Regulatory Impact Statement

Demergers

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue. It provides an analysis of options to address the problems with the tax treatment of demergers. The current tax treatment does not align with the economic substance of the relevant demerger.

A demerger describes a situation where a corporate group splits off part of itself and distributes that part to its shareholders. The effect of a demerger is that companies which were grouped under a single shareholding are separated into two different shareholdings (initially held by the same shareholders), so they can be dealt with separately. Demergers can have real economic benefits. Generally the full value of the shares in the demerged company is a dividend for the shareholder because (subject to certain exceptions)a dividend includes any transfer of value from a company to a shareholder that is caused by the shareholding.

The current tax treatment of demergers is a problem because a demerger is in substance the division of a corporate group rather than a distribution of income. This issue has been raised by the New Zealand Shareholders Association as an urgent issue which requires a legislative solution. Due to this urgency, the focus of the proposed solution is more narrowly focussed on demergers of Australian listed companies.

A limitation of the analysis is that Inland Revenue has not yet consulted more widely on the detail of the proposed demerger regime. This was to ensure that the amendments sought by the private sector can be enacted as early as possible. However, officials intend to undertake further targeted consultation with the private sector on the detail of the demerger regime. Changes arising from this consultation can be incorporated into the proposals before the introduction of the bill.

A further limitation is that it is not possible to accurately quantify the size of the problem, as the number and size of Australian demergers varies from year to year and Inland Revenue does not record the income returned by New Zealand shareholders on such demergers. However, it is understood that recent high profile demergers of Australian listed companies could have impacted thousands of New Zealand shareholders.

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STATUS QUO AND PROBLEM DEFINITION

1. A demerger, or spin-off, is where a corporate group splits off part of itself and transfers that part to its shareholders. This can occur by the parent company distributing an existing subsidiary to its shareholders, or by an operating company transferring part of its own business to a new subsidiary, and then distributing that subsidiary to its shareholders.

2. The effect of a demerger is that companies which were grouped under a single shareholding are separated into two different shareholdings (initially held by the same shareholders), so they can be sold separately.

3. A demerger is generally undertaken by a corporate group when it believes its constituent parts would perform better if separated. This can be for a variety of reasons, such as where the group is valued at less than the sum of its parts. Accordingly demergers can have genuine economic benefits.

Current tax treatment of demergers

4. A demerger involves the transfer of value from the company to its shareholders (being the distribution of the shares in the demerged company) that is caused by their shareholdings. Under the Income Tax Act 2007 (the Act) the full value of the shares in the demerged company is generally a dividend for the shareholder. This is because the Act defines a dividend (subject to certain exceptions) as any transfer of value from a company to a shareholder that is caused by the shareholding.

5. Shareholders are therefore liable to pay tax on the full value of the shares in the demerged company when a demerger occurs. This is despite the fact that the value of their two shareholdings should be approximately the same as their previous one shareholding, as the underlying assets are unchanged. Furthermore, the amount of the dividend is usually very large, as it will equal a significant percentage of the corporate group's total market value.

6. A demerger can be often be structured to prevent dividend taxation (in whole or part) by arranging a share repurchase or a liquidation.

7. A New Zealand company which intends to demerge could "buy-back" a portion of its shares from shareholders, with the shareholders receiving shares in the demerged company as the consideration. This would not be characterised as a dividend provided the amount was less than the company's paid up share capital (referred to as "available subscribed capital", or ASC, for tax purposes).

8. It is also possible to structure a demerger as a liquidation of the holding company in order to prevent dividend taxation. In this case the holding company would be liquidated and the shareholders would be provided with the holding company's assets – being shares in the two demerged companies. An amount equal to any net capital gains (realised and unrealised) plus the ASC of the distributing company is excluded from being a dividend.

9. Further, a dividend arising from a demerger involving a non-resident company will only be taxable if the shareholder is not subject to the foreign investment fund (FIF) rules. If the New Zealand shareholder is subject to the FIF rules the investment will be taxed under the fair dividend rate (FDR) which is a tax on 5 percent of the value of the investment. As dividends are not separately taxed under the FDR method demergers are also not subject to tax. Generally, a shareholder in a non-resident company is not subject to the FIF rules when

they are a natural person whose total offshore shareholdings (not including shares in Australian listed companies) cost $50,000 or less.

