

# Imputation and the New Zealand Dividend Psyche

An analysis of corporate and  
investor attitudes

September 2015

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# Foreword

I am delighted to present EY's report on Imputation and the New Zealand Dividend Psyche. The report presents the findings of in-depth interviews with a cross section of 25 New Zealand corporates, and 12 investor groups. Our content and method has produced unique research and our findings reveal that tax does have a major impact on corporate dividend policy. As a result of this, we believe the role of imputation is both undervalued, and, under-estimated.

This examination of the relevance of imputation to corporate dividend settings gathers greater significance given emerging Australian government doubts over the merits of its imputation regime. We examine the ramifications for New Zealand capital markets if developments in Australia lead to the abandonment of imputation there, and potentially in New Zealand.

At the heart of this report is first-hand information from New Zealand corporates and investors about the determinants of corporate dividend policy, and from this, the role, practices, and uses of dividend imputation. This is supplemented by dividend and imputation data sourced and deciphered from the NZX and IRD. Underpinning this study is a wealth of data gathered on corporate policies towards dividend pay-outs.

Of significance is that imputation has played a strong hand in New Zealand's high dividend pay-out culture. Corporates largely believe that fully imputing dividends is their optimal strategy, and in many cases this belief has led to tax induced behaviours.

Imputation is now fully embedded within the corporate and investor dividend psyche, although differences do exist between these two as to the inherent value proposition. Our research has also revealed a raft of other insights about corporate attitudes and behaviours, as well as investor perspectives on such corporate actions.

On behalf of EY, I express our gratitude and thanks to the companies and individuals who gave many hours of their time to make this report possible. I also want to acknowledge the members of the EY team whose hard work, keen interest, and dedication to this research was invaluable.

I hope that you find this report valuable and stimulating.



**Andy Archer**  
Partner, International Tax



## Executive summary

**New Zealand is one of only a few countries that use a dividend imputation regime. Imputation has become an integral part of determining how corporates deliver returns to shareholders and appears to largely underpin this country's relatively high rate of dividend pay-outs.**

Currently, Australia is reconsidering its own imputation system, and this raises questions around what effect, if any, this could have on New Zealand.

Introduced in 1988, New Zealand's imputation regime removes double taxation on distributions by attributing to shareholders a credit for the tax borne on profits at the company level. Benefits include a single layer of tax, a reduced cost of capital for local businesses and their investors, and a relatively high amount of domestic corporate tax for the government.

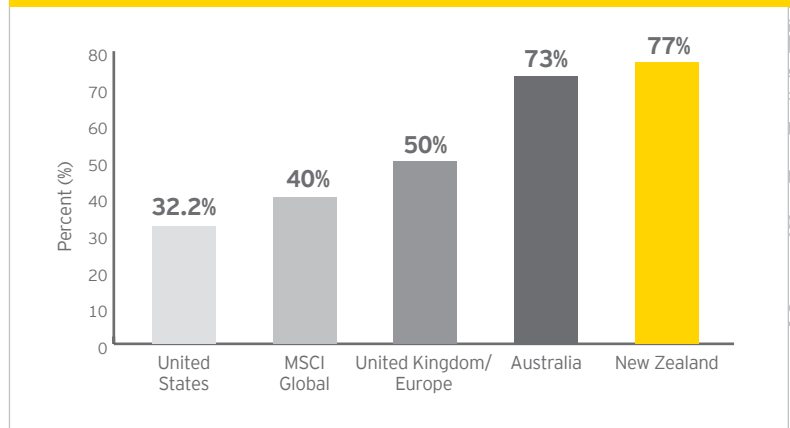
Given the apparent significance of imputation in New Zealand, there have been surprisingly few studies examining how it affects corporate and investor behaviours. The current report aims to fill this gap through speaking directly with both sides of the marketplace who work with the system.

## New Zealand corporate dividend policies

New Zealand experiences some of the highest corporate distributions in the world at a 2014 average of 77% of post-tax company income. This compares with an estimated global average of around 40%. Australia, our imputing neighbour, also has a comparatively high pay-out ratio of around 73%.

The research uncovered a number of drivers for New Zealand's uncommon dividend practice. Primary considerations reported by corporates were some form of capital management, and the need to meet pay-out targets. Credit rating considerations and cash flow management were the other two most commonly discussed dividend policy drivers. While just over half spoken to mentioned tax efficiency, imputation itself was not overtly listed as a key driver. However, responses indicate that it is strongly in the background of corporate thinking.

Comparison of international corporate pay-outs for 2014



This country's high pay-out culture goes hand in hand with a significant proportion of corporates prioritising high profit pay-outs over growth agendas. Providing shareholders with strong cash returns is the single most pressing objective for New Zealand corporates. Fourteen of the 25 corporates participating in the study noted their stocks were wholly or primarily yield oriented, with a further seven saying yield came a close second to growth. Just four were wholly growth focussed.

Most of our investor proxies appear comfortable with this approach, noting that post-GFC investors are looking for high returns. Additionally, New Zealand's domestic market is seen as offering limited opportunity for growth, but where opportunities are identified, investors are confident companies are in a position to take advantage of these, given low gearing and the current low cost of raising capital.

That being said, some investors are concerned about the sustainability of high dividend pay-outs, and question the ability of Directors to think longer-term.

When it comes to other distributions, DRPs were most highly regarded, especially by corporates who saw them as an efficient tool for raising capital cheaply. Investors as a group had mixed perceptions; in practice, discounts are often necessary to induce higher uptake rates. Overall, however, in an environment of high ordinary dividends, alternative ways to make shareholder returns are less common.



# Providing shareholders with strong cash returns is the single most pressing objective for New Zealand corporates.

## How imputation affects dividend settings

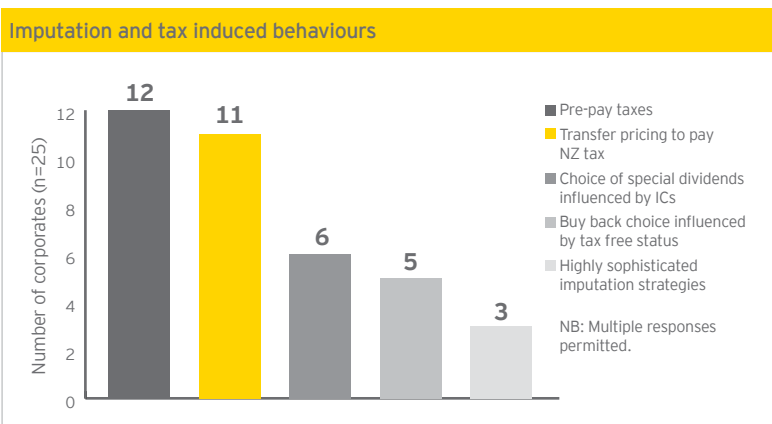
New Zealand's imputation system sits alongside a policy setting of closely aligned individual and company tax rates, and this framework effectively removes most of the tax friction for shareholders on receipt of dividends. This tax neutralising effect supports and perhaps encourages a fundamental mind-set for directors and CFOs, that is, paying out high dividends with attached imputation credits is the optimal pay-out position.

Curiously, the entrenched corporate pay-out psyche and high use of the imputation regime do not seem to be supported by an in-depth understanding of the system's details.

In practice, corporates generally impute at the maximum rate possible. However, less than one third have any meaningful (formalised) approach to imputation within their dividend policies, even though imputation ratio calculations are almost always included with dividend communications.

The research identified a corporate over-estimation of how influential imputation credits are on investor decision-making; investors appear less influenced than corporates believe, with commercial factors holding more sway in their behaviour and advice to investor clients.

Tax and imputation have a significant impact on other corporate distributions, clearly observable through the increasing use of DRPs, which provide a tax-neutral tool for re-investing dividends. Also, some preference for special dividends over tax-free share buy-backs was discernible, again driven by the imputation effect.



## Imputation and tax induced behaviours

In a corporate environment that values imputation highly, a number of strategies are employed to increase the available pool of credits. These include pre-paying tax, transfer pricing to pay New Zealand tax, and the use of alternative return tools such as special dividends and share buy-backs.

Prepaying tax is the most common practice, and ranges from a few companies paying substantial sums in the tens of millions, to the more usual strategy of making smaller, short term prepayments to manage the timing of imputation credits. Investors are generally opposed to the former, considering it irrational.

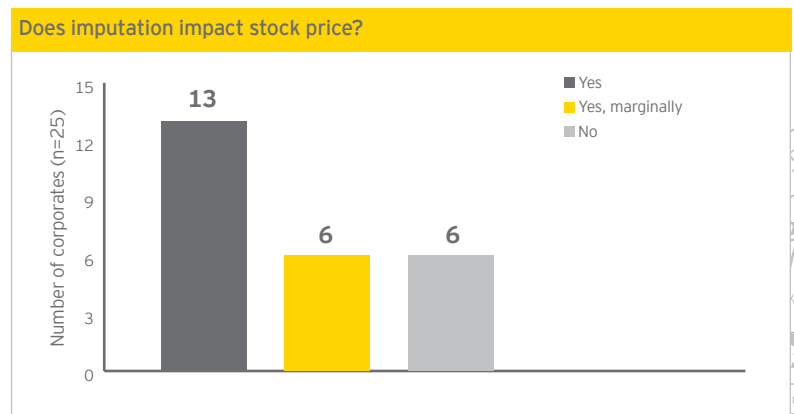
Interestingly, despite the lengths some corporates go to increase their pool of imputation credits, the benefits to shareholders vary enormously, with overseas investors receiving very limited advantage, and many other shareholders receiving no or relatively low advantage only.

## What is the market value for imputation credits?

While there is no market for imputation credits, their value can be considered in two ways: an embedded share price premium, and the ultimate redemption value to shareholders.

Share price value has been researched primarily in Australia, with most research concluding that imputation credits have a value of around 50% - 60% of their face value. New Zealand corporates view imputation credits as highly valuable. Nineteen out of 25 corporates believed that an imputing company would, or should, command a premium to its share price, although most could not quantify what that value impact might be. Conversely, investors attributed very little share price premium to the imputing practice of companies, even though they are clear on the existence of an ultimate redemption value to shareholders.

The ability to redeem imputation credits varies according to shareholder profiles and this contributes to a high proportion of credits effectively being wasted; up to 40% are never, or only partly, utilised. As of 2013, the accumulated New Zealand pool of undistributed imputation credits amounted to almost \$38 billion, with a concentration within closely held companies rather than widely held/listed companies – a logical outcome given our record of high dividend pay-outs.



# Removing New Zealand's imputation regime would likely have significant impacts on our capital markets.

## The winds of change?

There exists overall corporate and investor support for New Zealand's current imputation regime (30 of the 37 participants). Despite this, a number of suggestions for improvements to the system were offered. The two most often cited were trans-Tasman mutual recognition of credits, and domestic refunds of unusable credits.

New Zealand business is cynical about the prospects for mutual recognition given this has been a mirage on the horizon for too many years. Nevertheless, recent modelling now shows that mutual recognition would likely cost much less both in Australia and New Zealand than previously believed. That being the case, this highly supported bi-lateral tax measure merits a renewed effort in the push for change and preferably led by Australian business.

Coming back to the spectre of Australia moving closer to a classical tax system, or other tax system reform, a key factor remains the likely level of any corporate tax rate reduction that would follow. While a reduction to 20% has been mooted by some commentators, in reality it could be as little as a 4% rate cut from 30% to 26%. For New Zealand, any drop in the Australian corporate tax rate would create pressure to follow suit.

Removing New Zealand's imputation regime would likely have significant impacts on our capital markets. Smaller firms depend on domestic equity, but without the availability of imputation credits, local investors may place their money elsewhere. Compounding this effect is the likely reduction in dividend pay-out ratios, further reducing shareholder returns. With fewer local investors, New Zealand businesses could struggle to access capital, and the cost of such capital would likely increase.

The results of our survey lead us to the view that any move towards abolishing our imputation system could result in a radical challenge to accepted equity marketplace behaviour. It could lead to the less efficient allocation of capital. It would tilt the choice between debt and equity, and between onshore and offshore investment in an already thin market.



# 1. Introduction and context

This report aims to fill a gap in the existing literature around imputation regimes.

## 1.1 Research rationale

New Zealand is one of only a few countries that use a dividend imputation regime. This has become an integral part of determining how corporates deliver returns to shareholders and appears to largely underpin this country's relatively high rate of dividend pay-outs.

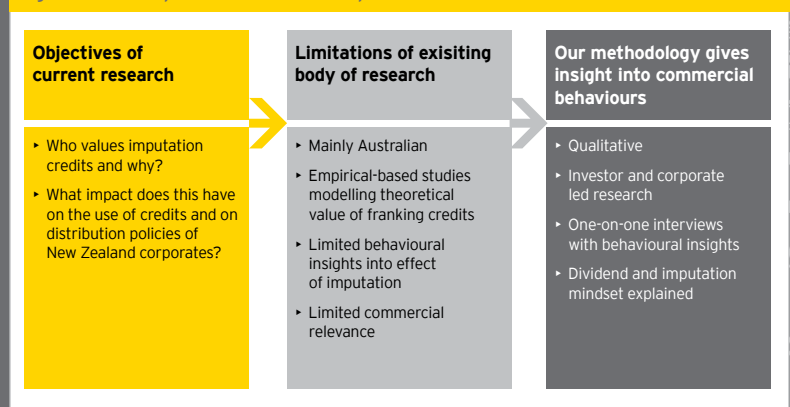
The "value" of tax imputation credits has been the subject of much research and literature, primarily in Australia. Unlike these empirical based studies, which commonly use dividend drop-off share price analysis and/or academic extrapolation, we have undertaken a market-based survey. In this way, the preferences and viewpoints of both corporates and investors have been explored and compared to show what impact imputation is actually having on decision-making and why. Given the sample size and composition, we believe that the findings and analysis are representative of the wider New Zealand marketplace.

Given the apparent significance of imputation in New Zealand, there have been surprisingly few studies examining how it affects corporate and investor behaviour.

The current research seeks to:

- ▶ Review corporate dividend pay-out policies
- ▶ Discover corporates' and investors' views on the New Zealand imputation regime
- ▶ Identify the use of dividend imputation by corporates and investors
- ▶ Compare how corporates and investors value imputation credits
- ▶ Explore how imputation affects corporates' dividend policy settings<sup>1</sup>

Fig. 1.1 EY's imputation research explained



<sup>1</sup> Imputation potentially also affects a wider range of capital structure decisions beyond dividend policy (particularly the choice between debt and equity) and investor decisions and promotes a bias towards New Zealand equities thereby reducing diversification. While we comment on aspects of these, they were not central to our original research.



## 1.2 Regime history in New Zealand

Introduced in 1988, New Zealand's imputation regime replaced a classical tax system that involved the double taxation of company income at a company and shareholder level. The regime removes double taxation on distributions by attributing to shareholders a credit for the tax borne on profits at the company level.

In its simplest terms, a cash dividend of \$100 without imputation credits is worth \$67 to a high tax rate investor (net of taxes). With full imputation, this same \$100 cash dividend is worth \$93 to a high tax rate investor (net of taxes). This is a 39% increase in the post-tax return to an investor and tangibly demonstrates the tax and cash benefits of an imputation regime.

Imputation only occurs when a company pays a dividend and attaches available imputation credits, so that a pre-paid tax receipt is delivered to shareholder investors. (This aspect leads us to start by exploring the dividend policies of New Zealand corporates.)

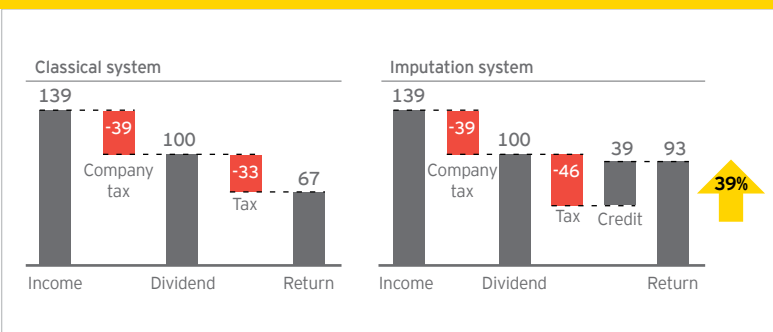
### Benefits to business

Advantages to business of a pure imputation system within the domestic context include:

- ▶ A single layer of tax leading to a neutral treatment of incorporated business (corporate) vs unincorporated business (self-owned/partnership) models. Both labour and capital income is taxed at the marginal tax rates of shareholders. This works best when personal and corporate rates are aligned.
- ▶ A reduced cost of capital for domestically owned businesses, given that single layer of tax.
- ▶ Less impact on company financing and distribution choices than a classical company tax system. A classical system, under which returns on equity are taxed twice but interest on debt taxed only once, favours debt finance over equity. Anecdotally, it was in part responsible for the debt build up prior to the 1987 stock market crash.
- ▶ Each dollar of investment should therefore flow to its most productive pre-tax use – the tax system's influence on business decisions is reduced. In effect, imputation (combined with tax deductible interest) replicates the properties of a tax free world.

More ambiguously, imputation reinforces a home country investment bias. The availability of imputation tax credits on home country tax makes it more attractive for New Zealand businesses to invest at home rather than overseas.

Fig. 1.2: Value of imputation credits to shareholder



# Imputation therefore helps to explain why New Zealand company income tax as a proportion of total tax revenue is higher than in other countries.

## Benefits to the tax system

Imputation also acts as a buttress to company tax, reducing the incentives for domestic companies to engage in tax reduction practices. Conversely, imputation encourages domestic companies to repatriate foreign revenues on a pre-tax basis (by way of transfer pricing) as they will prefer imputable New Zealand tax over unimputable foreign taxes. Both effects bolster New Zealand tax revenues paid.

As we note in Chapter 4 (Imputation and tax induced behaviours), we have evidence that many New Zealand companies advance tax payments and pre-pay taxes to generate imputation credits. Imputation also helps support a higher statutory rate of tax than a classical system, given the availability of imputation credits.

