonterra's constitution not been changed. This recommended temporary amendment could, in theory, apply to other co-operatives but in practice would likely only be of benefit to Fonterra. It would remove the effective over-taxation for this three-year period while providing time for officials, in consultation with Fonterra and its shareholders, to develop a permanent solution and, if necessary, for amending legislation to be enacted.

Limitations and Constraints on Analysis

Inland Revenue is limited in its ability to disclose sensitive revenue information, so the analysis presented in this RIS does not contain the full suite of information considered by officials in coming to the conclusions in this document. The sensitive revenue information included in this document is limited to that reasonable and necessary under section 18D(2) of the Tax Administration Act 1994. Fonterra is aware of the disclosure of this information.

Due to limited time to prepare this analysis we have consulted with Fonterra but have not consulted with its shareholders. This is one of the reasons the options considered have been limited to those that will not make individual shareholders worse off.

Responsible Manager(s) (completed by relevant manager)

Chris Gillion

Policy Lead

Policy and Regulatory Stewardship

Inland Revenue

8 August 2023

Quality Assurance (completed by QA panel)

Reviewing Agency:	Inland Revenue
Panel Assessment & Comment:	The Quality Assurance reviewer at Inland Revenue has reviewed the regulatory impact assessment prepared by Inland Revenue. The reviewer considers that information and analysis summarised in the regulatory impact statement partially meets the quality assurance criteria. Due to time limitations, it has not been possible to consult with Fonterra's shareholders and as a result some potential policy options have been ruled out of consideration at this time.

Section 1: Diagnosing the policy problem

What is the context behind the policy problem and how is the status quo expected to develop?

Background to deductible dividends

1. A co-operative company is a specific type of company with a number of features including that they typically return a portion of their profits to shareholders as rebates or as shares and has shareholders who:
   - Supply goods or services to the company,
   - Buy the company's goods or services, or
   - Enter into commercial transactions with the company.

2. The Income Tax Act 2007 (ITA)[1] provides the ability for a co-operative company to choose to treat distributions[2] paid to its shareholders as a deductible expense that reduces their taxable income. An earlier version of this provision was introduced in 2006 with the intention of applying to structures such as Fonterra had at that time.

3. For a co-operative with shareholders that are taxable at or above the company rate a deductible distribution provides the same total tax revenue as the conventional company treatment of a non-deductible dividend that is distributed with imputation credits.

4. For example, a business with a $100 operating profit that will be fully distributed to shareholders under a deductible distribution or an imputation credit regime:

	Deductible distribution	Imputation
Operating profit	100	100
Deduction for distribution	(100)	0
Company taxable profit	0	100
Company tax paid @ 28%	0	28
Cash distribution paid	100	72
Imputation credit attached	0	28
Shareholder taxable income	100	100
Tax credit on dividend	0	28
Tax payable @ 33%	33	5
Shareholder after tax income	67	67

5. If shareholders are taxed at less than the company rate (for example, if they have losses carried forward, are a charity or a Maori authority without sufficient other income) they will not get the full benefit of imputation credits so would be better off under a deductible distribution model.

6. This deductibility provision, and its predecessors, was created with the understanding that there would be a linkage between the shareholding and the goods or services supplied between the co-operative and its shareholders. In this way, an individual shareholder's shares and distributions would be approximately proportional to that

[1] Section CD 34B.

[2] This RIS uses the terms distributions and dividends. In most instances these terms can be used interchangeably; however, the ITA achieves a distribution being deductible by deeming it not to be treated as a dividend. This RIS maintains the same convention.

shareholder's transactions with the co-operative and, therefore, their ownership of the profits that the co-operative generated from those transactions. This provides an equivalent treatment between the deductible/assessable payment the co-operative pays or receives for the transactions with the shareholder and any distributions on the shares they hold. Therefore, where shareholders are required to hold shares (as they were under Fonterra's previous constitution), there is no tax concession and horizontal equity is maintained between shareholders, so that there is no tax incentive to hold these shares compared to investment in another entity.