10. The FIF rules do not apply to most Australian listed companies, which are instead taxed similarly to New Zealand shares. This means that under the current rules, demergers from Australian listed companies will be taxed as a dividend, in the same way that a New Zealand demerger would.

Problem definition

11. The current tax treatment is a problem because a demerger is in substance the division of a corporate group rather than a distribution of income. Following the demerger, the shareholders still have the same proportionate interests in the same underlying assets. Although the demerger is taxed as a dividend, economically there is no distribution of income or underlying assets by the corporate group.

12. This issue has been raised by the New Zealand Shareholders Association (NZSA) as an urgent issue which requires a legislative solution. Officials agree that an urgent solution is desirable so that New Zealand shareholders involved in any upcoming demergers are not faced with an unfair tax bill due to the operation of the current law.

Demerger regimes internationally

13. Australia, the UK, the US and Canada all have regimes which exempt qualifying demergers from dividend taxation. These regimes are generally subject to numerous restrictions to ensure that they only apply to demergers and cannot be used to effect a tax-free distribution of income to shareholders or a sale of the companies. For example, the foreign regimes apply only when active businesses are being divided. They usually also include specific anti-avoidance provisions.

14. Australian demergers are generally excluded from being a dividend either under:

- Australia's specific demerger regime; or
- because the demerger is treated as a return of share capital for Australian tax purposes.

Scale of the problem

15. The current tax treatment raises issues for demergers of both New Zealand and foreign companies. However the problem is particularly acute for demergers by listed Australian companies. This is because:

- New Zealand companies can often structure their demerger so that no dividend arises; and
- shares in other foreign companies are more commonly subject to the FIF rules which ignore dividends.

16. Listed Australian companies, however, often have several thousand New Zealand shareholders that are taxable on any dividends received, but they do not structure their demergers to be efficient for New Zealand tax purposes. For example, approximately 13,000 New Zealand shareholders were affected by the BHP/South 32 demerger in 2015, while about 9,000 New Zealand shareholders were affected by the NAB/Clysdale demerger in 2016.

Dividend taxation for Australian demergers can seem particularly unfair for New Zealand shareholders, as Australian shareholders are not usually taxable on the demerger.

OBJECTIVES

17. The **main objective** is to align a demerger's tax treatment with its economic substance. This will improve economic efficiency and ensure that New Zealand shareholders are not inappropriately taxed on the full value of their shares in the demerged company.

18. All options are assessed against the main objective and the following criteria:

- **Economic efficiency** – the proposed changes should align the tax treatment of demergers with their economic substance. This will improve the economic efficiency of the tax system. More particularly, it will ensure that the tax treatment does not incentivise shareholders to sell their shares in a company which is about to demerge (or disincentivise them from acquiring such shares).

- **Integrity of the tax system –** the proposed changes to the demerger regime should not create opportunities for abuse. What is in substance the distribution of income should not be able to be structured as a tax-free demerger.

- **Fairness and equity** – the proposed changes should improve the fairness of the tax system, by ensuring that shareholders are not taxed on a demerger when they have not derived any income in economic substance.

19. In this context, officials consider that the most weight should be given to meeting the objectives of fairness and equity, and the integrity of the tax system. Further, as the scope of the proposed change gets broader, there will be an increase in fairness and equity at the expense of integrity of the tax system. This is because a broader regime could lead to gaps in the law which require the development of provisions that prevent abuse of the regime. Officials consider that the solution should not be so broad as to create opportunities for abuse, and should be targeted at the arrangements which are actually causing problems in practice.

20. The constraint in relation to the proposal is as follows:

- **Timeliness** – it is important to have a legislative solution as soon as practicable. The private sector has asked for an urgent response, and officials have indicated that changes are proposed for the first tax bill of 2017.

REGULATORY IMPACT ANALYSIS

21. Officials have identified four options to address the problem:

- Option 1 – The status quo

- Option 2 – A full demerger regime, which applies to both New Zealand and foreign companies

- Option 3 – A limited demerger regime, which only applies to Australian listed companies

- Option 4 – A middle ground between the above two options, which would apply to all demergers by foreign listed companies (or potentially a subset of them)

Option 1

22. Option 1 is the status quo. Shareholders would continue to be taxed on demergers as a dividend.

Assessment against criteria – option 1

23. The status quo does not meet the main objective. Shareholders would be taxed on demergers even though in economic substance they had not received any income.

24. *Economic efficiency.* The status quo does not meet the economic efficiency criterion. Shareholders will be incentivised against owning shares in companies which are in the process of demerging.