Imputation therefore helps to explain why New Zealand company income tax as a proportion of total tax revenue is higher than in other countries. The Government benefits from:

- ▶ Gross company taxes paid at a higher statutory rate (currently 28%)
- ▶ Additional revenue to the extent that imputation credits are not offset against other forms of taxable income

On this latter point, not all imputation credits are offset. We term the proportion of distributed imputation credits that are actually creditable against shareholder personal taxes as the "utilisation" or "redemption" rate. If imputation completely integrated the company with its shareholders, full utilisation in the domestic context would be the norm. In reality, surplus imputation credits are not refundable, with the effect that many credits are not utilised. Tax exempt shareholders, such as charities, and lower rate taxpayers are likely to have surplus credits. Additionally, non-resident shareholders obtain only limited benefits from attached imputation credits.

Successive tax reviews have examined New Zealand's commitment to imputation, but all reviews concluded that imputation should be retained.<sup>2</sup>

<sup>2</sup> These include Tax Review 2001, the Capital Markets Development Taskforce (2009), and the Victoria University Tax Working Group (2009). EY's Rob McLeod was central to each of these reviews, chairing Tax Review 2001, and the tax sub-committee of the Capital Markets Development Tax Force, and being a member of the Tax Working Group.



### 1.3 Possible Australian government tax reforms amplify this imputation research

This report gathers significant relevance in the light of recent developments across the Tasman with Australian studies raising doubts about the relevance of an imputation regime and questioning its ongoing merits.<sup>3</sup> While many Australian businesses have spoken up in defence of imputation, as yet there is no word on its future.

Although some notable differences exist,<sup>4</sup> the New Zealand and Australian imputation systems are substantially the same. Our study helps to highlight just how well the current system is working. What are the implications for our tax policy if Australia as our largest source of inbound and outbound investment and as a major OECD country moves to abolish its imputation system while simultaneously cutting its company tax rate?<sup>5</sup> It is this question that we discuss in Chapter 6.

### 1.4 Audience and report users

One-on-one interviews with directors and CFOs have provided rich insights into corporate boardroom thinking and attitudes to both dividend policy and dividend imputation. Similarly, speaking with investor representatives has highlighted some opposing thoughts on the value of imputation. Regardless of differences, however, company directors and managers, as well as investor groups, must all balance a diverse range of dynamics:

- ▶ The workings and limitations of the imputation regime
- ▶ The differing values of imputation credits to differently profiled investors
- ▶ The variables of company revenue sources and the corresponding generation of imputation tax credits

The corporate data amassed here will be of direct interest to directors and CFOs as they compare their own policies to similarly sized companies. Contact us directly if you would like more direct analysis and specific benchmarking of your policies.

Investors and investor groups will be interested in how corporates understand their profile, what gaps exist, and the extent to which value is, and is not, being delivered or utilised under the imputation regime.

This report should also provide practical insights of genuine interest for tax policy specialists, revenue authorities, academics, and others.

<sup>3</sup> The *Re:think tax discussion paper*, *Murray Report* and *Henry Tax Review* have each commented that the case for Australia to continue with its imputation system is less clear than in the past.

<sup>4</sup> The more significant differences are that Australia grants refunds for excess unutilised franking credits, whereas New Zealand adopts a credit carry forward to use in future years rule (for companies this is instead a loss conversion mechanism), and also, Australia allows for accumulated but undistributed franking credits to be carried forward despite changes in company shareholdings, unlike New Zealand where changes of more than 34% result in accumulated imputation credits being forfeited.

<sup>5</sup> Refer to 6.3.1 (*Australia is questioning its imputation regime*).



## 2. New Zealand corporate dividend policies

### Need to know

#### Context

- ▶ High dividend pay-out policies dominate the New Zealand corporate market
- ▶ A pay-out ratio in excess of 75% of earnings typifies New Zealand company annual distributions, compared with a global average of around 40%

#### The New Zealand story

- ▶ Corporates have stretched their pay-out ratios in response to investor appetite for more
- ▶ Investor pursuit of increasing yields has seen a capital shift to equity in the current low interest rate environment
- ▶ The majority of New Zealand corporates see themselves as yield plays, but still with growth potential
- ▶ High dividend pay-outs are not yet seen as compromising corporate growth strategies/opportunities
- ▶ But investors have emerging concerns about the sustainability of this high pay-out trend
- ▶ Most NZX listed companies pay imputed dividends

#### Imputation influence

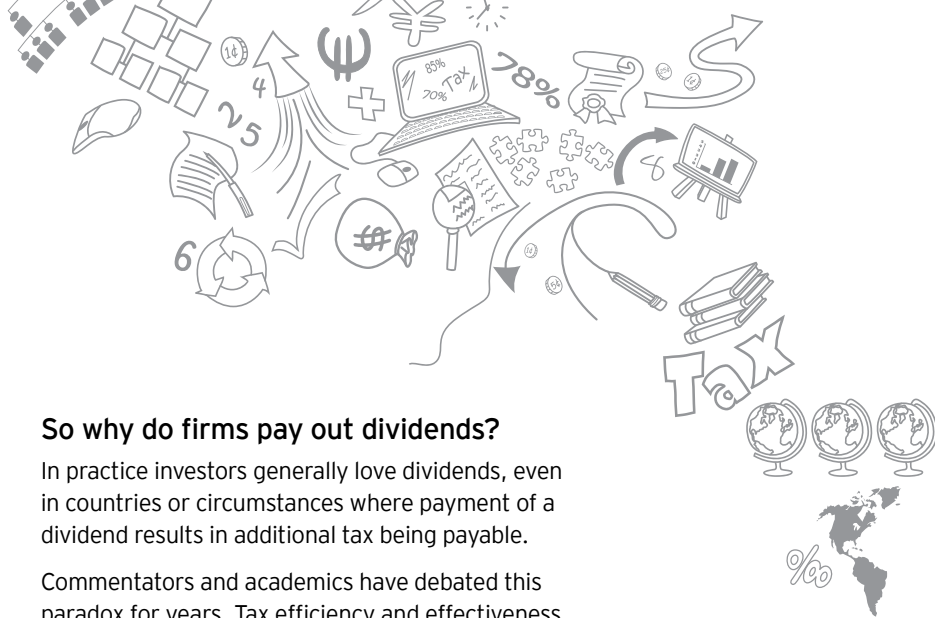
- ▶ In substantially removing the barriers implicit with double taxation, imputation plays a significant role in fostering high dividend pay-outs

#### Other forms of shareholder returns

- ▶ Special dividends are favoured over share buy-backs (with exceptions)

**This chapter sets the scene for understanding dividend policy. We start with corporate finance theories to explain dividend pay-outs; examine international comparisons; look at the New Zealand story with dividend profiles locally; and compare corporate and investor views on the topic. We discuss special dividends, share buy-backs, and other distributions.**





## 2.1 The dividend puzzle: dividend returns or capital gains?

Before tax is taken into account, a dividend should have no value. It should not matter whether an investor holds a share in a company with \$10 in cash, or just the \$10 directly. According to this “irrelevance theory”,<sup>6</sup> value, in the sense of shareholder wealth, is determined solely by the earning power of a firm’s assets, and dividends paid do not affect the value of a firm’s shares.

In theory, a firm’s share price should drop by the amount of dividends it pays. Thus, dividends paid out equate to capital gains lost. Investor value is based on future cash flows. Future cash flows are generated by the assets of the business, and by management competencies to harness growth.

Some commentators<sup>7</sup> view dividends as destroying shareholder value, rather than adding value. By depleting the intrinsic assets of the business, a dividend paying company is inhibiting its positive growth options. Successful growth by the business will value add shareholder wealth, which can be realised on exit. With a dividend lens, reinvestment and business growth should result in growing the future dividend capability of the firm.

Shareholders are investors who supply capital to businesses. As investors, a return on this capital outlay is expected. This return is delivered in various forms, including company pay-outs via dividends and share buy-backs, and also, by disposal gains which realise the shareholders’ increased wealth from company value accretion. These returns are in aggregate commonly referred to as “TSR”.

### So why do firms pay out dividends?

In practice investors generally love dividends, even in countries or circumstances where payment of a dividend results in additional tax being payable.

Commentators and academics have debated this paradox for years. Tax efficiency and effectiveness play an important part, but are secondary to commercial imperatives.

Arguments here include:

- ▶ Investors prefer value now rather than uncertain capital gains in the future (the “bird in the hand” approach)
- ▶ Behavioural economics around “mental accounting”. Selling shares is painful because it eats into capital; dividends, on the other hand, leave capital intact, with investor consumption restricted to the dividend flow
- ▶ For small cap shares, market liquidity can come into play – dividends are easy, whereas selling may involve high transaction costs and be constrained by thin markets
- ▶ The “signalling effect” – dividends demonstrate a company’s positive outlook on future earnings above required investment cash flow<sup>8</sup>
- ▶ Company maturity – where the business is stable and growth is limited, profits can be paid out. This is particularly relevant in the small New Zealand market
- ▶ Re-calibrating the important debt/equity mix to optimise capital and financial management
- ▶ Reducing “agency costs”, where a reduction of a firm’s free-cash flows through dividends will reduce opportunities for suboptimal decision making by managers with excess cash (e.g. management entering into acquisitions of dubious value)

Interesting points, but not the whole story for New Zealand as it ignores the tax factor.<sup>9</sup>

<sup>6</sup> Ascribed to Miller & Modigliani “Dividend Policy, Growth, and the Valuation of Shares”, Journal of Business, 34 (October 1961), pp.441-433.

<sup>7</sup> Refer to, for example, “How Dividends Destroy Value”, <http://www.forbes.com/sites/kenhacker/2010/12/13/how-dividends-can-destroy-value/>, retrieved 5 June 2015. It is argued that an excessive dividend altering the financial structure of a firm removes financial flexibility. That reduces the firm’s ability to create value by being able to generate free cash flow.

<sup>8</sup> The signalling effect of course works two ways: a dividend increase can suggest that the corporate has no growth opportunities, so retention of free cash can be a mark of confidence. This alternative approach was much in vogue during the technology shares bubble in the 1990s/early 2000s.

<sup>9</sup> Refer to Chapter 3 (How imputation affects dividend settings)

# We find it hard to imagine that imputation does not influence Australasia's high pay-out rates.

## 2.2 International comparisons

Nearly all corporate participants distributed at least 50%, and many more than 80% (even up to 110%), of some measure of post-tax income. From our survey of 25 companies, the average pay-out for 2014 was 73% of NPAT (adjusting to 79% if we eliminate two non-dividend paying companies). From NZX 2014 data, the average pay-out of 85 New Zealand companies was 77% of earnings<sup>10</sup>. Therefore, our sample group is closely correlated to the wider NZX data.

Six corporates and two investor representatives expressly identified that New Zealand's imputation system meant that corporate dividends were "efficient" since no material tax barrier exists to impede distributions to investors. In this way, the imputation system facilitates, if not encourages, higher dividend pay-out ratios by eliminating the double taxation of distributed corporate income.<sup>11</sup>

By contrast, the average dividend pay-out ratio for companies within the US S&P 500 was 32% for 2014.<sup>12</sup> US companies continue to aggressively buy-back their shares over larger dividend distributions – from 2012 to 2014, US S&P companies distributed US\$886 billion of dividends, compared to US\$1.36 trillion on buy-backs.<sup>13</sup>

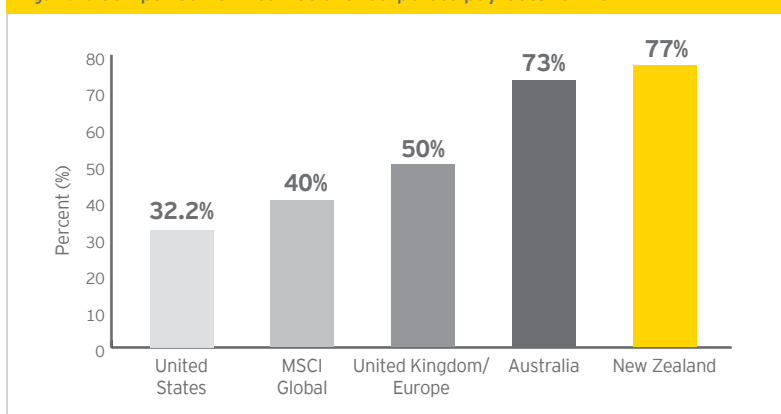
US companies' preference for share buy-backs makes sense considering the top ordinary income tax rate in the US is 39.6% (compared with our top individual tax rate of 33%), whereas long term capital gains tax rates (and qualified dividend rates) in the US are only 20% for taxpayers in the top tax bracket.<sup>14</sup>

For other economies, it is of interest that UK companies have trended an above 50% pay-out ratio, while European shares are closer to 50%. The MSCI<sup>15</sup> World Index shows a global ratio for dividend pay-outs of around 40% for 2014.

However, closer to home, Australian corporates resemble New Zealand corporates, with high dividend pay-outs prevailing. For 2014, the pay-out ratio of Australian companies was second only to New Zealand.

We find it hard to imagine that imputation does not influence Australasia's high pay-out rates.

Fig. 2.1: Comparison of international corporate pay-outs for 2014



<sup>10</sup> NZX data disclosed 110 companies that paid dividends in 2014, of these, 19 were foreign companies and so were excluded from the analysis. A further 6 companies disclosed no EPS data and so were also excluded

<sup>11</sup> Conceptually speaking, a fully imputed dividend is tax free to an investor whose marginal rate of tax is the same as, or less than, the corporate tax rate. Refer to Appendix C (Analysis of imputation tax credit value across different investor classes), where the examples demonstrate this.

<sup>12</sup> Although, the number of companies paying dividends has increased from 370-380 in 2005 to 420 companies in 2014.

<sup>13</sup> First Trust Portfolios – "S&P 500 Stock Dividends are Rising but the Payout Ratio is not"; (November 2014) <http://www.ftportfolios.com/Commentary/MarketCommentary/2014/11/6/sp-500-stock-dividends-are-rising-but-the-payout-ratio-is-not>, accessed 5 June 2015).

<sup>14</sup> Info taken from: <http://www.smbiz.com/sbrl001.html#pis15>; also see [http://www.irs.gov/publications/p550/ch01.html#en\\_US\\_2014\\_publink100010066](http://www.irs.gov/publications/p550/ch01.html#en_US_2014_publink100010066) for discussion on different types of dividends.

<sup>15</sup> MSCI describes itself as an independent provider of research-driven insights and tools for institutional investors, with expertise in the areas of risk and performance measurement that is based on more than 40 years of academic research, real-world experience and collaboration with its clients. The MSCI World Index captures large and mid-cap representation across 23 developed markets. With 1,631 constituents, the index covers approximately 85% of the free float-adjusted market capitalisation in each country.

## 2.3 The New Zealand story

Within this context of conflicting dividend considerations and a high New Zealand pay-out, what do corporates and investors say about setting dividends in this country?

### 2.3.1 Drivers of dividend policy

Corporates were asked to describe in their own words what the main drivers were for their dividend policies. These included both formal (documented) and informal drivers.

Four drivers in particular were mentioned by at least 20 out of the 25 participants. Reference to *capital management* in some form was universal, while the need to meet pay-out targets was also prominent. *Credit rating* considerations and *cash flow management* were the other two most commonly discussed dividend policy drivers.

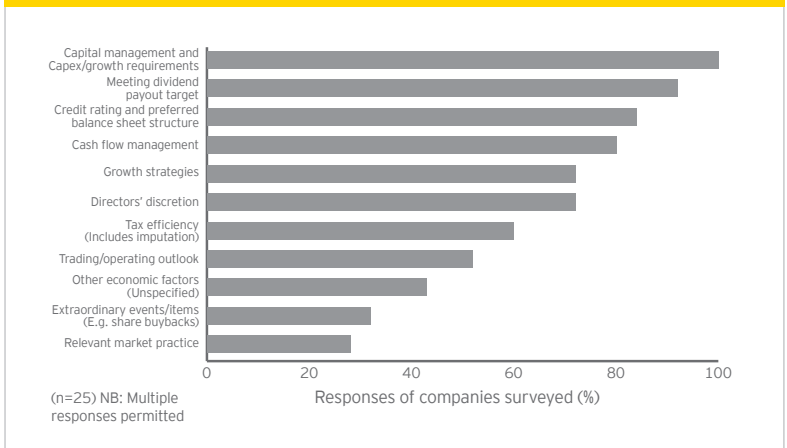
Tax efficiency was frequently mentioned (by 15 corporates), but not as a main driver. In many cases, companies did not refer to imputation directly, but the language used and description of effects suggested that imputation was at least in the background of corporate thinking, if not the foreground. We have combined responses which referred to tax efficiency or imputation in Figure 2.2.

#### Setting formal dividend policies

Corporates we surveyed reported setting their formal dividend policies relatively recently (generally in the last five to ten years), either for the first time or to replace existing policies. Fifteen corporates state that despite having target dividend pay-out ratios explicit in their policies, the percentage (generally of net profits after tax) actually paid out could vary depending on the company's circumstances at a given time.

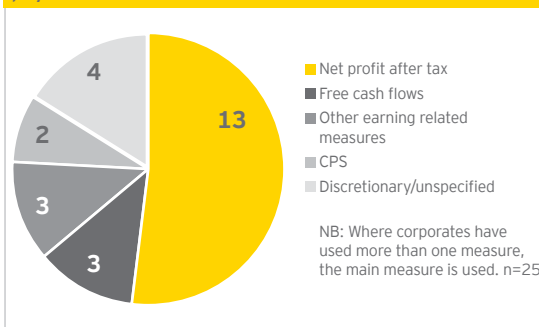
Target pay-out ratios specified by corporates were based on a number of measures, such as a percentage of net earnings, NPAT, adjusted NPAT, and free cash flows. By extrapolating these assorted targets, we estimate the average targeted pay-out ratio as a matter of corporate dividend policy to be approximately 65% of earnings, illustrating how most corporates strive to distribute a high proportion of profits. In fact, our sample of corporates exceeded this with a 2014 pay-out average of 73% with wider NZX data as high as 77%.

Fig. 2.2: Dividend policy drivers



Nearly all companies with policies around pay-out ratios use conventional accounting measures (NPAT or normalised profit etc.) as the basis for the designated dividend percentage. Commonly, this pre-set pay-out ratio is then only affirmed after factoring in (adjusting down) operational and (sometimes) investment capital needs. By contrast, some companies surveyed (notably infrastructure) used "free cash flows" as the reference point to calculate dividend pay-outs so as to factor in re-investment needs of the business.