7. It also provides a similar outcome to deductible rebates paid by other mutuals and co-operatives. For example, certain electricity lines companies owned by community trusts pay a deductible rebate to users proportional to the supplies (and therefore the profit) between that lines company and the electricity user. An equivalent treatment could be achieved by reducing the lines charge by the amount of the rebate; however, the lines company usually cannot predict their total profit with sufficient accuracy to do so at the time the lines charges are set.

Change in Fonterra's constitution

8. Fonterra has recently changed its constitution so that farmers are only required to hold one share for every 3kg of milk solids they supply. This change is designed to reduce the capital required to become or remain a Fonterra supplier and thereby make it easier for Fonterra to gain or retain market share against its competitors who typically have less expensive capital buy-in arrangements. Individual farmers can reduce their shareholding from the 1:1 ratio to the new 1:3 ratio but only by trading shares with other farmers so collectively Fonterra will still have approximately the same number of shares on issue as under the previous 1:1 approach. Fonterra still treats the 1:1 ratio as the "share standard" and shares up to this amount provide voting rights so a farmer holding less than 1:1 will have fewer votes than a farmer with the same supply and more shares.

9. For example, if Fonterra had 10 shareholders who each provided 100kg of milk solids they would have previously been required to hold 100 shares each. Under the new constitution each farmer could individually reduce their holding to a minimum of 33 shares but only by selling up to 67 shares to one of the other farmers so there were still 1,000 shares on issue.

10. Inland Revenue has determined, as part of a binding ruling, that, the deductible distribution would only be available for distributions on shares that shareholders were required to hold rather than those that were equal to their supply with Fonterra. This application means that, even where all shareholders held shares above the minimum holding and entirely proportional with their supplies, the deduction available to Fonterra would only be 1/3 of that available to an equivalent co-operative without that rule. In the example in paragraph 9, only distributions that relate to the minimum of 33 shares would be deductible and the distributions for the remaining 67 shares would not.

11. Each business will make decisions about how much capital to retain from its after-tax profit, leaving an amount that can be distributed to shareholders. For any level of profit a decrease in deductions will result in greater tax to pay and less cash to distribute. As Fonterra is unable to attach imputation credits to its distributions the shareholders will not receive any direct benefit from the increased tax paid by Fonterra and distributions would be expected to reduce.

Legislative requirements

12. As noted above, a deductible distribution and the imputation credit regime will, for most shareholders, result in an identical total tax payment. However, when deductible distributions and non-deductible dividends are paid on the same class of shares difficulties can arise.

13. The benchmark dividend rules in the ITA[3] require all dividends in a year to be imputed at the same ratio[4]. However, these rules do not apply to the current circumstance as a deductible distribution is not a dividend and cannot be imputed. Therefore, the ITA does not prevent an unimputed deductible distribution and an imputed non-deductible dividend to be paid by the same company on the same class of shares. To achieve the correct outcome the dividend must have a smaller cash amount with the difference made up by imputation credits. This is consistent with the example in paragraph 4 above.

14. The Companies Act 1993, however, prevents a distribution of a differential dividend[5] on a class of shares except in specific cases which do not apply here[6].

What is the policy problem or opportunity?

15. The policy problem is the current Income Tax Act and Companies Act legislation when combined with a constitution which does not specifically allow for some distributions to be imputed while others are paid fully in cash will result in Fonterra's shareholders effectively being overtaxed compared to distributions from other equivalent companies. This is explained in more detail below.

Policy problem

16. Where distributions are fully deductible or fully imputable there is no over-taxation as equal distributions can be provided on all shares.

17. If Fonterra can deduct distributions on some but not all shares, it will not be able to fairly compensate its shareholders even when an equal distribution on all shares is made. As Fonterra's constitution does not contemplate paying differential dividends, then they must provide equal value per share to all shareholders. This means they would be prevented from attaching imputation credits to all non-deductible dividends, either as a replacement for cash or in addition to it, as the holders of the shares which received the non-deductible dividends would then receive different value than the holders of shares which received deductible distributions.

---

[3] Section OB 61.

[4] There is limited ability to change this ratio during the year, for example where the company has insufficient imputation credits to impute a second dividend at the same ratio as an earlier dividend; however, this ability is not relevant to the current situation.