25. *Integrity of the tax system.* The status quo meets the integrity criterion. As shareholders are taxed on dividends arising from demergers there is no opportunity to demerge to access a tax free gain that should be taxable.

26. *Fairness and equity.* The status quo does not meet the fairness criterion. Shareholders will have to pay tax even though they have not economically received any income. This will make them worse off than other investors who will not have to pay tax.

Option 2

27. Option 2 would introduce a full demerger regime, which applies to both New Zealand and foreign companies.

Assessment against criteria – option 2

28. This option is the most conceptually pure approach, as demergers by New Zealand and foreign companies should be taxed the same way from a policy perspective. This option meets the main objective, as it would ensure that genuine demergers are not unfairly taxed as a dividend. This would align the tax treatment of all genuine demergers (whether by a New Zealand or foreign company), with their economic substance.

Economic efficiency

29. Option 2 is a significant improvement over the status quo, as there would be no tax consequences which arise from holding shares in a demerged company. There would no longer be any incentives against owning shares in a company which is in the process of demerging.

Integrity of the tax system

30. Option 2 is worse than the status quo. This option would have the greatest integrity risk, as New Zealand companies could attempt to exploit the regime to effect an in-substance distribution of income. For example a company could transfer cash or liquid assets to a subsidiary, and demerge that subsidiary by distributing it to its shareholders. The subsidiary could then be liquidated under the current law, thus providing all of the cash and/or liquid assets to the shareholders tax-free. The foreign demerger regimes referred to above have all included extensive anti-avoidance provisions to prevent such abuse. Therefore it is important

that any comprehensive demerger regime be carefully drafted so that it only applies to demergers that do not effect an in-substance distribution of income to shareholders.

Fairness and equity

31. Option 2 is a significant improvement over the status quo, as it would ensure that shareholders of demerged companies do not become liable to pay tax on the value of the demerged shares despite there being no in-substance change in their shareholding.

Constraints

32. A full demerger regime would be complicated and time consuming to develop, particularly concerning the anti-avoidance provisions required to prevent abuse of the regime. Such a regime could definitely not be developed in time for the first omnibus tax bill of 2017, or possibly the second. Consequently officials consider that option 2 is not feasible given the time constraints.

Option 3

33. Option 3 is a limited demerger regime, applying only to Australian listed companies. This option would exclude any demerger by a listed Australian company from dividend taxation provided the demerger was excluded from dividend taxation in Australia under either Australia's demerger regime or its return of share capital rules.

Assessment against criteria – Option 3

34. While not as conceptually pure as option 2, this is a pragmatic approach that would address the demergers that have been causing issues in practice without needing to be nearly as complex as a full demerger regime. This meets the main objective.

Economic efficiency

35. This option would improve economic efficiency, by aligning the tax treatment of a qualifying Australian demerger with its economic substance. As demergers by listed Australian companies are the problem for most shareholders, option 3 would address the issues faced by shareholders in practice.

Integrity of the tax system

36. The Australian demerger regime already has rules designed to prevent it being used to effect a distribution of income. Accordingly, officials are comfortable with excluding any demerger from New Zealand dividend taxation where the Australian demerger regime applies to it.

37. In relation to the return of share capital method, New Zealand already has similar rules to Australia that exclude a return of shareholder capital from being a dividend. However these rules require there to be a repurchase by the company of its own shares, while the Australian rules do not. Consequently New Zealand's dividend exemption often does not apply to an Australian demerger that is structured as a return of share capital (as such demergers often do not involve a repurchase of shares).

38. The requirement to repurchase shares is not a significant policy difference between New Zealand's dividend exemption and the Australian exemption – the more important point is that they both exclude a return of shareholder capital from dividend taxation. Therefore we do not see any integrity issues if the demerger dividend exclusion also applies to a demerger by a listed Australian company that is treated as a non-dividend return of share capital under the Australian tax rules.

39. On this basis, we consider that option 3 is equal to the status quo as it maintains the integrity of the tax system.

Fairness and equity

40. Based on past history this option would improve fairness and equity for most of the taxpayers who are taxable on demergers, namely shareholders in listed Australian companies. However it would result in shareholders in New Zealand companies and shareholders in other foreign companies who are not subject to the FIF rules remaining potentially taxable on any demerger dividends. Accordingly it would mean that shareholders in some companies were not taxable on a demerger (i.e. shareholders in listed Australian companies) while shareholders in other companies were. Consequently the differential treatment of shareholders under this option does result in some horizontal inequity.