Fig. 2.3: Measures used in setting dividend pay-out ratios



### 2.3.2 Yield trumps growth

**“Do you know the only thing that gives me pleasure? It’s to see my dividends coming in.”**

**John D Rockefeller**

*John D Rockefeller (1839-1937) was an American businessman and philanthropist notably as co-founder of Standard Oil.*

New Zealand corporates appear to share John D. Rockefeller’s sentiment. Survey responses from both corporates and investors suggest that being able to say “the dividend cheque’s in the post” is a sign of corporate virility. When pushed for a response, most corporates see themselves as primarily yield driven shares, albeit with some growth potential.

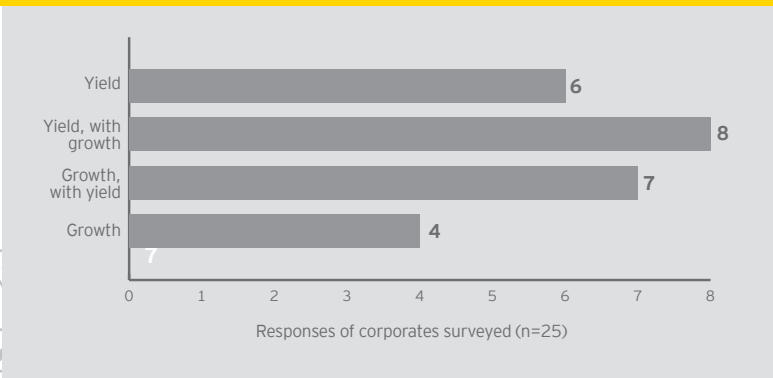
Well over half of corporates (14 of 25) reported being wholly or primarily yield focussed, while a further seven considered yield a close second to growth. A small minority regard themselves as actively growth focussed over providing yield to investors.

Of interest here is that companies that were not widely held listed companies demonstrated strong growth by expansion and acquisition under a clearly stipulated 50% pay-out/50% growth pursuit strategy. Even at 50%, this pay-out ratio is competitive internationally. Therefore, we find that overseas investors see this investment here as a yield play, valuable in attracting scarce international capital.

#### **Corporates report increasing pressure from investors to deliver high cash returns**

Companies with high yield shares, rather than growth shares, seem more attractive to investors. In fact, in the course of this survey, two companies specifically raised their pay-out as a direct response to investor sentiment. Stretching dividend pay-out has been a factor of post-GFC reliable earnings base, and stronger balance sheets. For the most part, the dividend policies adopted by corporates require that directors apply themselves to the company’s capital requirements, although in this regard many referred either to operating capital alone, or to operating capital ahead of investment capital. Twelve of the corporates surveyed referred to being positioned well for investments (should they arise) by virtue of having conservative balance sheets and debt raising headroom.

**Fig. 2.4: Do companies regard themselves as yield or growth shares?**



# This picture is in stark contrast to the USA, where unlimited reinvestment opportunities epitomise the market place psyche there.

### 2.3.3 Investor attitudes

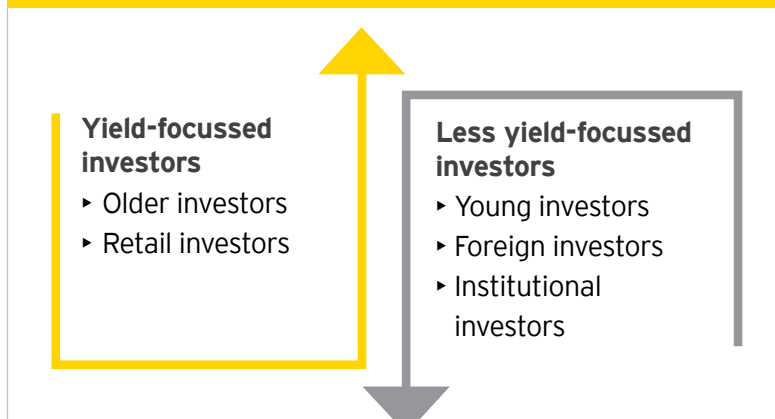
Investor proxies provided viewpoints on a range of marketplace behaviours which underlie the prevalence for high corporate pay-outs in New Zealand.

#### What are investors looking for?

Not surprisingly, nine out of the twelve investor proxies surveyed believe that the high pay-out ratios of New Zealand corporates are strongly driven by investor appetite for dividends. To some extent, this demand reflected a post-GFC flight of capital from what was a high interest rate environment, to equities with stretching yields.<sup>16</sup> New Zealand equities with high yields are also attractive to international investors searching for a stable earnings story. Investors were also quick to identify that with imputation, shareholders did not cop a hefty tax bill with dividend pay-outs. The inhibiting tax barrier that exists elsewhere (e.g. the USA) is not the same impediment in New Zealand.

The current global trend favours yield, with local retail investors showing particular interest in shares with high yield plus imputation credits. Institutions were reported as having a stronger emphasis on TSR, with both components of dividend pay-out and share price growth factoring.

Fig. 2.5: Investor patterns and appetite



#### Investors highlight lack of growth opportunities in domestic market

Investors highlighted the lack of growth opportunities in the domestic market as a closely related factor underpinning high dividend pay-outs. By its size alone (4.6 million population), New Zealand is a comparatively small market place, where many companies have attained full potential and maturity. Growth for many therefore means offshore expansion, which carries risk - the failure of investments abroad by a number of New Zealand corporates, albeit somewhat dated, still resonated with investors who maintain high benchmarks for trust in corporate managers.

Investors believed that the dividend component of TSR was heightened in New Zealand given a marketplace that lacks growth opportunities.

This picture is in stark contrast to the USA, where unlimited reinvestment opportunities epitomise the market place psyche there.

<sup>16</sup> "Dividend paying companies gained as investors hunt for yield in a globally low interest rate environment". Reported in the New Zealand Herald Business (Markets), Wednesday, 17th June 2015

## Investors do not believe high dividend pay-outs currently compromise growth

Investors implicitly challenge aspects of corporate policies. Investors tend to weigh factors such as consistency and sustainability of pay-out ratios more highly than large pay-outs.

Investors were asked whether they believed the prevalence of high dividend pay-outs compromised corporate pursuit of investment opportunities and growth. All investor proxies believed not.<sup>17</sup>

Reasons expressed here included:

- ▶ Lack of growth opportunities exist (generally)
- ▶ Post-GFC balance sheets are stronger and de-gearred. Therefore, companies are growth ready, even with high pay-outs
- ▶ A high proportion of NZX-listed companies by market capitalization are in the utilities sector, which by its nature is comprised of businesses with high pay-out ratios. In general, the NZX is also skewed towards defensive shares, with the New Zealand economy as a whole misrepresented in terms of the listed shares on the NZX
- ▶ Access to capital (debt and equity) is easier and historically less costly, and therefore cash stockpiling is unnecessary

Investors did not mention lower entrepreneurship and lower research and innovation as issues for New Zealand businesses that rewarded their shareholders with high profit distribution.

In a New Zealand-centric approach to the “dividend puzzle”, the reality with NZX companies post-GFC is that they have, in the main, provided strong total returns to investors. High dividend returns, combined with a rise in the bourse reflecting accreting capital gains, has been somewhat of a NZX story, and this phenomena does not bear out the dividend/value irrelevance theory.<sup>18</sup>

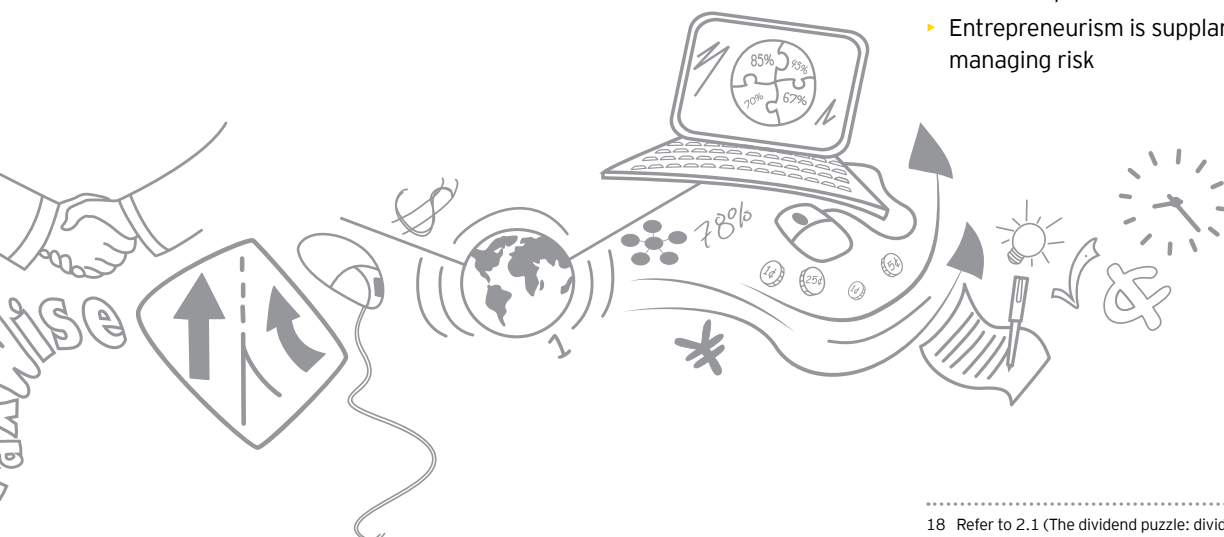
But investor proxies are keen to have things both ways. They held concerns with the sustainability of pay-outs, noting that once set, investors' dividend expectations would be difficult to peg back, and also, some believe that corporates are too focused on maintaining dividends at the expense of long term gain.

## Investor attitudes to directors varies

Investor attitudes to directors, and directors' approaches to managing dividend policy and imputation vary. Six investor groups rated directors as good-to-strong. One believed directors should have a good grasp of the issues.

Five investor groups rated directors as fair-to-poor. These five said that directors' weaknesses include:

- ▶ Not enough real thought and attention to real dividend drivers (especially in the property sector)
- ▶ Not enough skilled rigour in capital and financial management
- ▶ Overly focussed on dividend pay-out
- ▶ Short-term thinking leading to unsustainable dividend pay-outs
- ▶ Insufficient focus on free cash flow, which in cases could extend the level of pay-out, and beyond the level of imputation credits<sup>19</sup>
- ▶ Entrepreneurism is supplanted by a focus on managing risk



<sup>17</sup> Investors felt the property sector an exception, with high pay-outs unsustainable.

<sup>18</sup> Refer to 2.1 (The dividend puzzle: dividend returns or capital gains?)

<sup>19</sup> This observation is interesting since contrary to other comments, it suggests more, rather than less, dividend pay-out, and also suggests that corporate pay-outs are unnecessarily limited by the level of imputation credits.



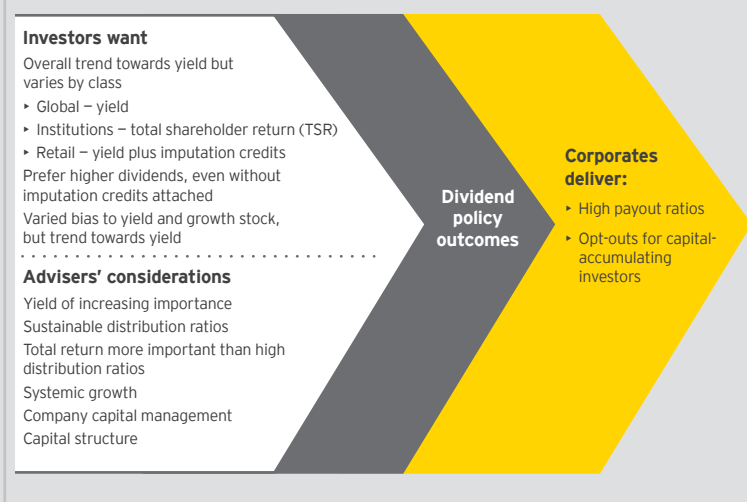
# Investors favour yield, consistency, and sustainability.

## Investors and their advisers influence outcomes

Our view is that investor sentiment materially changes corporate dividend policy. As noted earlier, in the course of this survey, two companies specifically raised their dividend pay-out as a direct response to shareholder sentiment.

Investors favour yield, consistency, and sustainability. They tend to be risk averse, noting stronger post-GFC balance sheets and not favouring the build-up of reserves for offshore expansion. Some investors have greater need for cash than others, leading to opt-outs such as DRPs for more accumulative investors. The overall investor approach chimes well with the collective corporate drivers around meeting targets and maintaining strong balance sheets but opens up some debate on the extent to which corporates focus on cash flow management and growth aspirations.

Fig. 2.6: Channels through which investors and their advisers influence dividend policy



## 2.4 Special dividends, buy-backs, DRPs, and bonus issues

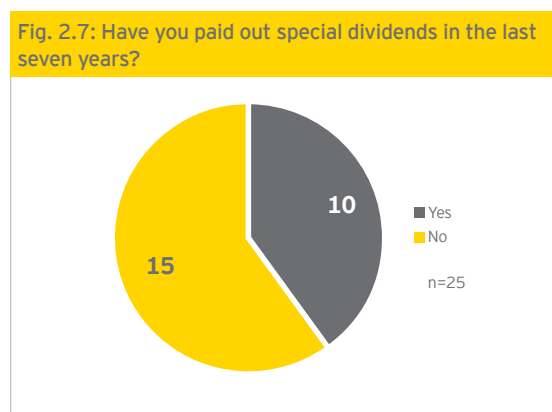
Special dividends, capital return buy-backs, DRPs, and bonus issues all represent common capital and investor management tools. Our research revealed that tax and imputation plays a strong hand in the incidence of these alternate distributions.

A common theme among corporate and investor attitudes to these distribution methods were concerns over the possibility that a negative signalling effect might ensue – in particular, that using these methods would signal that the Board and managers were unable to find any re-investment growth opportunities. Eight companies also felt that share buy-backs and DRPs involved greater complexity, and needed to be explained carefully to shareholders.

New Zealand corporates had differing experiences with these distribution tools, with the majority driven and rationalised by the particular circumstances for the company at the time. In most cases, improving corporate capital management was a common driver.

### 2.4.1 Special dividends

Less than half of corporate respondents reported paying a special dividend in the preceding seven-year period.



A significant factor affecting the need for special dividends was that corporate cash reserves were regularly being depleted by high ordinary dividend pay-outs. In consequence, the lack of excess cash build up obviates any calling for a special dividend.

That said, these were common drivers reported by corporates for special dividends:

- ▶ To manage the build-up of surplus cash reserves where historic dividends were low
- ▶ Preferred over any increase in ordinary dividends to manage elevating investor expectations
- ▶ As a one-off, to distribute disposal cash gains (over and above cash needed for re-investment and debt reduction)
- ▶ As a capital management exercise to re-gear the balance sheet
- ▶ To “wash out” surplus imputation credits, notably where imputation ratio changes have occurred (by reason of corporate tax rate reductions,<sup>20</sup> and also because of individual rate changes)
- ▶ As a pre-ownership change measure to “wash out” imputation credits that would be forfeited,<sup>21</sup> and to depress the enterprise value and buy price

**Fig. 2.8: Reasons for paying special dividends**



<sup>20</sup> After a long period of stability, the company tax rate dropped from 33 cents in the dollar for income years 2008 and earlier to 30 cents in the dollar for income years 2009 to 2011 and to 28 cents in the dollar for income years 2012 and later.

<sup>21</sup> New Zealand's imputation regime limits the carry forward of company imputation credits by requiring continuous ownership of the company by the same 66% group of shareholders as owned the company when the imputation credits first arose.

## 2.4.2 Share buy-backs and capital returns

Of our corporate sample, twelve had undertaken a share buy-back within the last seven years, although of this group, five did not feature any material distributions, but were for purposes of tidying the share register or to give effect to executive share schemes.

Fig. 2.9: Have you made any share buy-backs in the last seven years?

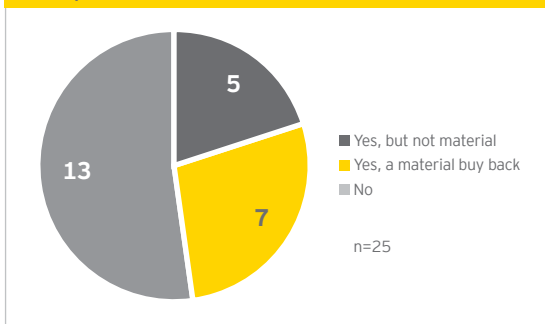


Fig 2.10: Reasons for making share buy-backs



The reasons advanced for buy-backs from those companies that had undertaken this form of distribution were:

- ▶ To exit shareholders from the share registry (typically a parting of the ways)
- ▶ To bolster the share price with on-market buy-backs, given a view that the market pricing undervalued the company against its NTA backing
- ▶ As a capital management exercise to re-gear the balance sheet
- ▶ To give effect to executive share schemes
- ▶ To provide “currency” for shareholders where the market is thin or companies are unlisted, allowing shareholders to realise their investments (within treasury stock parameters)<sup>22</sup>
- ▶ To make distributions tax free to shareholders (for companies with and without imputation credits)<sup>23</sup>

Investor proxies felt that New Zealand investors place lesser value on company distributions by way of share buy-backs than they do on dividends, as did one of our corporate sample.

Reasons provided by investor proxies for this include:

- ▶ Buy-backs are seen as more transitional and not very popular
- ▶ Dividends are preferred because they are regular and liquid, whereas buy-backs are illiquid and their value depends on uncertain future capital gains
- ▶ Dividends are considered regular cash returns, and less risky than longer-term investments and capital gains
- ▶ The signalling value of dividends is considered more important, because buy-backs provide less information as they are one-off and are not capitalised into share price
- ▶ Buy-backs require directors to take on a lot of potential liability

<sup>22</sup> Under section 67A of the Companies Act 1993 companies can, subject to certain restrictions, purchase or acquire their own shares from their shareholders. Thus, they can effectively hold shares in themselves, provided the number of shares held at any time does not exceed 5% of the shares of that class previously issued by the company. Shares held in this way are called treasury stock. The constitution of the company must expressly permit the company to hold its own shares. These shares are specifically not cancelled when re-purchased, and are available for re-issue.