[5] This is the term used in section 53 of the Companies Act where different shares in the same class receive distributions of different values.

[6] The exceptions are for multi-rate portfolio investment entities or where the company's constitution permits under an objective criteria. The distinction between shares that support supply and shares that do not is an objective criteria; however, Fonterra's constitution does not currently allow for this. There is also a provision in section LP 6 of the ITA which overrides this requirement for supplementary dividends but this cannot apply to this situation.

18. The cost of not being able to impute the non-deductible dividends would be shared across all shareholders, including holders of shares with deductible distributions, who, due to the effective over-taxation, would receive a lower after-tax return than intended.

19. For example, consider a co-operative with 100 shares and $100 of operating profit. If this is fully distributed to shareholders with a 33% marginal tax rate and all distributions are deductible the effective tax rate on shareholders is 33%.

Operating profit	100
Distribution	100
Less deduction for distribution	(100)
Co-operative taxable profit	0
Co-operative tax payable (28%)	0
Shareholder taxable income	100
Shareholder tax on taxable income (33%)	33
Total effective tax rate	33%

20. In comparison, under the same facts but with only 50% of distributions being deductible, a non-deductible non-imputed distribution results in over-taxation.

	Deductible (50%)	**Non-deductible (50%)**	**Total**
Operating profit	50	50	100
Distribution[7]	41.86	41.86	83.72
Less deduction for distribution	(41.86)	0	(41.86)
Co-operative taxable profit	8.14	50	58.14
Co-operative tax payable (28%)	2.28	14	16.28
Shareholder taxable income	41.86	41.86	83.72
Shareholder tax on taxable income (33%)	13.81	13.81	27.63
After-tax cash	28.05	28.05	56.09
Total effective tax rate	32.2%	55.6%	43.9%

[7] This distribution falls to provide the co-operative with sufficient cash to pay their tax liability. The calculation of how this amount is arrived at has not been shown in this RIS.

21. If Fonterra is faced with this situation under current legislation and with a constitution that does not provide for differential dividends it would subject its shareholders to over-taxation at any level of distribution above zero.

22. This problem would arise for any co-operative with a similar constitution to Fonterra's that also relied on the deductibility provision; however, officials are not aware of any other co-operative in that situation.

Ability for shareholders to utilise imputation credits

23. As referred to in paragraph 5, there are some shareholders that cannot utilise imputation credits due to their specific tax characteristics. These investors would prefer a cash dividend over a larger dividend that was partially provided in the form of imputation credits; for example, a $80 cash dividend would put them in a better position than a $72 cash dividend with $28 of imputation credits even though most shareholders would prefer the smaller but imputed dividend.

24. This is an existing issue for shareholders with these features and is outside the scope of this RIS to consider this issue, for example by considering whether imputation credits should be refundable.

What objectives are sought in relation to the policy problem?

25. The main objective is to allow Fonterra (and by extension any co-operative company that meets the criteria including that it does not require a 1:1 relationship between supplies and shareholding) to distribute its profits to shareholders without those effectively being subject to tax at greater than intended effective tax rates.

26. A secondary objective is to prevent an unexpected decline, due to those greater than intended effective tax rates, in the after-tax distributions received by Fonterra's shareholders for the 2022-23 income year.

Section 2: Deciding upon an option to address the policy problem

What criteria will be used to compare options to the status quo?

27. The criteria that have been used to assess the options are:
    a. Equity and fairness – The tax system should be fair. Assessment of both vertical equity (the relative position of those on different income levels or in different circumstances) and horizontal equity (the consistent treatment of those at similar income levels, or similar circumstances) is important.
    b. Efficiency, effectiveness and coherence – Individual reform options should make sense in the context of the entire tax system. While a particular measure may seem sensible when viewed in isolation, implementing the proposal may not be desirable given the tax system as a whole. More generally, revenue should be raised in a way that has the least impact on economic behaviour, in particular, does not distort investment decisions in favour of any particular investment.

What scope will options be considered within?