41. However New Zealand companies have in the past been able to structure their demergers so dividend taxation does not arise. In addition, the problem of demerger taxation does not seem to be problematic in practice for shareholders in other foreign companies. Consequently this lack of fairness across shareholders does not seem to be so significant in practice.

Constraints

42. Option 3 is the least resource intensive of the options, and so it could be implemented the fastest. In particular, the Australian demerger regime already includes anti-avoidance rules designed to prevent abuse. Accordingly the regime could leverage off those rules, by restricting the New Zealand dividend exclusion to demergers by listed Australian companies that are not treated as a dividend under Australian tax legislation. This would significantly simplify the necessary legislation and thus the time required to develop it. This option is the only one which would be able to be included in the first 2017 omnibus tax bill.

43. Accordingly this option best accommodates the current constraints.

Option 4

44. Option 4 would introduce a limited demerger regime applying to all demergers by foreign listed companies. This regime would be a broader solution to the issue than option 3, as it would also cover (in addition to shareholders in listed Australian companies) New Zealand shareholders that are not subject to the FIF rules (generally natural persons with foreign investments costing less than $50,000) who invest in foreign companies outside of Australia.

Assessment against criteria – Option 4

45. This option is not as conceptually pure as option 2, as it would only address demergers of foreign companies. This option is a pragmatic approach that would address the demergers

that can cause issues in practice without needing to be as complex as a full demerger regime which includes New Zealand companies. It would however be a wider approach than option 3, which is targeted at Australian listed companies only. This option can therefore be considered a middle ground between options 2 and 3. This option meets the main objective.

Economic efficiency

46. This option would increase economic efficiency compared with the status quo due to the broader scope of its dividend exclusion for demergers. This option would be a larger improvement than option 3 but not as large as option 2. However as noted above, it is Australian demergers that are causing the problems in practice. Consequently the increase in economic efficiency and fairness over option 3 does not seem to be significant.

Integrity of the tax system

47. This option also poses an increased risk to the integrity of the tax system compared with option 3 (but not option 2) due to its broader reach. However foreign-listed companies would not structure their demergers specifically to avoid New Zealand tax. Consequently this increased risk could be largely mitigated with some anti-avoidance provisions.

Fairness and equity

48. This option is an improvement over the status quo for shareholders in demerged foreign listed companies, as it would prevent dividend taxation in genuine demerger situations. This option could result in shareholders in New Zealand companies remaining potentially taxable on a demerger. However, in practice New Zealand companies usually structure demergers so dividend taxation does not arise. Consequently this lack of fairness across shareholders does not seem to be so significant in practice.

Constraints

49. Option 4 would be more complex than a regime limited to listed Australian companies (option 3). This is because the regime would need to distinguish between genuine foreign demergers and demergers that are an in-substance distributions of income (which should be taxed in New Zealand) to shareholders. As the regime would apply to demergers by companies in multiple jurisdictions, it could not simply use one country's existing anti-avoidance rules (as can be done for a demerger regime limited to Australian listed companies). Option 4 would therefore be more time consuming to develop than option 3 (although less so than option 2). While this impact on constraints is not fatal to option 4, there is a significant risk of officials being unable to develop legislation for option 4 in time for the first 2017 omnibus tax bill.

Fiscal costs

50. Option 3 will have a fiscal cost, as New Zealand shareholders will no longer derive income on the demerger of Australian listed companies. This fiscal cost is the lowest out of the three options other than the status quo, as option 3 has the narrowest scope and the lowest integrity risk.

51. It is impossible to accurately estimate the fiscal cost, as the number and size of Australian demergers varies from year to year and Inland Revenue does not record the income

returned by New Zealand shareholders on such demergers. Officials do not anticipate a material impact on tax revenue baselines.

CONSULTATION

52. The Treasury has been consulted and agree with Inland Revenue's recommendations.

53. Formal consultation has not yet taken place; however the issue was originally raised by the NZSA and the Securities Industry Association. Accordingly officials are aware of the views of the private sector on this issue.

54. The NZSA supports the introduction of a limited demerger regime which excludes all demergers by foreign listed companies from dividend taxation (option 4). However the NZSA focussed on the issues caused by Australian demergers in their correspondence with us, and officials' interactions with the private sector indicate that option 3 would also be well-received given the timeliness of the solution, and the fact that it would address the private sector's primary concern in practice (demergers by listed Australian companies).