<sup>23</sup> Refer to 3.5 (The impact of imputation on other corporate distributions).

### 2.4.3 Special dividends versus share buy-backs

When considering one-off distributions, corporates have two options: special dividends or share buy-backs. Corporates overall favoured special dividends over comparable share buy-backs by a small margin - of the 19 corporates that responded to this question, 11 preferred special dividends and eight preferred buy-backs.<sup>24</sup>

Simplicity and ease were cited as the main reasons for choosing special dividends over more complex buy-backs. Five company directors and managers expressed a preference for buy-backs, mainly as a price driver, but accepted stronger investor sentiment in favour of special dividends.

Investors too prefer special dividends over share buy-backs, and harboured some doubts about the corporate rationale for some buy-backs.

The tax influence drew mixed responses. Six companies specifically alluded to share buy-backs as delivering better tax results for investors. Three felt that without a stock of imputation credits they would consider share buy-backs.<sup>25</sup>

### 2.4.4 Dividend re-investment plans (DRPs)

DRPs are generally regarded as an efficient tool to raise capital with low transaction costs. Around half of companies surveyed had DRPs, which reflects the relative prevalence of this tool, although a number were suspended because of changing corporate circumstances. The proportion of companies in our survey deploying DRPs is higher than the one-third of all NZX-listed companies which deployed a DRP.

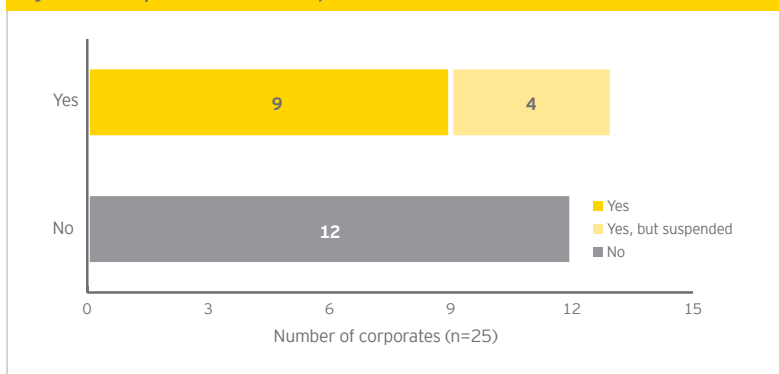
There is a discernible tax influence with DRPs, with the imputation system playing a large role in the high company interest in using them.

#### Corporate rationales for establishing DRPs

When asked what rationale existed behind establishing a DRP, the main reasons given were:

- ▶ As a cash savings, liquidity measure
- ▶ To build the balance sheet by accumulating share capital
- ▶ As an investor relations tool, to cater for loyal, and growth-focussed investors

Fig. 2.11: Do you have a DRP in place?



<sup>24</sup> If we eliminate the share buy-backs that did not involve material distributions (e.g. to facilitate executive shares, low share parcels, and shareholder exits), we are left with 7 companies in the sample that utilised a share buy-back to make a distribution to shareholders.

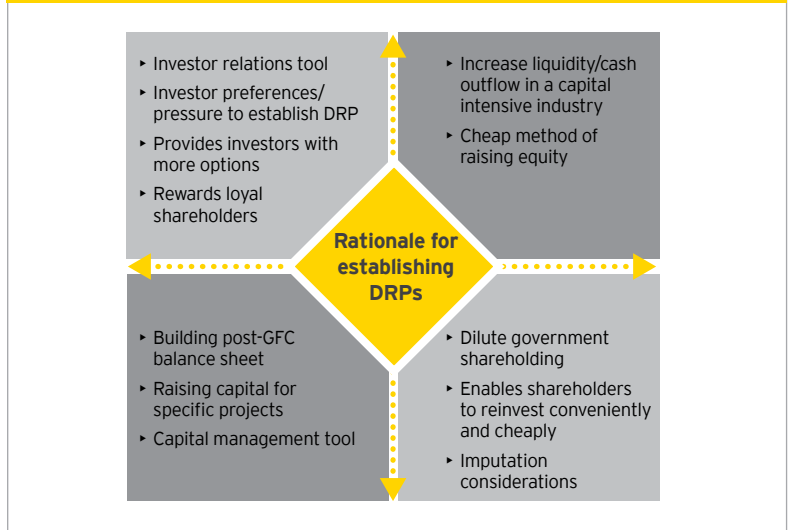
<sup>25</sup> Responses on this lacked full knowledge on the tax rules that permit buy-backs to be tax free. See further on this at 3.5 (The impact of imputation on other corporate distributions.)

We examine the stated rationale further:

- ▶ The liquidity rationale is interesting, since investors readily identified reduced headline dividend pay-outs as alternatives to DRPs. Clearly, directors felt that maintaining a robust dividend ratio was price positive. Less obviously, companies with offshore earnings can face impediments in accessing dividends so may prefer additional equity (because of dividend trap reasons, tax barriers, forex etc.). With dividend pay-out ratios based on consolidated profits, these circumstantial impediments are not obvious.
- ▶ On the balance sheet build point, investors responded that the cheapest form of equity is retained earnings (i.e. profit retention) with no discount required.<sup>26</sup> Some queried the logic of raising capital to pay a dividend.
- ▶ The investor relations tool is multi-rationalised. Some corporates reasoned that with high dividend pay-outs prevailing, a DRP enabled them to cater to those investors who preferred capital growth rather than yield. Some companies alluded to DRPs as a means to reward loyal shareholders who want to invest more.

Five companies were restricted from utilising DRPs because of the dilution effect on controlling shareholders. Unusually, one company deployed its treasury stock to buy-back shares issued under its DRP as an annual exercise.

Fig. 2.12: The broader reasons advanced for using a DRP (and in many cases multi-reasons) are represented below



### Investors have mixed views on the merits of DRPs

Nine of our investor sample consider that DRPs can be efficient and effective. DRPs are viewed as bridging the tension between a high pay-out policy for investors, and the cash needs of the company. To the “investor in the street”, DRPs are favoured for reasons that they cut out the broker (transaction savings), and frequently provide a better price entry to more shares. On this latter point, a discounted DRP is a “sweetener” given to shareholders by the company, and this represents a de facto dividend in itself (albeit at the expense of non-participating shareholders).

<sup>26</sup> This ability to use retained earnings as a cheap, less visible, source of finance is consistent with our experience in practice. It does, however, provoke some tension with traditional finance theory regarding the relative cost of equity compared to higher-ranked debt.

However, investor proxies generally harbour suspicions if: DRPs are misused to prop-up declared dividend rates; or DRPs are highly subscribed.

This is because DRPs used in these circumstances signify the offering as too heavily discounted, and have a dilution effect. Five investors also viewed DRPs as “back-door equity” or “capital raising by subterfuge”, but not wrong in and of themselves. Indeed, three investor groups acknowledged their self-interest here in their willingness to participate in discounted DRP offers.

### Discounts drive DRP take-up rates

From corporate feedback, DRP discounts were primarily used to kick-start new DRPs and achieve higher take-up levels. Take-up levels always vary, and the percentage identified from corporates surveyed ranged between 15% and 50%. Without a discount, the average take-up was 15%. With discounts, take-up varied from 20% to 50%.

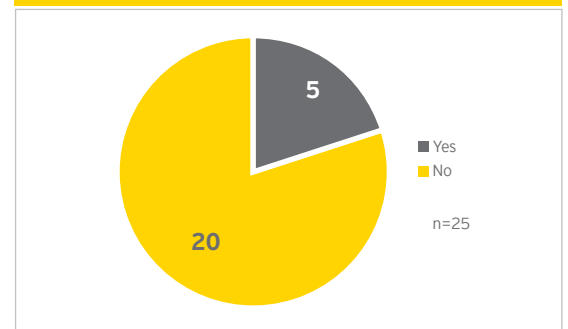
Fig. 2.13: Corporate feedback on level of discount and DRP take-up rate

Discount	Take-up
0%	15%
1.5%	20%
2%	37%
2.5%	10% to 50%
3%	43%

### 2.4.5 Bonus issues

The incidence of bonus issues by New Zealand corporates sampled was rare, with only five out of twenty five corporates reporting the use of this strategy.

Fig. 2.14: Have you undertaken a bonus issue in the last seven years?



Of those corporates that undertook a bonus issue, no dominant reason was advanced, however the following explanations were offered:<sup>27</sup>

- ▶ To distribute imputation credits out to shareholders
- ▶ To promote increased share liquidity, without requiring payments from shareholders
- ▶ Using bonus issues as part of a profit distribution plan (using permissive tax measures in place at the time<sup>28</sup>)
- ▶ Wanting to keep share prices static

Comparatively speaking, a taxable bonus issue (fully imputed), equates with a DRP. The bonus issue is a cash-free delivery of more shares to shareholders at a low/no tax cost,<sup>29</sup> with the shares being “paid for” out of company reserves. Bonus issues, like DRPs, preserve the cash reserves of the company since in both situations the company’s earnings are capitalised to share capital, rather than paid out. Both can be fully imputed. The tax consequences to investors are the same.

Yet, bonus issues are rarely undertaken, unlike DRPs.

<sup>27</sup> Refer to 3.5 (The impact of imputation on other corporate distributions).

<sup>28</sup> Law changes in 2009 shut down this form of corporate distribution.

<sup>29</sup> A “taxable” bonus issue is at the election of the company and is categorized as a dividend, as also are bonus issues in lieu of dividends. As such, the company can attach imputation credits to these bonus issues.



**Investor attitudes to directors and their approaches to managing dividend policy and imputation vary. Half of our sample believed directors to be rated as good to strong, with many saying approaches had improved of late.**



## 2.5 Summary

2.5.1 By international comparisons, New Zealand corporates pay-out more profits as dividends than any other country with an average close to 77%. Australia is a near second at around 73%. UK & European stocks pay-out a materially lower 50% (approximately), and, at a distant low, in the USA, a mere 32% dividend pay-out ratio exists. As will be evident later in this report, imputation plays a material role in these contrasting markets.

2.5.2 The primary determinations of dividend policy are: capital management; pay-out targets; balance sheet structure; performance; and cash flow management. Tax is consciously factored into dividend considerations by a (small) majority of corporates, but is not a driver.

2.5.3 Over one half of New Zealand corporates see themselves as a primarily yield driven stocks, albeit the majority of this group declare themselves as maintaining a growth agenda. Exceptions do naturally exist. Two factors are at play here. Corporates report that in a low interest rate post-GFC environment, investors are pressuring them to stretch their pay-out returns. Secondly, the opportunities for corporate growth are limited in a small 4.6 million person economy, with offshore investment a very bold step for many. Interestingly, investor groups do not see such high profit pay-outs as (currently) compromising opportunities for investment growth, with balance sheets ready for growth, and access to capital easier and cheaper.

2.5.4 That said, investors still harbour concerns about the sustainability of high dividend pay-outs, noting that once set, it will be difficult to peg back distributions.

2.5.5 Investor attitudes to directors and their approaches to managing dividend policy and imputation vary. Half of our sample believed directors to be rated as good to strong, with many saying approaches had improved of late. Five investors rated directors as fair to poor, with weaknesses including insufficient rigor in capital and financial management, overly focussed on dividend pay-out, and short term thinking.

2.5.6 With respect to other distributions – special dividends, buy-backs, DRPs, and bonus issues - a common theme amongst companies and investor groups is concerns with possible negative signalling that might ensue. With a high amount of ordinary dividend pay-outs, the need for special dividends or buy-backs diminishes. However, balance sheet re-structuring was a common rationale for undertaking a one off distribution. A slight favouring of special dividends over buy-backs was identified between these substitutable return methods.

2.5.7 DRPs were in play for 13 of our 25 sample companies, with most identifying this as a useful investor relations tool that assists corporate liquidity. Not unsurprisingly, our sample showed that shareholder take-up increased markedly with the discount offered. Investors note the implicit de facto dividend to the extent of the discount offered, albeit some were suspicious of companies offering sizeable discounts.

# 3. How imputation affects dividend settings

## Need to know

### Effects on pay-outs

- ▶ Corporates regard imputation as highly important, with fully imputed distributions as the optimal dividend position
- ▶ Even so, the more important goal is driving higher cash returns, with or without imputation
- ▶ Investors, along with corporates, are very focused on the cash cheque, but with mixed appreciation that if the dividend is partially imputed or unimputed this translates to less cash
- ▶ Corporates generally adhere to the view that imputation is good for all investors, despite disparities in value to differing investors
- ▶ Investors appear to not rate imputation as highly as corporates, with commercial factors dominating

### Effects on share price

- ▶ Corporates believe that imputing dividend shares should rationally command a premium to unimputed shares
- ▶ Investors believe that imputation has only a marginal impact on share price, at best, and therefore they get a "free-ride" with the inherent value delivered
- ▶ Australian research shows imputation does, in fact, influence share price



**The majority of corporates surveyed regard imputation as highly important. Now, we take a closer look at the effects imputation has on both corporate behaviour and investor response. Further, we explore the ways in which this regime impacts on share price, and other distributions.**

### 3.1 The imputation influence – feeding the dividend psyche

Imputation is rightly perceived as tax efficient. It comes close to replicating a tax free marketplace, neither encouraging nor discouraging distributions. It works best for companies with domestic business and earnings (that generate New Zealand tax), but does not work well for international operations (where the tax is foreign). In some sense, it could be said that the imputation system inhibits foreign expansion.

However, the overall result of New Zealand's imputation system combined with a policy setting of closely aligned, low rates of tax across individuals and companies, means that there is only a low, or no, tax friction to companies paying dividends to shareholders. This represents a fundamental mind-set for directors and CFOs, and so underpins a developed mantra that imputation is a good thing, and that imputed dividends can be paid in spades.

Companies and investor groups surveyed had a reasonable understanding of the effects of imputing dividends to shareholders, but understandably lacked a more detailed analysis of the variables within the system. The impression conveyed by a large number of companies and investors is that on a per se basis, imputation is an embedded practice and director mind-set. Perhaps underestimated is that imputation has played a significant role in influencing New Zealand dividend policy, and has lubricated the corporate and investor obsession with dividends. In short, just as a high dividend tax rate depresses dividend pay-out and a classical system of double taxation is an impediment to distributions, the converse applies in New Zealand where imputation, and the amelioration of investor tax, elevates dividend pay-out<sup>30</sup>.

The allure of a full imputation policy is secondary to the fundamental objective by corporates of providing investors with an attractive cash yield. However, to the extent that a dividend is only partially imputed, or unimputed, the cash deliverable reduces since an automatic tax take out occurs in the form of RWT. This point was not fully appreciated by corporates or investors, and yet again underpins how imputation is under-estimated.

### 3.2 How corporates view imputation in their dividend settings

**"Your premium brand had better be delivering something special, or it's not going to get the business."**

**Warren Buffett**

*Warren Buffett is an American business magnate, investor, and philanthropist. He is widely considered the most successful investor of the 20th century.*

Corporates consider imputed dividends much more desirable for shareholders than unimputed dividends, with the result that investors in New Zealand companies typically receive imputed dividends. In Warren Buffett's terms, imputed dividends are "something special". Our interpretation of NZX data shows that 83% of dividends paid in NZD from NZX-listed companies were imputed dividends, of which 63% were fully imputed. Prior to the GFC, nearly 83% were fully imputed.

<sup>30</sup> This was the conclusion of Australian research, that the introduction of imputation raises dividend pay-outs, see Pattenden & Twite (2007)

### 3.2.1 Corporate support for imputed dividends

New Zealand directors have been described as wedded to imputation,<sup>31</sup> and this is a pretty fair generalisation.

This corporate attitude and preference was espoused most strongly by closely held companies, and those where a share register was dominated by a few private sector investors. Shareholder directors with a vested interest in the dividend pay-out strongly supported a fully imputed dividend policy, and valued imputation credits highly.<sup>32</sup>

In the main, corporates identified that fully imputing dividends was an optimal approach, and failing this, would maximise tax efficiency by allocating whatever tax credits were available via a partially imputed dividend. Of some importance here is that a company's share of imputation credits is not free from risk of forfeiture. Our imputation rules reflect a policy perspective that company taxes that drive imputation credits belong to the current crop of shareholders. So, when changes in shareholding occur,<sup>33</sup> the accumulated bank of imputation credits is lost. On this basis, companies can de-risk their position by regularly distributing imputation credits.

### 3.2.2 Corporates seek to provide an attractive cash yield

The allure of a full imputation policy is secondary to corporates' fundamental objective of providing investors with an attractive cash yield. Providing shareholders with cash returns is the predominant objective for corporates<sup>34</sup>, and imputation follows this as "the tail on the dog", albeit a long tail.

If there is a shortfall of imputation credits or no credits at all, corporates will adhere to their primary goal and pay dividends, while maximising what credits do exist with a partially imputed dividend. This reinforces the attitude that imputation credits have value, and that imputation is optimal even if there are insufficient credits for full imputation.

Four corporates do not consider imputation highly important. These companies mostly have:

- ▶ Significant offshore earnings, with limited ability to generate credits  
Or
- ▶ Dominant growth agendas, with reinvestment needs and/or high gearing

They generate few imputation credits, and (understandably) prefer returns to shareholders via value appreciation and capital gains.

### 3.2.3 Imputation in dividend policies

Corporate signalling of approaches to imputation was somewhat mixed across the range of formal dividend policies. While the majority of companies viewed imputation as a highly important factor, only eight of the corporates surveyed explicitly refer to imputation in their formal dividend policies. Most references generically stated an intention to fully impute where possible, but none attempted any clearer statement about the balance of imputation credits available, for example, being able to fully impute the next three years' dividends. Conversely, upon making dividend pay-outs, nearly all companies make reference to the imputation credits attached as part of a normal shareholder communication policy. A minority of companies and analysts leveraged this communication to explain their pay-out with imputation credits in higher numerical gross terms.<sup>35</sup>

The example here demonstrates this "leveraging":

- ▶ Net cash dividend – 7.2 cps
- ▶ Imputation credits attached – 2.8 cps
- ▶ Gross dividend – 10.0 cps

Of interest here is that this "leveraged" reporting shows that the imputation credit is valued, and this adopts a simplified 100% of its face value, despite the fact that different investor groups will value the tax credit differently.<sup>36</sup>

Given stated representations by corporates that imputation is "highly important", why do more corporates not articulate their imputation approach within their dividend policies? Similarly, is there a case for more common dividend reporting on a "gross of imputation" value as above?