28. To prevent the effective over-taxation of Fonterra's shareholders for the 2022-23 income year it is necessary to consider a legislative solution. It is proposed that this solution be included in a Supplementary Order Paper to the Taxation (Annual Rates for 2023-24, Multinational Taxation, and Remedial Matters) Bill which is currently being considered by the Finance and Expenditure Committee.

29. Two permanent solutions to this situation would be to make all distributions in this situation non-deductible (which is consistent with the treatment of an ordinary company) or to allow non-deductible dividends to be imputed while not imputing deductible distributions (an example of this is provided in an appendix to this RIS).

30. Imputing non-deductible dividends, while still having a portion of deductible distributions, could only be achieved by a change in a company's constitution or by legislation overriding that constitution. Both of these options have the same consultation issue explained below so for these purposes have been carved out of scope for the same reason.

31. While all of these options would make most shareholders better off, this would not be the case for shareholders who cannot utilise imputation credits[8].

32. In that circumstance, it does not seem appropriate to impose an option on shareholders which could make some of them individually worse off without providing them any opportunity to be consulted on this decision. Such consultation has not been practical given the timeframes. Accordingly, these options have been considered out of scope for the purpose of this RIS.

---

[8] Refer to the examples in paragraph 5 and the explanation in paragraphs 23 and 24.

33. The exclusion of these options means that option two, considered below, is for a limited time period in order that a separate project to find a more permanent resolution can be completed. The options considered out of scope above can be reconsidered as part of that second project.

34. As noted in paragraph 24, this RIS also does not consider the wider treatment of imputation credits by all entities that cannot fully utilise them; for example, by making imputation credits refundable.

What options are being considered?

35. The options to be considered are:
    i. Status Quo – Fonterra will be unable to attach imputation credits to non-deductible dividends while they also pay deductible distributions on the same class of shares. This would mean Fonterra would need to further amend its constitution to rectify this problem.
    ii. Temporary extension of deductibility to also allow deductible distributions on shares that are no longer required to support supply. This would allow Fonterra to continue deducting distributions on shares up to its level of supplies with each shareholder based on the previous 1:1 ratio, but only for a limited period while a permanent solution is determined and implemented.
    iii. Permanent extension of deductibility. As with option 2, except it would apply for all future periods.

36. As noted above, legislative options to remove all deductibility and to impute non-deductible dividends have not been considered as they would make some shareholders worse off and there will be no opportunity for consultation with them before introduction of any proposed law change.

Option One – *Status Quo*

37. As a co-operative that pays a mixture of deductible and non-deductible distributions, Fonterra's constitution does not allow for differential dividends to be paid, so it will not be able to attach imputation credits to its non-deductible dividends. This means its shareholders will not receive any benefit for tax paid by Fonterra, resulting in greater total tax paid than is intended, effectively being taxed twice.

38. Under this option, Fonterra could change their constitution to allow for differential dividends. However, its shareholders may not agree to this and there would be insufficient time to achieve this before the distributions for the 2022-23 income year (and possibly later years) are determined. Therefore, this option may eventually achieve the main objective but would not meet the second objective of mitigating the over-taxation of their shareholders in the 2022-23 (and possibly later) income years.

39. Also, this option would subject Fonterra to the cost of changing its constitution and impose compliance costs on its shareholders to consider this change. Officials are yet to conduct a policy project to determine the appropriate permanent policy position for Fonterra's distributions. In the event this project determined that a legislative change was desirable (for example, to make all distributions deductible or no distributions deductible), this would make further changing Fonterra's constitution unnecessary. While Fonterra is able to progress changing their constitution at any time, officials prefer developing the project to consider a permanent resolution before recommending that Fonterra follow this path.

40. This option has poor horizontal equity. A shareholder deriving their portion of income from Fonterra would be subject to a higher effective total tax rate than if they had derived that income through a different structure.

41. This option is also not coherent in the absence of a constitution change. It provides a disincentive to invest in Fonterra over other structures.

Option Two – Temporary extension of deductibility

42. This option involves a change to the ITA to allow Fonterra to choose to deduct distributions on shares a supplier/shareholder chooses to hold up to the amount supplied. This would be consistent with Fonterra's previous treatment that previously required shares to be held up to the amount supplied. Dividends on shares above the level of supplies would continue to be non-deductible, which is the treatment that has always applied[9].