55. Inland Revenue has not yet consulted more widely on the proposals. However, officials intend to undertake further targeted consultation with the private sector on the detail of the demerger regime before introduction of the first omnibus taxation bill in 2017. Details to be decided through the consultation process include:

- how the available subscribed capital in the distributing company is to be divided between the original share in the distributing company and the newly held share in the demerged company; and
- how the cost base of the original share in the distributing company is to be divided between the original share in the distributing company and the newly held share in the demerged company.

56. This consultation will include the NZSA, the Securities Industry Association, the Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand, and the New Zealand Law Society. Changes arising from this consultation can be incorporated into the proposals before the introduction of the bill.

CONCLUSIONS AND RECOMMENDATIONS

57. The following table summarises the consideration of the options from the regulatory analysis section above. Within the overview table the following symbols are used:

PP Significantly better than the status quo
P Better than the status quo
O No better than the status quo
OO Worse than the status quo

Options	Analysis against the objective and criteria
Options	**Analysis against the objective and criteria**
Option 1 – Status quo	Does not meet the main objective
Option 2 – Full demerger regime	Meets the main objective Economic efficiency PP Integrity of the tax system OO Fairness and equity PP Does not meet constraints
Option 3 – Limited demerger regime applying to Australian listed companies	Meets the main objective Economic efficiency P Integrity of the tax system O Fairness and equity P Meets constraints
Option 4 – Middle group applying to all demergers by foreign listed companies	Meets the main objective Economic efficiency P Integrity of the tax system O Fairness and equity P Does not meet constraints

58. Option 2 increases the economic efficiency and fairness of the tax system by the greatest amount. However it is not feasible given the time constraints.

59. Option 3 increases economic efficiency and the fairness of the tax system, but its narrower scope means it does so by less than option 4. Option 3 best meets the criteria of maintaining revenue integrity, although its advantage over option 4 in this regard is not that significant. Accordingly the choice between option 3 and option 4 is essentially a trade-off between increased efficiency and fairness (option 4) versus reduced time for implementation and integrity risk (option 3).

60. Officials consider the reduced time for implementation and integrity risk of option 3 outweighs the increase in economic efficiency and fairness of option 4. In this regard, option 3 would address the demergers that are causing the problems in practice. Accordingly option 4's increased economic efficiency and fairness would not be a significant benefit. It is notable that the private sector has focussed on the problems with the tax treatment of Australian demergers, rather than demergers by foreign companies generally. This shows that the economic and efficiency gains of option 3 are perceived as being sufficient to address the pressing issues with demergers.

61. Option 3 best meets all the criteria given the constraints. Therefore Inland Revenue recommends the introduction of a limited demerger regime. This would exclude demergers by listed Australian companies from giving rise to a dividend for New Zealand tax purposes, provided the demerger is not treated as a dividend for Australian tax purposes (under either Australia's demerger regime or under its return of share capital rules).

IMPLEMENTATION

62. Changes to introduce a limited demerger regime would require amendments to the Income Tax Act 2007. These amendments would be included in the next available omnibus taxation bill, scheduled for introduction in the first quarter of 2017. We propose that the recommended option apply from the beginning of the 2017–18 tax year. This is something we intend to consult on with the private sector however.

63. The detail of the demerger regime will need to specify how the available subscribed capital and the cost base of the original share in the distributing company is to be divided between the original share in the distributing company and the newly held share in the demerged company. It should also provide that the newly held share is held on the same basis as the original share (for example, it should be held on capital account if the original share is held on capital account). These and other details will be finalised following further consultation.

MONITORING, EVALUATION AND REVIEW

64. New Zealand demergers do not in practice lead to unfair tax treatment for shareholders, and shareholder of foreign companies (excluding Australian listed companies) are generally subject to the FIF rules. Therefore the problem is mainly confined to Australian-listed companies and the recommended option is expected to be a permanent solution which resolves this issue in practice. It is not expected that a broader demergers regime will be needed in the future.

65. In general, Inland Revenue's monitoring, evaluation and review of new legislation takes place under the generic tax policy process (GTTP). The GTTP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995.

66. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for the new legislation to have its intended effect would be prioritised in the context of the current Tax Policy Work Programme, and any proposals would go through the GTTP.