<sup>31</sup> Refer to "Dividend policies under scrutiny", Gaynor, B (New Zealand Herald, 23 July 2004) which uses pay-out ratios of leading NZX-listed companies to argue that directors are "reluctant to pay a dividend when no imputation credits are available". While that may be an extreme interpretation, the point is well made.

<sup>32</sup> On this refer to Chapter 5 (*What is the market value for imputation credits?*)

<sup>33</sup> To carry forward un-distributed imputation credits, a company must retain continuous shareholding ownership by the same persons as to 66%.

<sup>34</sup> That is for dividend paying companies, not for solely growth companies.

<sup>35</sup> <http://www.fletcherbuilding.com/investor-centre/dividend-information/> provides an excellent example.

<sup>36</sup> Refer to Ch. 5 (*What is the market value for imputation credits?*), and Appendix C (*Analysis of imputation tax credit value across different investor classes*).



# Given stated representations by corporates that imputation is “highly important”, why do more corporates not articulate their imputation approach within their dividend policies?

## 3.2.4 Corporate attitudes to shareholder profile

In general, corporates view imputation as desirable for all shareholders, and believe that this approach will at least deliver benefits to those who can use the tax credits in some way.

This finding is irrespective of shareholder profile. Directors’ hands are tied here, since imputation credits cannot be streamed to certain classes of shareholders over others – rules dictate that all shareholders must share equally in the credits a company is able to attach even when they cannot realise the full benefits.<sup>37</sup>

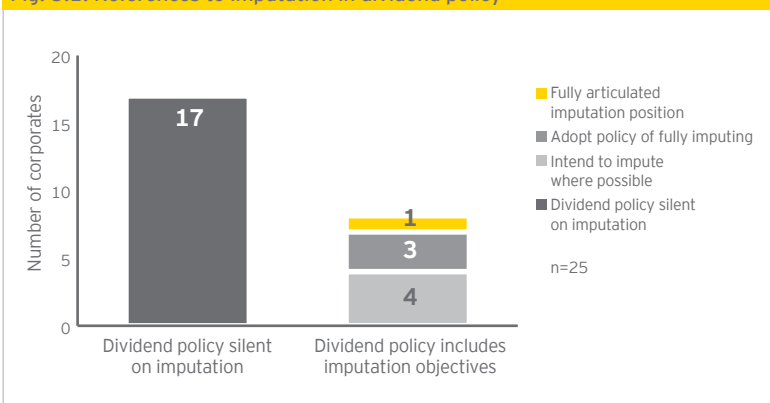
But the value of imputation credits varies across different shareholder profiles, which can include:

- ▶ Foreign shareholders (as opposed to New Zealand shareholders)
- ▶ Tax exempts
- ▶ New Zealand shareholders with differing tax rates<sup>38</sup>

<sup>37</sup> See Income Tax Act 2007 section GB 35 and the Government’s Discussion Document on Streaming and Refundability of Imputation Credits (August 2008)

<sup>38</sup> Of direct relevance here is our analysis in Chapter 5 (What is the market value for imputation credits?)

Fig. 3.1: References to imputation in dividend policy

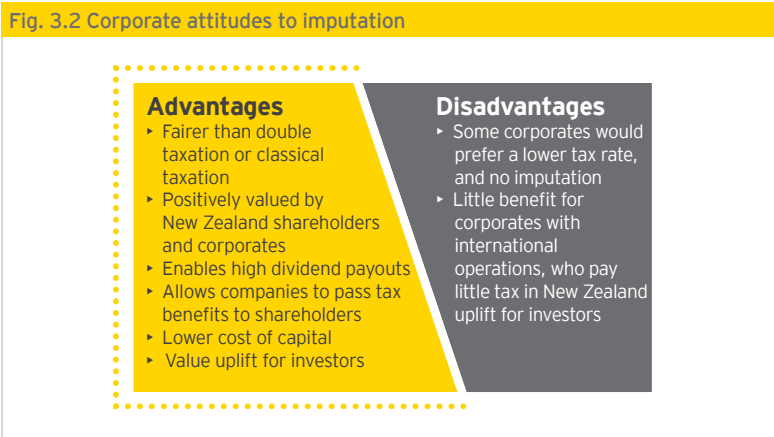


Directors and corporate managers claim they appreciate that different classes of investors will value credits differently. However, we see few examples of directors actively considering this differential value.<sup>39</sup>

Most corporates surveyed seek to allocate any available credits to shareholders, irrespective of shareholders’ utilisation rates or the value shareholders attribute to imputation credits. An example of this is a company with 60% foreign shareholding that maintains a full imputation policy in relation to all dividends, despite the imputation credits providing limited benefit to its majority shareholder group (with only 40% of shareholders are resident in New Zealand and capable of extracting their full value). The real value of imputation credits is explored more fully in chapter 5.

<sup>39</sup> A number of companies demonstrated a highly structured approach to finding ways to increase the value of imputation credits to their shareholders – refer to 4.2.4 (More sophisticated strategies).

A selection of responses that demonstrates corporate attitudes to imputation is shown at Fig.3.2 below.



### 3.3 How investors view imputation in their returns

Our research revealed differences between investors and corporates in terms of the level of importance they place on imputation.

**“The customer rarely buys what the company thinks it’s selling them.”**

**Peter Drucker**

*Peter Drucker (1909-2005) was a writer, professor, management consultant, and self-described “social ecologist” who explored the way human beings organise themselves and interact.*

#### 3.3.1 Imputation credits only slightly influence most investor decisions

By way of contrast, investors are pre-occupied with aspects of corporate policies. Investor proxies do take account of imputation crediting when evaluating investment options/recommendations, but such tax considerations are notably subordinate to weightier factors such as consistency and sustainability of pay-out ratios, commercial drivers, and measures such as free cash flow. Imputation credits only slightly influence investor decisions. Sometimes imputation has a stronger influence. For example, when evaluating investment options in New Zealand equities against Australian equities, the inability of investors to utilise franking credits<sup>40</sup> can be a differentiator. Also, tax imputed dividend returns are generally favoured by retiree retail investors.

Our view is that with imputation now firmly ingrained, and representing an almost normative position for companies and dividend pay-outs, the low rating given to imputation as a decision making factor may well be a behavioural reflex. The acid test here, is how investors’ perceptions of value and influence would change in a world without dividend imputation tax credits.

Of the classes of investors, our findings identified local retail investors (especially the elderly) and institutional investors as being most attracted to yield with imputation credits attached (when compared to foreign investors). Investor proxies believe foreign investors pay little if any attention to a company’s imputation capability.

<sup>40</sup> The trans-Tasman imputation regime provides only a partial, and relatively little used exception. This imputation option is common with New Zealand banks with fully imputed dividends paid to their Australian group parent, and in turn, Australian Parent Bank dividends bearing some portion of New Zealand credits for use by New Zealand investors. However, the pro rata method is significantly restrictive, since the Australian Parent Bank must allocate NZ imputation credits across its total shareholders, and so the value for NZ shareholders is massively diluted. Related to this is the long affair with seeking Australia and New Zealand mutual recognition of imputation credits. Refer to further coverage on this at 6.4.1 (Mutual recognition).

### 3.3.2 The cash reduction effect of RWT and the imputation interplay

The table (Fig.3.3) below shows the impact of imputation on a domestic shareholder, notably the impact of resident withholding tax (RWT). Imputation credits can be allocated at any amount up to a maximum of 28% (the corporate tax rate). In parallel with dividend imputation is the RWT regime which applies at a flat rate of 33% (being the top marginal rate for individuals), but this reduces by the offset of the actual imputation credits attached to a particular dividend.

RWT is a deduction from the cash pay-out, thereby decreasing the cash receipt where the imputation credits allocated are less than the fully imputed amount (28%).

**Fig. 3.3: The cash effect of imputation credits and RWT on dividends**

	Fully Imputed (cps)	Partially Imputed (cps)	Unimputed (cps)
Dividend (net of imputation credits)	10.0	10.0	10.0
Imputation credit	3.9	1.9	0.0
RWT reduction	-0.7	-2.0	-3.3
<b>Net cash to Investor</b>	<b>9.3</b>	<b>8.0</b>	<b>6.7</b>

This simple table explains the interplay between imputation and RWT. We found that companies and investors exhibited a low understanding of this relationship, and when proclaiming that “cash is king” for dividend policy appeared to not fully appreciate that the cash dividend to investors was a direct outcome of the level of imputation credits allocated.

Of course this is not the whole picture since shareholders can utilise the RWT in their individual tax returns, and where their residual tax liabilities are exceeded by taxes withheld and paid, the RWT excess is refundable. This is in stark contrast to the treatment of “excess” imputation credits which are not refundable, but may be carried forward as an eligible credit against future years’ income. The point here, is that RWT applied to dividends (being a function of the level of imputation) reduces the cash dividend received on a pre-tax basis, but “may” be recoverable on a post-tax basis after tax returns have been filed and all taxes reconciled. On the later point, we do address this level of “redemption” of imputation credits (and, relatedly, the RWT) by New Zealand investors, and question the degree to which imputation credits (and RWT) are just not claimed, and consequently “wasted”.<sup>41</sup>

### 3.3.3 The “clientele effect” – investors respond to company policy

Companies with specific policies will attract investors who benefit from those policies. Consider a company that currently pays a high, fully imputed dividend and has attracted clientele whose investment goal is to obtain a high tax-paid cash flow. If the company decides to decrease its imputed dividend, for reasons such as growth opportunities or profits not subject to tax in New Zealand, theory holds that these investors will move on. The share price may fall.

Investors implicitly know their tax profiles and will follow the profiles with their investment choices. Investor tax characteristics and the differential taxation of dividends and capital gains can lead to tax induced dividend clients.<sup>42</sup>

In theory, firms that pay lower dividends attract investors with higher marginal tax rates, while retail investors and tax-advantaged institutional investors tend to favour firms with higher distribution ratios.<sup>43</sup>

<sup>41</sup> Refer to 5.3.2 (Distribution rates vs utilization rates of imputation credits).

<sup>42</sup> Miller and Modigliani (ibid), 1961.

<sup>43</sup> Jun, A., Gallagher, D. R. and Partington, G. H. (2011)

# There is a widespread view by corporates that paying imputed dividends will command a premium to the share price over unimputed dividends.

We find that corporates believe in the reality of the clientele effect. Sixteen of the corporates surveyed responded they are well aware of their share register composition, particularly the domestic/overseas breakdown. Generally, corporates do not delve deeply into individual investors' probable tax profiles, but instead assume a rational, informed and tax aware shareholder. Implicit here is little incentive to change, but to keep the status quo since that is what the "current" shareholders prefer. Anecdotal evidence suggests such a belief may be a little optimistic.<sup>44</sup>

## 3.4 Is imputation priced into a company's share price?

This is a significant value proposition for the relevance of imputation. Yet the views of corporates and of investor proxies contrast each other.

### 3.4.1 The corporate view that a premium exists

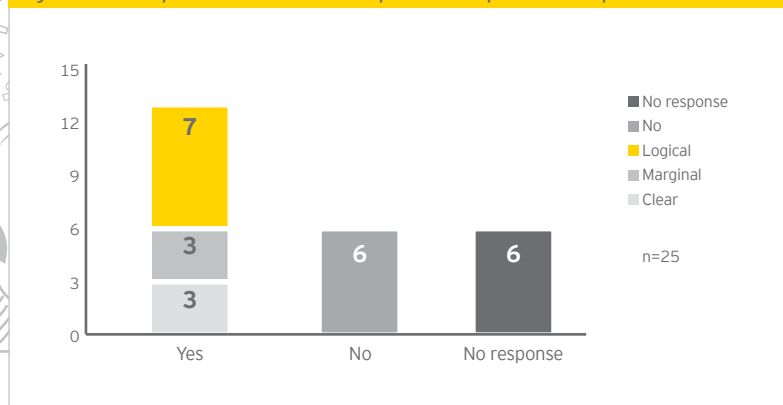
Corporates were asked whether imputation was priced into a company's share price.

Of the 19 who responded to this question, 13 companies identified that a correlation between share prices and whether dividends are imputed does exist, or should logically exist on the premise that rational investors will place more value on an imputed dividend than an unimputed dividend.<sup>45</sup> However the majority of this group (11 out of 19) were unclear on exactly to what extent imputation impacts share pricing (if at all, in some cases). Corporates that did identify a correlation between imputation and share price generally believed that since the marketplace is highly attuned towards dividend pay-outs (yield pigs get slaughtered when they fail to deliver), investors are sensitive to whether credits are attached, and so a pricing adjustment would likely follow any changes to credits attached.

Six companies were of the view that imputation is not a driver of share price, other factors being prevalent.

Some pressure is therefore exerted on corporates in keeping up with the NZX trend to high dividend pay-out. While the extent of any price sensitivity was not clear, there is a widespread view by corporates that imputed dividends will underscore a premium in the share price.

Fig. 3.5: Do corporates believe that imputation impacts share price?



<sup>44</sup> Investor preferences on an after-tax basis, and the clientele effect, are well presented by Dr. Peter Gardner and Dr. Don Hamson (2013).

<sup>45</sup> Charities and other domestic tax exempts are the obvious exception. Non-residents – even tax exempts – obtain partial value through an effective exemption from non-resident withholding tax.

Several examples of share price movement attributable to imputation changes do exist. One company claims to notice an ex-dividend price drop off in excess of the net cash dividend. Another company experienced negative shareholder sentiment to an unimputed special dividend which resulted in a share price dip. We have other evidence (that pre-dates this survey) which involved the generation of refundable dividend withholding payment credits in lieu of non-refundable imputation credits<sup>46</sup> resulting in an upsurge of foreign shareholdings for the company, with a corresponding share price rise. Elsewhere, several examples of share price movement attributable to imputation changes do exist.<sup>47</sup>

Anecdotally though, a change in imputation policy often causes little visible adverse investor reaction: underlying expectations around future earnings and cash flows appear to dominate. One high-profile survey respondent's recent change in imputation policy attracted remarkably few queries from analysts.

Nevertheless, directors and CFOs all believe that paying imputed dividends will command a premium to the share price over unimputed dividends. Conversely, four directors and CFOs opined that a change away from a full imputation policy would be received negatively (the rational market response) and they would anticipate some discounting of the share price.


### 3.4.2 The investor view that no premium exists

By contrast, the investor proxy group differed, instead considering that imputation was only marginally influential in share pricing at best. Although this investor group were more clearly of the view that imputation credits carried a value to investors (often at 70% of the credit face value or more), this did not translate through to the share price they felt. As such, one respondent was prompted to state that investors get a "free-ride" with their receipt of imputation credits since the market did not adjust for their true value (i.e. via dividend drop-off pricing).

Empirical research has attempted to value imputation credits from examining share price drop-off from cum-dividend pricing to ex-dividend pricing between fully imputed shares and unimputed shares. Research results have shown that the market does attribute positive value to imputation credits – see more on this in Chapter 5: What is the market value for imputation credits?

<sup>46</sup> Prior to 2009, under the imputation regime, New Zealand companies paid a Foreign Dividend Payment (FDP) upon receipt of dividends from offshore. The resulting FDP credits could be attached to dividends as an imputation credit. A significant difference existed (when compared with the current regime) in that FDPs were "refundable" to foreign shareholders to the extent that the FDP exceeded the 15% NRWT.

<sup>47</sup> Refer to Bell, Leonie and Tim Jenkinson, "New evidence of the impact of dividend taxation and on the identity of the marginal investor" (2000), <http://www.economics.ox.ac.uk/research/WP/PDF/paper024.pdf>. Empirical evidence on reform of the United Kingdom's imputation system (known as Advance Corporation Tax), shows significant changes in the valuation of dividend income after the reform, in particular for high-yielding companies.

The background of the page features several stacks of coins. On the left side, there are two prominent stacks: one of copper-colored coins and one of silver-colored coins. The coins are stacked vertically, with the silver stack in the foreground being more in focus than the copper stack behind it. The rest of the background is a soft, out-of-focus light beige color.

**Our research revealed that tax and imputation were recognised as having a significant influence on companies' overall preference for special dividends over share buy-backs.**



### 3.5 The impact of imputation on other corporate distributions

Our research revealed that tax and imputation were recognised as having a significant influence on companies' overall preference for special dividends over share buy-backs. While share buy-back distributions can be made on a wholly tax free basis,<sup>48</sup> a combination of surplus imputation credits and other commercial factors meant that corporates surveyed often gave priority to fully imputed special dividends. In some instances, share buy-backs were preferred at the corporate level, but investor demand swayed the distribution as a dividend.<sup>49</sup> If imputation credits were not available, managers surveyed believed this investor preference would dissipate. Reinforcement is found with two situations where a special dividend was paid on an unimputed basis, and the companies concerned suffered an investor backlash.

The growth of DRPs has been strongly influenced by our imputation system. A DRP share is a non-cash dividend for tax purposes. To render shareholders with a cash tax liability is unlikely to be popular (tax without the receipt). Hence, imputation which substantially defrays, if not eliminates, this liability, makes a DRP a tax effective re-investment option.<sup>50</sup> Australian research has also found that "the imputation tax system provides the tax-based preference for the adoption of a DRP".<sup>51</sup>

As noted above, the use of bonus issues is rare. When used, bonus issues have predominantly been driven by imputation outcomes. For example, where tax rates are changing,<sup>52</sup> or company ownership changes will result in the forfeiture of existing imputation credits.

### 3.6 Summary

3.6.1 Imputation has fed the New Zealand dividend psyche. Without the existence of major tax barriers that exist with a classical system, companies can pay dividends in spades. Our imputation system sits within a tax policy setting of low and closely aligned rates of tax, and in this context comes close to replicating a tax free marketplace for dividend payouts, and exploiting this outcome is recognised as a corporate opportunity to harness.

3.6.2 While high cash returns are seen as the predominant objective, the overriding message from our survey is that corporates consider imputed dividends as the optimal pay-out mechanism.