43. This would meet the main objective for the period of the extension but would not do so beyond that, so a further project would be necessary. It would meet the secondary objective as it could be introduced and enacted before the 2022-23 income year return was due to be filed. It is possible that at the end of considering a second project the final position under option two would be equivalent to that in option one, so consideration is mostly for the period of the extension.

44. This option improves horizontal equity for the period of the extension as income earned through this structure, by most investors, would be taxed consistently with equivalent income earned through other structures. Some investors who had tax rates lower than the corporate tax rate would be better off than if they earned equivalent income through other structures but this would be consistent with other co-operatives and Fonterra's previous constitution where they were required to hold those shares; however, in those instances suppliers are required to hold the shares rather than choosing to. Any distributions on shares above the level of supplies would continue to be non-deductible so there would be no tax incentive to acquire shares above the amount that was previously required to be held.

---

[9] The imputation treatment of these dividends is not considered as part of this RIS and would not be addressed by the considered options. This would be incorporated into the second policy project that is part of the preferred option.

45. This option improves coherence for the period of the extension but, by design, does not provide any change in coherence beyond that. Although there may be an incentive to invest in Fonterra (or given existing holdings this would be more accurately to not divest an existing investment in Fonterra) by a small group of investors[10] who would receive tax favourable treatment this would only apply for a limited period so is not expected to materially influence investor decisions. After the end of the extended period a further change would be necessary, but this can be considered as part of a separate project.

Option Three – Permanent extension of deductibility

46. A change to the ITA to allow Fonterra (and any other future co-operative in a similar situation) to choose to deduct distributions on shares a supplier/shareholder chooses to hold up to the amount supplied. This would be consistent with Fonterra's previous treatment that required shares to be held up to the amount supplied.

47. For the initial period that matched the period in option two the tax treatment would be identical. However, it would provide a permanent concession[11] to certain investors that would not be available to other investors with different tax attributes or any investors in other entity types. That is, the ability for an investor who cannot fully utilise imputation credits to benefit from deductible dividends in a way that they wouldn't be able to with a regular company. This concession does not exist for investors in other co-operatives or Fonterra under its previous constitution, even where the tax outcome is the same, as the shares that are required to be held are proportionate with supplies and therefore the shareholders are not able to consider other investment choices beyond indirect effects such as from changing their level of supplies.

48. This option would improve horizontal equity as for the majority of investors the over-taxation problem would be resolved and they would be taxed appropriately. However, as it permanently introduces a concession for a smaller group of investors, it does not improve horizontal equity by as much as option two.

49. This option is less coherent than the status quo as it introduces a permanent concession that is not available to other investment choices and, therefore, incentivises investment in Fonterra (and any co-operative who adopted a similar structure in the future). However, that concession would still be limited to dairy farmers (or other activities for a separate future co-operative) so the overall effect would be somewhat limited.

---

[10] Refer to the examples in paragraph 5 and explanation in paragraphs 23 and 24. The tax advantage arises from the additional cash dividend that is available from the deductible distribution compared to an equivalent imputed dividend. Based on Fonterra's 2022 distribution officials estimate this benefit for an average farmer, provided they had the necessary tax criteria would be in the region of $1,000 for a year. However, some holdings, particularly by charities, may be larger than the average in which case the potential benefit would be proportionately larger.

[11] As with option two, officials estimate this benefit to be in the region of $1,000 for a year based on Fonterra's 2022 distribution; however, this would continue indefinitely and would increase proportionately to any future increase in distributions.

Māori perspective

50. There will be a variety of Māori investment into Fonterra including through Maori authorities and charities. Due to the varying tax structures, these investments may not be able to (fully) utilise imputation credits for the reasons explained above.

51. The constraints applying to the analysis, specifically the absence of consultation with shareholders, means that we don't have a good understanding of the arrangements that Māori may use to hold shares in Fonterra.

52. As such, it is difficult to know if there are any disadvantages for Māori over and above those already mentioned in the analysis, being the potential for imputation credits to be unused (because of the tax rate differential). The same comment also applies to charities and other affected entities. Although the tax rate for Maori authorities, at 17.5% is lower than the imputation credit rate of 28%, many Maori authorities will have other taxable income that could benefit from surplus imputation credits.[12] Therefore, to the extent imputation credits cannot be utilised this is more likely to arise where Fonterra shares are owned by a charity than by a Maori authority.

53. However, the status quo and the other options considered in this RIS all cover the deductibility to Fonterra and the consequential effect on cash distributions and have no direct imputation credit effect. The treatment of cash distributions will be consistent with all other income earned by these groups. In other words, a distribution becoming deductible is expected to result in that cash distribution being larger. Therefore, all shareholders, irrespective of their tax status, would receive the same benefit in proportion to their shareholding. The tax consequences of that increased distribution would, then, follow that shareholder's individual tax status (i.e., taxed at their marginal rate, used to reduce losses that would otherwise be carried forward, or non-taxable). The same analysis would not apply to a proposal to impute non-deductible dividends as that would change the relative benefit to shareholders depending on whether they could utilise imputation credits; however, that proposal is not being considered in this RIS. The additional time to consult arising from a second policy project will resolve this issue to the extent possible.

[12] For example, a Maori authority receiving deductible distributions from Fonterra will also receive payments from Fonterra for milk supplied and the surplus imputation credits would reduce the tax payable on any net profit from supplying that milk.

How do the options compare to the status quo/counterfactual?

	Option One – *Status Quo*	Option Two – Temporary extension	Option Three – Permanent extension
Equity and fairness	0	++ *This option will resolve the issue but only for a temporary period so that a further response will be necessary. It will introduce a temporary concession for a subset of investors who cannot utilise imputation credits.*	+ *Permanently resolves the over-taxation issue. However, permanently introduces a treatment that could be considered a concession for a subset of investors*
Efficiency, effectiveness and coherence	0	+ *Due to the temporary nature it is unlikely to affect investment decisions*	- *Would create an incentive to invest in the co-operative rather than other companies and for other co-operatives to consider restructuring to apply the provision.*
Overall assessment	0	++ *Allows the previous status quo to continue while providing time for a permanent resolution to be developed.*	– *This would resolve the over-taxation but create a permanent concession that is likely to, at the margin, skew investment decisions.*

Example key for qualitative judgements:

++	much better than doing nothing/the status quo/counterfactual	-	worse than doing nothing/the status quo/counterfactual
+	better than doing nothing/the status quo/counterfactual	- -	much worse than doing nothing/the status quo/counterfactual
0	about the same as doing nothing/the status quo/counterfactual		

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

54. Option two is the preferred option. It would allow the treatment that applied to the 2021-22 and prior years under the previous constitution to be continued on a temporary basis while a permanent solution is developed. By not allowing this treatment permanently (option three) it would not introduce a permanent concession to incentivise investment in Fonterra (and other future co-operatives adopting a similar structure) over alternative investment choices. As the temporary extension would only apply until the end of the 2024-25 year, the benefit would only be available to Fonterra suppliers rather than other investors. Further, as the average benefit for an individual year is relatively small, it is unlikely to incentivise holding additional Fonterra shares even for the temporary period.

55. As noted in the scope section, option two will not provide a permanent resolution to this issue. However, the only way a permanent resolution can be achieved is by providing a permanent concession or providing an option that advantages some shareholders relative to others and this cannot be achieved within the timeframes available. A separate project will need to be commissioned to consider this – this project would consider whether a further law change is necessary or whether Fonterra should make further changes to its constitution. Moreover, it would also provide the opportunity for wider consultation.

56. Option one is not viable if there is to be a solution for the 2022-23 distribution as Fonterra could not change its constitution in time, and shareholders may not necessarily agree to such a change. Also, as noted above, this would impose costs on Fonterra and its shareholders that may not be necessary if the policy project referred to in option two determines that a treatment other than a partially deductible, partially imputed distribution is preferable.

What are the marginal costs and benefits of the option?