3.6.3 Exceptions exist for companies with a dominant growth agenda (and from which tax free exits to realise disposal gains was advocated). However, if dividends were on the menu, then the prevailing view was to impute where possible, be that only partially if a shortfall of tax credits exist in the ICA.

3.6.4 Notwithstanding such a strong imputation mind-set, just under a third of corporates addressed imputation in their formal dividend policies, and even here this was a simplistic intention to impute rather than any more meaningful communication on the company's ability to impute. Also, and consistent with the above, corporates believe that providing an imputed dividend will benefit "the shareholders". However, while most understood the make-up of their share register, few articulated the worth or value of imputation credits to different shareholding clienteles (foreign vs tax exempt vs NZ resident retail vs institutional).

<sup>48</sup> Share buy-backs are limited as to their tax free basis. Companies have a finite level of paid up share capital (Available Subscribed Capital) which is needed to fund a buy-back of shares tax free. There are other rules, such as anti-avoidance dividend substitution rules, which limit a company's ability to make regular buy-backs.

<sup>49</sup> New Zealand research concluded that investor reactions to a dividend increase announcement are more positive than initial buyback announcements. "It is reasonable to conclude that the neutralization of tax implications delivered by the dividend imputation system trumps the absence of a capital gains tax". See Warwick Anderson and Samuel McLaughlin (2010)

<sup>50</sup> That said, DRPs are deployed by companies without full imputation coverage, notably the mining and exploration sector.

<sup>51</sup> See Matthew Abraham (August 2012), involving a study of DRP's within listed firms on the ASX in the 1995-2009 period, and also Pattenden & Twite (2007)

<sup>52</sup> Refer to Hamish Anderson, Steven Cahan and Lawrence Rose (2001)

# Investors place less importance on the imputation effect than corporates.

3.6.4 Investors place less importance on the imputation effect than corporates. With investment recommendations, the imputation effect is subordinate to "weightier factors". There was inconsistent attention by investors to the imputation effect. Investors are fixated with the cash dividend, and yet few understood the cash reducing interplay between imputation and RWT (whereby imputation shortfalls on dividends are replaced by RWT deductions).

3.6.5 The majority of corporates believe that companies which pay regular imputed dividends will command a premium in their share price. However, little evidence was provided on the extent of this share price premium. Only limited examples were given and ranged from nominal to no investor reaction to imputation changes, to shareholders backlash at special dividends paid without any allocation of imputation credits.

3.6.6 Investor proxies, by contrast, generally doubted whether a company's ability to impute would influence its share price, and if it did, would be marginal at best. That said, investors were clearer than corporates about the worth of imputation credits to shareholders (often put at 70% of its face value), but this did not translate through to share price. This prompted an investor response that shareholders got a "free ride" on receipt of dividend imputation credits given that the market appears to attribute little value with no discernible share price drop-off ex-dividend.

3.6.7 Notwithstanding this investor attitude, Australian dominated empirical research has identified that the market does impound the value of imputation credits into the share price.

3.6.8 Our research shows that tax and imputation do have a significant impact on other corporate distributions. With special dividends and share buy-backs (capital returns) being largely substitutable, we noticed a slight preference for special dividends on a fully imputed basis over tax free capital returns. This demonstrates the effect of imputation (in providing a largely tax credited return) that results in a dividend preference over a tax free capital return. Similarly, we noted the prevalence of companies adopting DRPs and we attribute the growth in use of this investor tool as attributable to the tax neutral effect for shareholders of re-investing through the imputation effect.

# 4. Imputation and tax induced behaviours

## Need to know

- ▶ Imputation suits wholly domestic New Zealand businesses
- ▶ Imputation creates challenges for New Zealand based international businesses

## Corporate strategies

- ▶ Prepaying tax to enable fully imputed dividends is common
- ▶ A small number of companies amassed substantial pre-paid tax positions – demonstrating the directors' conviction about the high value of imputing
- ▶ Investors see substantial tax pre-payments as irrational, however in appropriate cases, smaller scale tax pre-payments can be justified
- ▶ Corporates with offshore earnings were well attuned and active in the advantages of transfer pricing to move earnings onshore, and thereby promote New Zealand tax imputation credits
- ▶ In replicating a near tax free outcome, imputation “neutralises” the taxable difference between special dividends and capital share buy-backs
- ▶ Imputed special dividends are favoured over share buybacks
- ▶ More sophisticated companies demonstrate highly structured techniques to deliver greater imputation benefit to shareholders

**New Zealand corporates have a love affair with paying dividends, especially imputed dividends. This has elicited some discernible behaviour in the quest for imputation credits. The current research shows the imputation system has contributed to an emerging preference for taxable dividends over tax free capital gains.**



## 4.1 The best tax to pay...is New Zealand tax

Companies that are domestic businesses have little pressure on their imputation credit account since their earnings are pre-dominantly New Zealand sourced, and therefore their taxes are local taxes. Given that only New Zealand taxes qualify as imputable taxes, companies with offshore operations confront challenges.

Under some simple assumptions, a company wanting to fully impute dividends of, say, 70% of its NPAT must earn at least 70% of its taxable income in New Zealand. The higher the dividend distribution ratio, the more important it is to pay tax in New Zealand compared to overseas.

At Fig.4.1 we demonstrate this point for a New Zealand based corporate with a mix of offshore and onshore earnings (total consolidated amount of \$400) which we progressively vary. It assumes a single layer of New Zealand or overseas tax at 28%, shareholders with a 33% marginal tax rate, and no timing differences between taxable income and accounting profit.

Fig. 4.1: Group with 70% target pay-out, and mix of offshore/onshore earnings

	\$	\$	\$	\$	\$
<b>Earnings – onshore %</b>	0%	25%	50%	70%	100%
New Zealand	0	100	200	280	400
Overseas	400	300	200	120	0
Profit before tax	400	400	400	400	400
<b>Tax at 28% (same flat rate)</b>					
New Zealand	0	28	56	78	112
Overseas	112	84	56	34	0
Total tax	112	112	112	112	112
Profit after tax	288	288	288	288	288
<b>Dividend paid (70% of profit after tax)</b>					
Net dividend	202	202	202	202	202
Imputation credits (@28/72)	0	28	56	78	78
Gross dividend	202	230	258	280	280
<b>Resident withholding tax (at 33% default rate)</b>					
Resident withholding tax payable	-67	-48	-29	-14	-14
Offset imputation credits allocated	+0	+28	+56	+78	+78
Resident withholding tax payable	-67	-48	-29	-14	-14
<b>Net cash received by shareholders</b>	<b>135</b>	<b>154</b>	<b>173</b>	<b>188</b>	<b>188</b>

**“Frankly, if I had paid more (taxes) than legally due, I don’t think I’d be qualified to become president.”**

### Mitt Romney

*Mitt Romney is an American politician and businessman who was the Republican Party’s nominee for President of the United States in the 2012 election.*

Once income taxed in New Zealand falls below 70% of group income, full imputation is no longer possible, with additional RWT deductions applying with the result that the shareholders receive lower cash-in-hand.

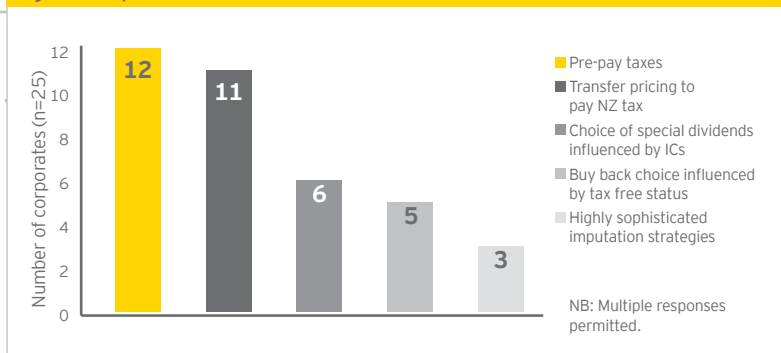


## 4.2 Strategies to feed the imputation beast

Companies demonstrate a range of strategies to increase the available pool of imputation credits, as shown below.

Survey respondents demonstrated impressive creativity in generating imputation credits. The Government should be particularly pleased by the extent to which companies seek to use transfer pricing techniques to increase the level of tax paid here at the expense of tax paid overseas.

Fig. 4.2: Imputation and tax induced behaviours



Each of these strategies is discussed in more detail below.

### 4.2.1 Pre-paying corporate taxes – the good, the bad, and the ugly

The most commonly reported strategy by corporates for maximising imputation credits is pre-paying tax. This can either be carried out as a matter of timing, or it can result in large amounts of tax being paid to the IRD on an ongoing basis.

**“Pre-paying tax is like taking crack cocaine. It feels good the first time.”**

**Survey participant**

## Incidence of pre-payments

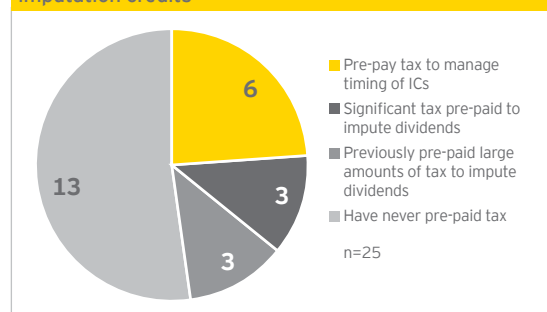
Paying tax in advance to top up imputation credit accounts, and so enable the making of fully imputed dividends, is the single most common imputation-induced behaviour. It seems unlikely that Mitt Romney, quoted earlier, would agree with the approach to pre-paying tax displayed by many New Zealand corporates.

Larger corporates view that, within reason, pre-paying delivers value. They are possibly more sophisticated, resourceful, and investor focused than their smaller counterparts, for whom tax pre-payments are of less concern.

Our survey found that 12 corporates surveyed have prepaid tax in advance. A typical pre-payment can be between \$2 million to \$8 million. Top-ups are commonly made to manage timing issues around dividend payment dates and the imputation credit account year end.<sup>53</sup>

Six of the corporates felt justified in pre-paying their taxes on the basis that it is timing only, and that their profit projections show that future tax liabilities are anticipated within 12 months of prepayment. Therefore, the pre-paid tax would be consumed on a short term basis against emerging liabilities for the company.

Fig. 4.3: Pre-paying taxes to top up available imputation credits



<sup>53</sup> Tax law provides that companies can impute dividends and, in doing so, put their ICAs into debit balance/tax deficit if necessary. To avoid tax penalties, however, companies must ensure their imputation credit accounts are not in debit balance on 31 March each year. Since companies have differing dividend payment dates, which will not necessarily coincide with when tax payments are due, some decide to pre-pay tax in order to generate sufficient credits to attach to their dividends.





However, within the group of corporates that reported having pre-paid tax, three companies had paid or were pre-paying substantial amounts of tax over a longer term. They had, or have, high pay-out ratios, and had accumulated pre-paid tax balances in the order of \$50 million to \$60 million. This pre-payment represents up to three years of their annual tax liability in New Zealand. We note that prior to the GFC, the incidence of companies pre-paying their tax to significant amounts appears to have been higher.

This pre-payment behaviour in its various forms provides a powerful indication of the attitude that corporates place on delivering a fully imputed dividend. Implicit here is that directors place a high value on providing tax imputed returns. But is this attitude ill-founded?

The combination of a high pay-out ratio and a desire to fully impute the entire dividend risks leaving corporates with a tax asset of considerably less value to them than cash, a weaker overall balance sheet and reduced flexibility to meet future capital needs.

### When might pre-paying tax be beneficial?

Pre-paying tax can become an option where a company faces a short term dip in profitability or has significant offshore earnings in a period, and as a result pays little New Zealand tax.<sup>54</sup> The fundamental viewpoint that imputation credits are valuable and that it is good practice to maintain a full imputation policy (and maintain high pay-out ratios), seems to be the driving rationale to prepay tax.

### An example demonstrates this:

A New Zealand company earns consolidated profits of \$40m. Of these consolidated profits, \$15m are generated from Australian operations and \$5m from Europe. The company has a dividend policy that targets a pay-out ratio of 75% of their consolidated net profits, which is \$30m. For the year in question, the company pays New Zealand taxes on New Zealand earnings of \$5.6m, and correspondingly has an imputation credit account balance of \$5.6m. Of the \$30m dividend, \$10m is effectively sourced from offshore earnings (although the actual payment will be from the most liquid resources). The company requires \$11.7m of imputation credits to fully impute the dividend. To achieve full imputation, the company pre-pays New Zealand taxes of \$6.1m.

This approach is likely to be unsustainable. Year on year, pre-payments are required even though the underlying structure of the business suggests that the tax will not be utilised within a reasonable period.

A company may also pre-pay tax where there are material timing differences between its accounting profits (on which it calculates its dividend) and taxable income.

### When does pre-payment seem irrational?

Investors certainly see substantial, long term pre-payments as irrational and react adversely to companies prepaying tax. While temporal and small scale advance tax management could be acceptable where there is certainty of tax utilisation within a year, all investors considered large tax pre-payments as "grossly irrational".

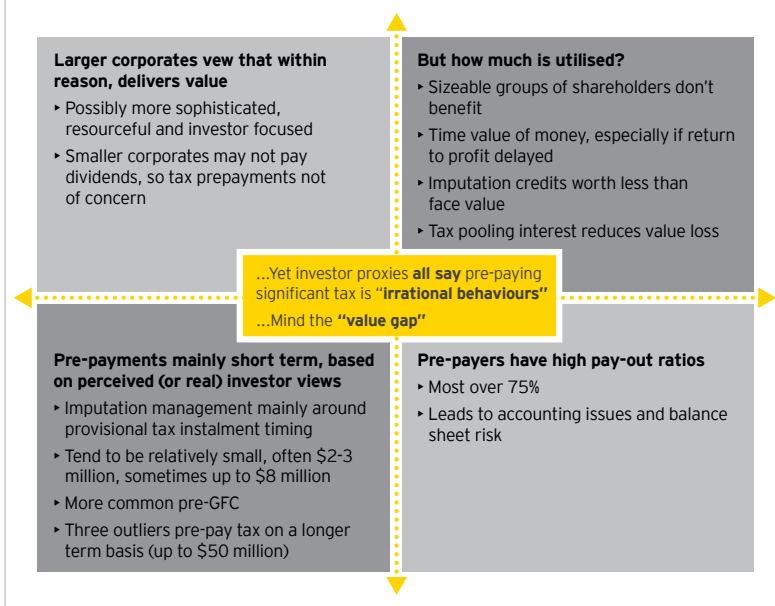
Investor attitudes here are consistent with the perspective that they place less significance on imputation credits than do corporates.

This oppositional view, which we fully understand, throws out a real challenge for some of the corporates surveyed, and questions company boards that decide to adopt large tax prepayment positions. Are longer term prepayments really in the interests of all shareholders?

<sup>54</sup> One corporate with significant earnings from overseas previously pre-paid tax so that it could attach imputation credits to dividends. The corporate concerned has now stopped pre-paying in this way.

## Overall, the value of pre-payments to shareholders is questionable

Fig. 4.4: What common features emerge with pre-paying taxes?



The following questionable factors arise with pre-pay tax situations:

- ▶ Sizeable groups of shareholders will receive only low, or no benefit from pre-paid taxes (notably foreign shareholders and tax exempts).
- ▶ The above mentioned "utilisation rate" of imputation credits may be lower than assumptions of the company.<sup>55</sup>
- ▶ Even for fully taxable domestic investors, by pre-paying tax the corporate has suffered a time-value cost.<sup>56</sup> Risks exist that this cost can increase, especially in GFC-style events if a return to anticipated profitability is delayed.
- ▶ From the above, a worst case scenario is where auditors deny the recognition of some or all of the pre-paid tax asset on the company's balance sheet.
- ▶ It is clear that a dollar of pre-paid tax, which translates into a dollar of imputation credit, is worth less than a dollar of unencumbered cash.

Finally, corporates looking at pre-payments will also need to be wary of increased gearing – the tax is an asset, but the funds to pay for it may have been borrowed.

### 4.2.2 Transfer pricing to pay New Zealand tax

The imputation system provides an incentive to pay tax in New Zealand, rather than overseas. This encourages corporates to bring offshore earnings to New Zealand on a "pre-tax basis", giving support to transfer pricing policies that promote income being in New Zealand rather than offshore. Companies in this situation were, in the main, active in their awareness and management of transfer pricing strategies<sup>57</sup> to shift as much income into New Zealand so that the New Zealand tax burden increases in proportion to foreign taxes and positively feeds their imputation pool.

The extent to which transfer pricing strategies were exploited to promote an imputed dividend policy varied, and were largely circumstantial; however pursuit of some form of profit attraction to New Zealand was a common theme with companies with mixed on shore/off shore earnings.

Of course, the attendant other benefit with these strategies is that this promotes cash earnings to New Zealand which is needed for the parent to fund its dividend pay-out.

### 4.2.3 Special dividends and buy-backs; the "dividend puzzle"

From a tax perspective, the "dividend puzzle" describes the propensity for firms to pay-out regular dividends, even though for most shareholders dividends are taxed more heavily than capital gains.<sup>58</sup>

<sup>55</sup> On this aspect of imputation "utilisation rates" refer further under Chapter 5 (What is the market value for imputation credits?)

<sup>56</sup> Tax pooling has reduced, but not eliminated, the cost. Advance payments to IRD, attracting an interest credit/return at only 2.63% (up recently from 1.75%), seem difficult to justify against the company's WACC for any length of time.

<sup>57</sup> Methods here include: pushing debt and interest obligations offshore (out of New Zealand); inter-entity group pricing of goods and services; royalties; management fees and robust head office charges to offshore entities.

<sup>58</sup> That is, shareholders who are capital account investors, rather than active share traders who are taxable on their gains. Investors who are professional share investors (habitual buyers and sellers), or speculative investors, or, who operate a business investing and selling shares, are taxed on their sale gains as revenue account taxpayers.

# The taxable status of dividends against the tax free status of capital returns is “neutralised” by attached imputation credits. This is the imputation effect.