Note that the table below does not include the cost to Fonterra (and indirectly its shareholders) or the benefit to Government revenue from distributions becoming non-deductible due to the change in constitution. This has been estimated by officials at $60 million over the forecast period which makes the net effect on Government revenue of the constitution change and the preferred option a gain of $2 million over the forecast period.

Affected groups *(identify)*	**Comment** *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks.*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.*	**Evidence Certainty** *High, medium, or low, and explain reasoning in comment column.*
Additional costs of the preferred option compared to taking no action			
Fonterra	Additional distributions paid due to lower tax liability than under the status quo. This reduction in tax and increase in distributions is expected to leave Fonterra in approximately the same position so has been netted to zero in this table	$0	Medium
Shareholders of Fonterra	Additional tax on increased dividends received. This amount will effectively be met by the increased cash dividends received so does not provide a net cost to shareholders. The actual amount is incorporated into the $58m in the cell below.	$0	Medium
Government	Reduced tax receipts. This cost represents a reversal of the effective over-taxation that arises the change in Fonterra's constitution . This cost is heavily dependent on the assumptions made in the model that calculated it and therefore is subject to	$58 million over the forecast period.	Low

	considerable uncertainty. However, that uncertainty also exists in the modelling of the increased tax arising from the constitution change		
Total monetised costs		*$58m*	*Low*
Non-monetised costs		*Nil*	
Additional benefits of the preferred option compared to taking no action			
Fonterra	In effect note, as we assume that the additional deductions available to Fonterra under the preferred option would be passed on to shareholders through increased distributions to a similar extent as before the constitution change.	$0	Medium
Shareholders of Fonterra	Increased pre and post-tax distributions from the reversal of the effective over-taxation arising from Fonterra's constitutional change. This benefit will be lower if Fonterra decides to take a share of the benefit by not distributing all of it.	$58 million over the forecast period	Medium
Government	None		
Total monetised benefits		$58m	
Non-monetised benefits		*Nil*	

Section 3: Delivering an option

How will the new arrangements be implemented?

57. The preferred option will require an amendment to the Income Tax Act 2007. This should be achieved by a Supplementary Order Paper to the Taxation (Annual Rates for 2023-24, Multinational Taxation, and Remedial Matters) Bill which is currently being considered by the Finance and Expenditure Committee. This Bill is expected to be enacted in March 2024.

58. As this Supplementary Order Paper will be released shortly before the House rises there will be insufficient time for the Finance and Expenditure Committee to call for public submissions on the proposals. However, officials have worked with Fonterra during the development of the Supplementary Order Paper and will continue to do so, to the extent necessary, during the remainder of the parliamentary process.

59. Although the preferred option will first apply for the 2022-23 income year which has recently finished, in many cases the income tax returns for that year will not be due to be filed until after the Bill is expected to be enacted.

60. A change in deductibility (to an amount consistent with what would have been expected had the constitution not changed) will affect the amount of distributions made and the calculations in income tax returns but does not have any material impact on the administration of the tax system.

How will the new arrangements be monitored, evaluated, and reviewed?

61. The preferred option is only to apply for a temporary period while a permanent resolution is developed. As the temporary extension is effectively a continuation of the position that applied prior to the change in constitution no specific monitoring of the temporary extension will be required.

Appendix – Example of partial deductibility and partial fully-imputed dividends

The effective over-taxation explained in this RIS can be resolved, while retaining the correct proportionate distributions, by replacing a portion of the non-deductible dividend with imputation credits which allows the overall dividend to increase. The example below uses the same 50% deductible example from paragraph 19 and 20.

	Deductible (50%)	Non-deductible (50%)	Total
Operating profit	50	50	100
Distribution	50	36	86
Less deduction for distribution	(50)	0	(50)
Co-operative taxable profit	0	50	50
Co-operative tax payable (28%)	0	14	14
Shareholder cash dividend	50	36	86
Shareholder imputation credit	0	14	14
Shareholder taxable income	50	50	100
Shareholder tax on taxable income (33%)	16.50	16.50	33
Shareholder tax credit	0	14	14
Shareholder cash tax payable	16.50	2.50	19
After-tax cash	33.50	33.50	67
Total effective tax rate	33.0%	33.0%	33.0%