New Zealand does not have a specific capital gains tax (“CGT”), and despite limitations on capital returns,<sup>59</sup> one might expect investors and firms to favour capital returns over dividend distributions.<sup>60</sup> Our survey suggests, however, that investors prefer dividends over capital returns, with special dividends preferred over share buy-backs.<sup>61</sup>

This preference is the same at the corporate level (eleven corporates told us they would favour special dividends over share buy-backs).<sup>62</sup> This suggests that the benefits to shareholders from a firm undertaking a share buy-back and delivering a tax free return (over a special dividend) is insufficient and does not warrant the additional effort required by the company.<sup>63</sup>

The taxable status of dividends against the tax free status of capital returns is “neutralised” by attached imputation credits. This is the imputation effect. Corporates with sufficient credits are able to pay-out fully imputed special dividends, and since there is little difference between the top individual tax rate and the company tax rate, there is little residual tax for investors to top up.<sup>64</sup>

Therefore, insofar as the investor is concerned, on an after-tax basis, there is little difference in his/her receipt between a fully imputed dividend, and a capital return (share buy-back).

In contrast to the above, we record that companies solely or predominately growth focused expressed the view that higher share values (through re-investment) offered investors the most tax efficient return via tax free disposal gains.

## 4.2.4 More sophisticated strategies

Of the 25 corporates surveyed, three demonstrated a more innovative approach to finding better ways to deliver more value to their shareholders.

These companies showed a stronger focus to how they could deliver the best value return to shareholders, and this thinking was evident over many years. Their approach can be described as a highly structured one, and in most cases, is reflective of a more complex earnings and shareholder profile than more domestic-focused companies.

In addition to transfer pricing, strategies here have included:

- ▶ Non-taxable bonus issue shares up until 2009 involving profit distribution plans under which shareholders received distributions in the form of non-taxable bonus issues were utilised by some companies. Shareholders then had the option of selling the shares back to the corporate for cash (i.e. share buy-backs). This practice discontinued after the law changed so that bonus issues under a profit distribution plan would be taxed as dividends.
- ▶ Maximising use of tax free capital returns (buy-backs) to shareholders.
- ▶ Use of trans-Tasman imputation groups, most notably with alternate imputing and franking of dividends.

As noted, these strategies are not available to most companies, but where more complex profiles do exist, a number were highly motivated to pursue ways to maximise shareholder returns by increasing the imputation value delivered.

<sup>59</sup> For example the available subscribed capital (ASC) rules, which broadly limit the amount that a firm can pay-out tax free on cancellation of shares to the funds originally subscribed.

<sup>60</sup> This was the hypothesis of several commentators. See for example, Bradley Nuttall, *BNL Dividend Policy: Should Investors prefer Dividend Yields to Capital Gains?* Undated commentary, accessed 16 July 2015; Kerry Pattenden (University of Sydney) and Garry Twite (2007).

<sup>61</sup> This finding equates to the conclusions from research undertaken by Warwick Anderson and Samuel McLaughlin (2010).

<sup>62</sup> Refer coverage on this under 2.4.1 (Special dividends).

<sup>63</sup> A director of one surveyed company that had gone to considerable effort to deliver tax effective returns via a share buy-back believed that retail investors had not appreciated the upside benefits, and questioned their understanding (although institutional investors received it well).

<sup>64</sup> Low rate investors may instead end up paying too much tax since New Zealand's imputation regime does not generally refund excess credits. With many low rate taxpayers not required to file tax returns, it is likely that surplus credits will be wasted rather than offset against other income or carried forward.

**As noted, these strategies are not available to most companies, but where more complex profiles do exist, a number were highly motivated to pursue ways to maximise shareholder returns by increasing the imputation value delivered.**

### 4.3 Summary

4.3.1 Companies demonstrate a range of strategies to increase their ability to pay imputed dividends. This follows from directors' belief that the optimal dividend to pay is an imputed dividend; that investors will value imputation credits equally; and their imputable status will underscore a share price premium. As such, NZ corporates adopt tax induced behaviours to generate and promote imputation credits where they can. Some companies adopt a greater range of behaviours than others, although circumstances do dictate the opportunities available here.

4.3.2 The most common strategy (half of our sample) to maximise imputation credits involved companies prepaying tax. The majority of companies here undertook prepayments of tax as a matter of timing, involving amounts of tax ranging from \$2 million to \$8 million. This behaviour was rationalised on the basis that it delivers value, and the advance payment of tax is fully recoverable within 12 months based on company performance.

4.3.3 However, at the extreme end were a small set of three companies that paid very large amounts of tax in advance, upward of \$50 million to \$60 million, to enable dividends to be imputed. This behaviour is a very clear demonstration of the high value that directors place on imputation credits, and an obsession to deliver imputation credits. However, investors see this behaviour as irrational, and this illustrates the value gap that exists between investors and companies about imputation credits.

4.3.4 Given that only New Zealand taxes paid, rather than foreign taxes, generate eligible imputation credits, companies with a mix of domestic and offshore operations are incentivised to transfer price foreign earnings to New Zealand on a pre-tax basis. Companies in this situation were active in their management of transfer pricing strategies.

4.3.5 On the basis that special dividends and share buy-backs are substitutable forms of corporate distribution, companies that had undertaken these narrowly favoured special dividends on the basis they had sufficient imputation credits to fully impute. This is despite company buy-backs being capable of being wholly tax free to investors. Therefore, we observed the "neutralising" tax effect that imputation has effected here.

4.3.6 Finally, a small number of three companies exhibited what we have described as highly sophisticated approaches to finding ways to deliver more value to their shareholders via imputation and related tax strategies. These companies have more complex earnings and shareholder profiles than the mainstream companies.



# 5. What is the market value for imputation credits?

## Need to know

### Context

- ▶ Australian dividend drop off studies indicate that imputation credits have a market price of around 50% of their face value

### Corporate views on value

- ▶ Corporates believe imputation credits to be valuable to investors, but struggle to quantify that value

### Investor views on value

- ▶ Imputation credits have different values for different investors, and therefore will have a variable impact on how investor classes price-in the values
- ▶ New Zealand investors estimate the value of credits on average to be between 50% and 70% of their face value, and in a few cases up to 100%
- ▶ While investor groups factor in tax imputed returns, this does not drive their investment recommendations

### Shareholder utilisation rates

- ▶ The shareholder utilisation rates (from redeeming imputation credits they receive) is materially lower than the corporate allocation of imputation credits, or distribution rate

**There is no “market” for imputation credits as such. This chapter explores two concepts of “value”.**

**One is the market value, or price, and this is determined by the share price behaviour of companies on an ex-dividend basis, following research into the share price drop-off effect.<sup>65</sup>**

**The other concept is the “redemption value” to shareholder investors which is determined by the reduction of taxes that are claimable from imputation credits, and this in turn depends on individual tax positions.**

<sup>65</sup> This is well explained by authoritative researchers Neville Hathaway & Bob Officer – “when stocks go ex-dividend, the share price typically drops because the assets, in the form of dividends and franking credits, are being distributed. The drop off in share price reflects the market’s value of the cash dividend and the credit being paid out. If shareholders value the associated imputation credits, then the share price should drop further than to reflect the trade-off between capital value and the dividend cash plus credits. This is indeed what happens. Share prices of fully-franked dividends fall further, as shares go ex-dividend, than shares which pay unfranked dividend. We analyse the extra drop-off in the share price that is attributable to the credits as distinct to the drop-off attributable to the dividend alone”. *The Value of Imputation Credits* (Update 2004, P.5).



This chapter looks at market value approaches to imputation credits and asks corporates and investors for their own perceptions of market value. The evidence of imputation credits being used (utilisation rate) is extrapolated from IRD data.

Anti-avoidance measures specifically target any trading in imputation credits, such as companies “streaming” dividends and credits by companies to particular classes of shareholders who may value them, more than others.<sup>66</sup> As such there is no “open market” for imputation credits.

That said, over the years parties have used imputation credits to enhance the value from forms of financing arrangements<sup>67</sup> to provide lenders with a tax credited coupon return (as against a taxable interest return). In these instances, a “value” is established for the imputation credits that will flow. Most commonly this involved two parties with extreme tax profiles as fully taxable/full value from the credit, to exempt/nil value from the credit, to foreign/15% value from the credit.<sup>68</sup>

The face value of the imputation credit (at the tax effective rate) is typically arbitrated<sup>69</sup> between the issuer and lender.

Given this ambiguous situation, various researchers have attempted to find a value for imputation credits.

**“Price is what you pay. Value is what you get.”**

**Warren Buffett**

*Warren Buffett is an American business magnate, investor, and philanthropist. He is widely considered the most successful investor of the 20th century.*

## 5.1 Approaches to finding the value of imputation credits

Existing research is predominately Australian based, and typically adopts a “dividend drop off” method that tracks ASX ex-dividend share pricing to evaluate the value attributed to franking credits by the market. Prices of shares that pay fully franked dividends were observed as falling further ex-dividend than share price falls of shares that pay unfranked dividends.

<sup>66</sup> This tax provision recognizes that the value of imputation credits will differ for a range of shareholders, something that was expressly discussed in the Discussion Document, *Streaming and refundability of imputation credits: A Government discussion document* (August 2008).

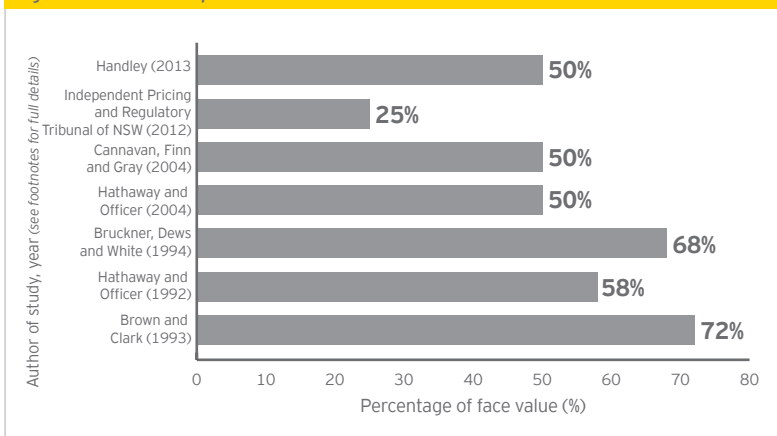
<sup>67</sup> Typically in the form of preference share lending (in lieu of debt) with imputed dividend coupons, and also with NZ equity swap trades as collateral to lending between offshore institutions and onshore lenders/parties.

<sup>68</sup> Refer to Appendix C (Analysis of imputation tax credit value across different investor classes).

<sup>69</sup> That is, the benefit of the imputation tax shield at (formerly) 33% or 30% is split between the counter parties.

Findings vary from study to study (over differing time periods). Formal Australian studies vary between 0%-70% of face value. From transactional experiences over the past two-years in Australia, we are aware that market advisors (investment bankers, equity analysts, and brokers) generically favour a value for an Australian franking credit at the higher end of this range.<sup>70</sup>

Fig. 5.1: Value of imputation credits from Australian studies



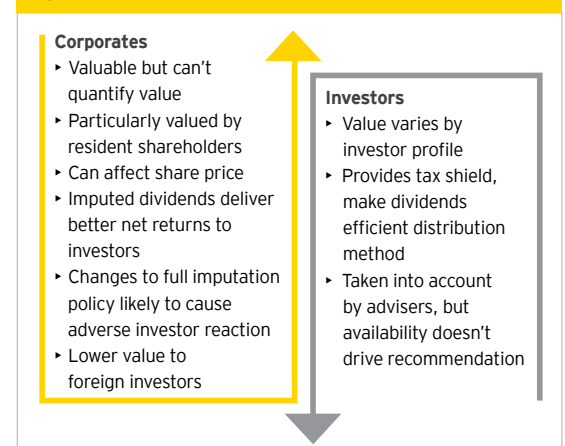
In the New Zealand market place, the only similar research<sup>71</sup> we located is long dated (1997), and this studied NZX companies' dividend data between 1987 and 1995. This concluded that the average market value attached to imputation credits is estimated at about 57% of the face value of the tax credit.

For completeness, we note that the value of an imputation credit only materialises when they are actually distributed and in the hands of an investor receiving a dividend. On a net cash basis, an investor will not suffer any further reduction of their fully imputed dividend receipt for RWT beyond 5%.<sup>72</sup> The value proposition arises at the "redemption" point, as a credit reducing the investor's personal tax liability. Prior to distribution, as an entry in a company's ICA, no value is accorded to the total credit balance by the company since it does not represent an asset of the company.

## 5.2 The New Zealand story

The current research sought to understand how imputation credits are valued by both corporates and investor proxies; some clear differences were observed.

Fig. 5.2: Corporate and Investor attitudes to valuing imputation credits



<sup>70</sup> The Australian tax reforms in 2000 that introduced tax credit refunds for unused franking credits, has been attributed to a material increase in the value of imputation credits there. Of related interest here is John Wasiliev's views in the Australian Financial Review (21 November 2012) that Australian Superannuation and Pension schemes were involved in "active" share trading either side of dividend date in pursuit of franking credits on dividend paying stocks. John C. Handley (Nov 2008);

Independent Pricing and Regulatory Tribunal of New South Wales (March 2012) IPART, NSW;

Damien Cannavan, Frank Finn, and Stephen (2004);

Neville Hathaway and Bob Officer (November 2004);

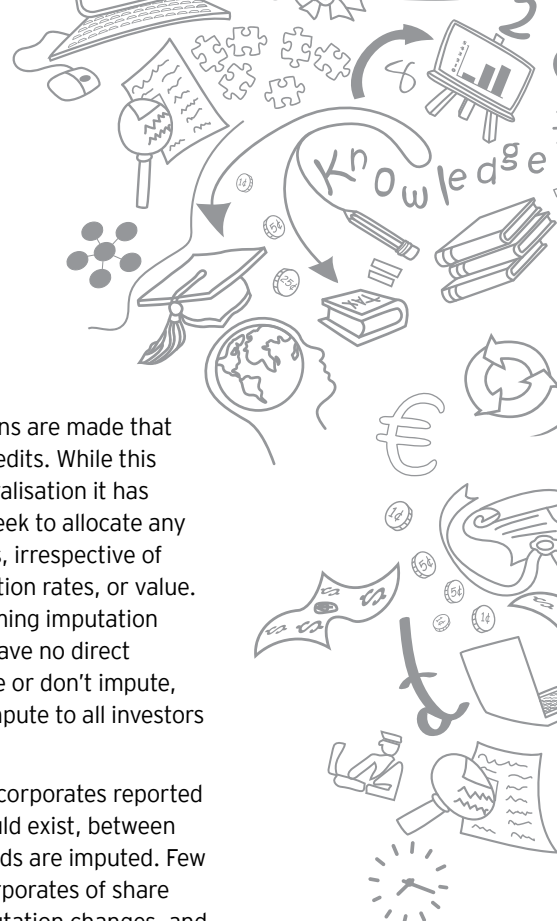
Kris Bruckner, Nigel Dews and David (1994). McKinsey & Company;

Hathaway & Officer (1992);

Brown & Clark (1993).

<sup>71</sup> Refer Carol L Day & Bert D Ward (1997)

<sup>72</sup> Refer how this works in our example at 3.3.2 The cash reduction effect of RWT and the imputation interplay.



### 5.2.1 Corporate views of value

Corporates unanimously agree that imputation credits are “valuable”, thus reinforcing the widely held belief that they are highly important to investors, especially New Zealand individuals. But few had a view as to what that value is. Three corporates were prepared to estimate imputation credits as having a market value in the range of 50% to 70% of the face value of the credit. However, the broader value statement appears to be a standing pre-conception, seemingly reinforced by retail investors at shareholder meetings, and also directors themselves in their capacity as personal investor shareholders.

Directors and corporate managers claim that they appreciate different classes of investors will value credits differently. However, we see few examples of directors actively considering this differential value. Those that did stood out as demonstrating a highly structured approach to finding ways to increase the value of imputation credits to their shareholders.<sup>73</sup> One company is distinguished for its close scrutiny of shareholder value disparities, and lobbying the government for changes to imputation utilisation rules.

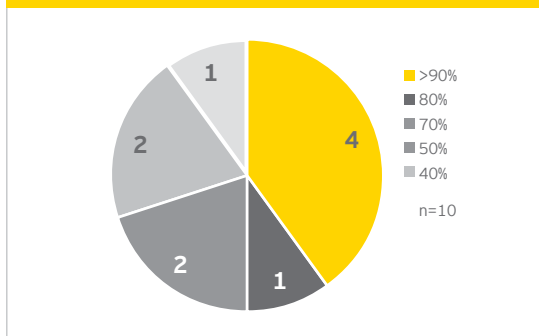
In practice, sweeping assumptions are made that all investors can benefit from credits. While this is an over-statement, as a generalisation it has merit. Most of those surveyed seek to allocate any available credits to shareholders, irrespective of disparities in shareholder utilisation rates, or value. The tax law restriction on streaming imputation credits means that companies have no direct options here. They either impute or don't impute, and if they impute, they must impute to all investors on the same basis (pro rata).

As we canvassed earlier at 3.4, corporates reported that a correlation exists, or should exist, between share price and whether dividends are imputed. Few examples were evidenced by corporates of share price movement relative to imputation changes, and as such the belief that imputing shares command a premium appears to be rationalised by logic more than tangible proof.

### 5.2.2 Investor views of value

Investor proxies varied in their assessment on the value of an imputation credit. The upper value was 70% to 100% of face value of the credit, while the lower value was 40% (with two investors undecided).

Fig. 5.3: Investor groups' value of Imputation credits (as a percentage of the face value of credits)



<sup>73</sup> Refer to 4.2 (Strategies to feed the imputation beast).

# An investor's individual tax profile will have a direct bearing on their perceptions of value of imputation credits.

Investor proxies were all aware that the value of imputation credits can differ between different classes of investor, be they high tax rate investors, low tax rate investors, foreign, or exempt,<sup>74</sup> and this is sometimes factored into recommendations.

Ideally, investors will prefer returns that are fully tax credited so leaving no, or only nominal, tax liability remaining. Therefore, an investor's individual tax profile will have a direct bearing on their perceptions of value of imputation credits. Investors with high marginal tax rates will value credits more; those with lower marginal tax rates will value credits less. To illustrate, an investor receiving a 28% imputation credit may derive no value from the excess over their 17.5% marginal tax rate, that is, the excess 10.5% difference to the maximum 28% imputation credit.<sup>75</sup> Resident investors will value credits higher than foreign investors who may only extract the withholding tax benefit (15% maximum)<sup>76</sup>. Imputation credits to tax exempts, such as charitable trusts, and others (e.g. Accident Compensation Corporation) are valueless.

As to market value, investor proxies were sceptical, and generally doubted that imputation credits would have any influence on share pricing beyond only a marginal impact. The preferred view was that share price was dominated by a range of commercial factors relative to any particular company, with the imputation component of dividend pay-outs a "nice to have" additional benefit.

## 5.3 The gap between imputation credits distributed, and imputation credits redeemed

Clearly, the full face value of imputation credits will not be realised by all shareholders, who differ markedly in terms of benefitting from the regime. Looking at the big picture, we can see there is a significant gap between distribution and redemption.

### 5.3.1 The New Zealand pool of imputation credits

Up until 2013, the accumulated pool of undistributed imputation credits was nearly \$38 billion.<sup>77</sup> This has been an increasing balance year on year. This pool of credits could fully impute corporate dividend distributions of close to \$100 billion. A pool of accumulated, but undistributed imputation credits should logically correlate to the build-up of company retained earnings from undistributed profits.

NZX data<sup>78</sup> reveals that 63% of 2014 NZX dividends were fully imputed, with a further 23% partially imputed. Pre-GFC, the proportion of fully imputed dividends was over 83%.

Almost half of these unallocated credits are accumulated within closely held companies. That proportion has trended up over the years. It seems likely that private company shareholders disfavour taking out excess dividends given this would create personal tax liabilities in excess of the maximum available imputation credit, that is, a tax cost of 5% to their top marginal rate (previously 8% and 6%).<sup>79</sup>

<sup>74</sup> The redemption value for imputation credits will vary depending on the taxable position of each investor. On this further, refer to our analysis in Appendix C, (*Analysis of imputation tax credit value across different investor classes*).

<sup>75</sup> Investors may file individual income tax returns to offset surplus imputation credits against other income, but we are unclear on the extent to which this happens in practice.

<sup>76</sup> Investors informed us that foreign investors place little, if any, weight on the imputation credits and the imputable profile of NZ shares (despite the receipt of "supplementary dividends" that arise only on imputed dividends flowing to foreign portfolio investors, and that neutralise the cash effects of NRWT deductions).

<sup>77</sup> IRD data on imputation credits is limited. This figure comes with a number of caveats explored further in Appendix E (*Imputation credit data*).

<sup>78</sup> Refer here to Appendix E (*Imputation credit data*). Reference NZX data on NZ corporate dividends.

<sup>79</sup> 2008 top personal tax rate 39% vs company rate of 33%; then 2011 top personal tax rate at 38% vs company rate at 30%; now top personal tax rate of 33% vs company rate at 28%.

By contrast, NZX companies have comparatively lower stockpiles of imputation credits which is consistent with the New Zealand environment of high dividend pay-outs.

### 5.3.2 Distribution rates vs utilisation rates of imputation credits

Who is claiming imputation credits? What are the redemption rates, in terms of utilisation of credits by investors via their tax status and profile?

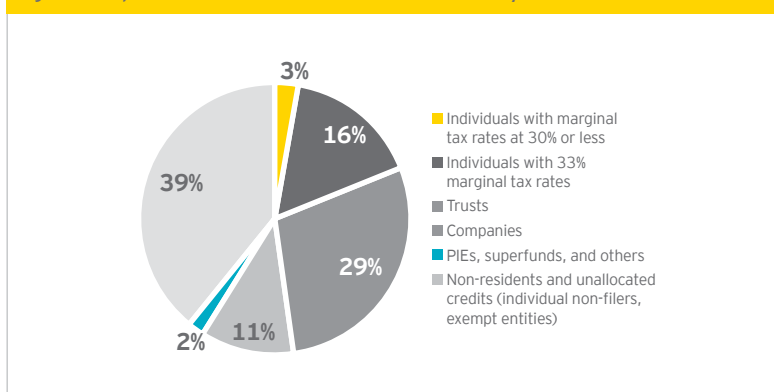
The system of imputation is effectively a pre-payment of personal tax, paid by the company on behalf of shareholders with respect to their tax liability arising on receipt of dividends that are distributed from the company. However, in the context of how integrated the system is, adjustments are necessary to arrive at the true 'utilisation rate' of the imputation credits that have been allocated. In simple terms, if only 40% of shareholders (by value) actually redeem the tax credits imputed, the utilization rate is 40%. By contrast, the "distribution rate" of imputation credits is that proportion of taxes paid by the company that are allocated out as imputation credits (and this is obviously correlated to the company's dividend pay-out ratio).<sup>80</sup>

Fig. 5.4: Who redeems dividend imputation credits?

Imputation Credits claimed in the 2013 income year	\$'000
Individual 10.5%	13
Individual 17.5%	82
Individual 30%	95
Individual 33%	1310
Trust	2361
Company	904
PIEs, superfunds, and other	159
Non-resident and unallocated (individual non-filers, exempt entities)	3155
<b>Total</b>	<b>8079</b>

(Source: New Zealand IRD)

Fig. 5.5: Imputation credits claimed in 2013 income year



\$8.1 billion imputation credits were reported by companies in returns to IRD in 2013. Essentially, we can conclude that – ignoring timing differences – a minimum of 61% of the credits have been claimed in tax returns, so have released value to underlying investors.

While that can be seen as endorsing the workings of the current system – and it's higher than we had expected – it still means that up to 40% of imputation credits generated in 2013 were not utilised.

For those credits that were utilised, less than 3% were claimed by individual investors who are on tax rates lower than the top tax rate. This perhaps reflects that being on lower marginal tax rates they have less disposable income to invest. Further, where such individuals are primarily salary or wage earners, they might choose not to file income tax returns and so they would partially, but not wholly, utilise their allocated ICs, and nor would they carry them forward to use in future income years. It suggests that where credits are utilised, they are mostly utilised for value.

The 40% of non-resident and unallocated imputation credits indicates that a significant portion of imputation credits are not utilised and are essentially wasted.

<sup>80</sup> Refer Martin Lally, November 2013.



# The 40% of non-resident and unallocated imputation credits indicates that a significant portion of imputation credits are not utilised and are essentially wasted.

## 5.4 Summary

5.4.1 There is no “market” for imputation credits as such, that is, they cannot be traded, nor can unused credits be refunded by the government.

5.4.2 There are two “value” propositions for imputation credits, albeit these are related. One is the “market value” as is determined by share price movements for companies that pay imputed dividends, versus companies that pay unimputed dividends. The other is the “redemption value” which represents the ultimate realisation of a company’s imputation credits as credits/reductions of tax otherwise payable by shareholders (via their tax return process).

5.4.3 New Zealand corporates widely regard imputation credits as “valuable” but struggle to attach any specific value to them. Our investor proxies were much clearer about attaching a shareholder’s value to imputation credits and these broadly averaged out at 70%.

5.4.4 Notwithstanding the above, when it came to market pricing, corporates generally believe that an imputing company would command a premium to its share price (and conversely a discount if it ceased imputing). This follows closely from the corporate mind-set that regards imputing as highly important for maximising shareholder returns.

5.4.5 By comparison however, investors felt that imputing or not imputing would have little, or only marginal at best, impact on share prices. In contrast to this, research (primarily Australian driven) has long existed that the market does price in a premium for imputing shares over unimputing shares. While this share price drop-off research (ex-dividend), has arrived at varying values for imputation credits (in the market), the reasonably consistent value is around 50% to 60% of the face value of the credit.

5.4.6 Interestingly here, a significant gap exists between imputation credits distributed, and those that are actually utilised or redeemed. Our interpretation of IRD data suggests up to 40% of distributed imputation credits are unutilised and wasted. We suspect that this figure is higher still. This refers to the actual redemption of imputation credits through the tax return process. Many investors are unable to extract full value from the distributed credits by reason of their status as foreign shareholders, or tax exempt shareholders, or low tax rate non-filing investors. So, while \$100 of corporate generated imputation credits may be distributed, only \$60 or less may actually be either fully or partially redeemed against shareholder tax liabilities.

5.4.7 While a number of corporates were highly analytical about their shareholders, and what tax profile and imputation strategies could work best for certain classes, the mainstream adopted a straightforward approach. This was simply to attach full imputation credits on the basis that if a group of shareholders could benefit, then that was sufficient. So, companies that were majority foreign owned could still benefit their minority New Zealand shareholders by attaching full credits (as required<sup>81</sup>). This is hard to argue with, and makes sense. If a company has paid New Zealand tax and has accumulated imputation credits, then given this balance is of no asset value to the company, then justification exists with an approach to pass them out on dividends to shareholders thereby benefiting a minority, even though the majority of credits may be of no benefit and wasted.

<sup>81</sup> The Income Tax Act 2007 imputation provisions require this (sections GB 35 and GB 36).

# 6. Imputation and the winds of change?

## Need to know

### Context

- ▶ Imputation has been in place for nearly 30 years in both New Zealand and Australia
- ▶ Australia is now reviewing whether its imputation system still has a part to play

### Survey respondents believe

- ▶ Overwhelming support exists for our imputation regime from both corporates and investors
- ▶ Support is based on the way it taxes profits once and only once, lowers the cost of capital and is fair and equitable
- ▶ There's also support for mutual recognition of imputation and franking credits between New Zealand and Australia - but no confidence that it will happen

### What does this mean for New Zealand?

- ▶ If Australia abandons its imputation system and cuts its company tax rate, pressure could build on New Zealand to follow
- ▶ A strong business case exists for retaining imputation, even if Australia changes tack
- ▶ Recent new financial modelling suggests that mutual recognition may cost governments much less than previously thought - this warrants a further push for change, but Australian business needs to shoulder this
- ▶ An alternative would likely be an (inefficient) classical tax system, with a headline corporate tax rate cut of perhaps only 2%
- ▶ Many New Zealand businesses depend on access to scarce domestic capital, and a change to a classical system would make that access harder (at our peril)
- ▶ Imputation is also good for the government as it discourages tax avoidance and encourages tax payments in New Zealand rather than overseas

**This chapter reflects on the widespread support that exists for imputation across both corporates and investors, while also outlining preferences for changes to the existing system. Meanwhile, within Australia many argue the system of imputation may no longer be delivering the benefits originally intended.**

**If this were to result in changes to abandon the system, there would likely be repercussions for New Zealand. We think imputation remains a good system and we would be reluctant to see major change regardless of any steps taken by Australia.**

## 6.1 New Zealand support for our imputation regime

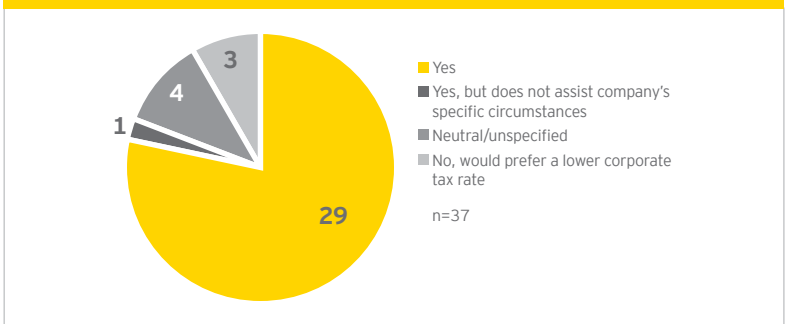
Both corporate and investor participants were asked whether they supported the continuation of New Zealand's imputation regime, and the reasons for their answers were explored.

From our survey, 20 corporates (out of 25) and 10 investor groups (out of 12) strongly supported our dividend imputation regime. The main reasons given were because it:

- ▶ Eliminates the double taxation that would arise in a classical tax system<sup>82</sup>
- ▶ Is therefore fair and equitable for shareholders
- ▶ Enables companies to make high dividend pay-outs
- ▶ Lowers the cost of capital for domestic equity investors
- ▶ Provides value uplift for investors
- ▶ Is a logical, coherent system and works well
- ▶ Integrates the company taxes with its shareholders

This last point is significant. The relatively small 5% difference in the corporate and top personal tax rates in New Zealand means that the integration aspects of our imputation system work better than Australia's.<sup>83</sup>

Fig. 6.1: Corporate & investor support for dividend imputation



This graph reflects the overwhelming support for imputation given a 30 strong vote of confidence, with 4 neutrals, and only 3 seemingly interested in an alternative to imputation.

### Imputation's effect on cost of capital

The point regarding imputation lowering the cost of capital is worth further exploration.

Imputation systems work best when the marginal, price-setting investor is subject to the domestic tax system. This seems likely to be the case in New Zealand, given the relatively low and declining profile of overseas ownership of NZX-listed companies (as shown in Appendix D).

Companies invest where the expected return on that investment at least covers the rate of return required by providers of the company's capital - both debt and equity. In a closed economy, it could be expected that imputation would reduce the cost of capital compared to a classical system - equity investors pay less tax.

<sup>82</sup> A classical system is clearly seen as the main alternative to imputation in New Zealand, and this chapter treats classical tax as the main counterfactual to imputation. Australian studies tend to look to other corporate tax systems, such as an expanded and greater allowance of foreign tax credits, as viable changes to its system. New Zealand business has no such expectation, with mutual recognition of franking and imputation credits being the main focus of debate here.

<sup>83</sup> For an elucidating explanation of New Zealand's tax policy and the effects here within an imputation setting, see Matt Benge and Rob McLeod (2012).

However, where an economy is open to foreign capital, and such capital is readily available, the cost of capital will be influenced by international capital markets. International investors will benefit from imputation credits to a much lesser extent. If – and it's a very big if – the cost of capital is set by the international capital markets, the availability of the tax credit can be seen as a subsidy to the domestic equity investor.

Of course, as imputation makes domestic investment cheaper for New Zealand businesses, it makes offshore investment more expensive in the long run. Foreign taxes are non-creditable taxes for imputation purposes as against domestic investments that generate imputable taxes. New Zealand companies that invest offshore will be unable to impute dividends sourced from overseas profits on which no New Zealand tax has been paid. While any shareholder liability only arises on eventual distribution, that still means that companies will require a higher rate of return to justify offshore investment.<sup>84</sup>

### Reservations over our imputation system do exist

The minority with reservations felt the regime disadvantaged corporates with predominantly international operations. They argue that a lower corporate tax rate would be preferable.

We suspect this minority does not appreciate how small any tax cut is likely to be. Under a classical (double tax) system, we would expect behavioural change at a corporate level, with implications for investors, and ultimately the government. It is virtually certain that dividends would reduce, with a strong incentive for companies to retain profits, reducing the second level of shareholder tax take and affordability of any cut. IRD analysis for the Capital Markets Development Taskforce suggested that the extent of this behavioural change on a move to a classical tax system would allow only a small reduction in the corporate tax rate: perhaps 2%.<sup>85</sup> That's lower than we would estimate for Australia, as unlike New Zealand, Australia currently allows refundability of unused franking credits to Australian superannuation funds and certain income tax exempt organisations and so this concession would be priced in to the tax rate trade off.



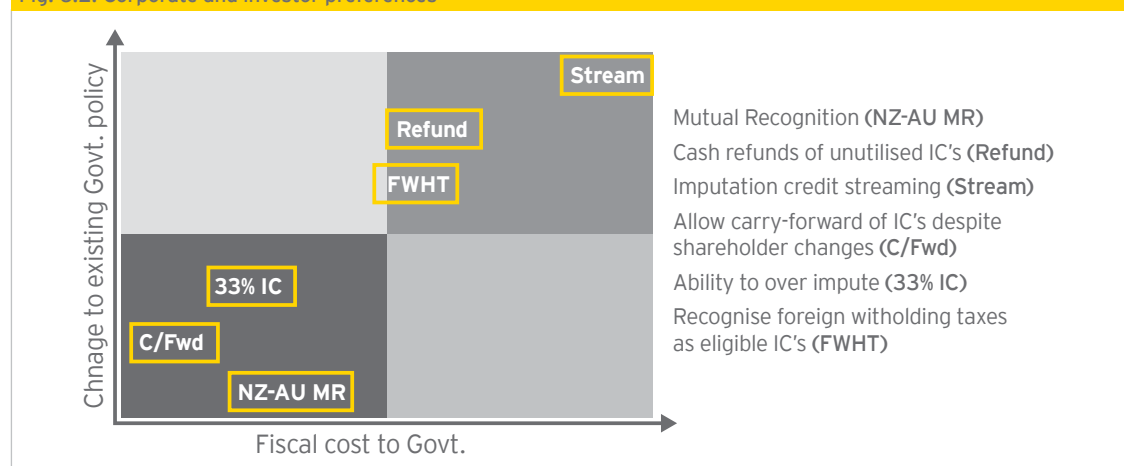
<sup>84</sup> This analysis assumes that a foreign investment is substitutable for a domestic investment. The New Zealand experience of a small domestic market instead suggests that foreign investment is more likely to be complementary to domestic investment, rather than substituting for that investment, or even that foreign investment can be the only choice for particular asset types given the thin domestic market.

<sup>85</sup> Refer to extended analysis in chapter 6 of *Capital Markets Matter: Report of the Capital Markets Development Taskforce* (December 2009).



# Any calls for tax reform would require considerable support, a strong business case, and an outcome that is not inconsistent with wider tax policy.

Fig. 6.2: Corporate and investor preferences



## 6.2 Suggested improvements to our imputation regime

Respondents were also asked how the current system could be improved. Despite the majority agreeing that the system works well, there were still calls for:

- ▶ Mutual recognition of imputation and franking credits between New Zealand and Australia
- ▶ Cash refunds of imputation credits that are unable to be utilised by shareholders (e.g. low rate investors, and tax exempts/charities)
- ▶ Imputation credit streaming
- ▶ Companies to be permitted to carry forward their imputation credit balances, rather than forfeiting them when material changes of shareholder occur
- ▶ Over-imputation, from the current maximum 28%, at rates of up to 33% thereby removing any residual liability for domestic shareholders
- ▶ Recognising foreign withholding taxes as eligible imputation credits

We note these cover well-traversed ground, evidencing the stability of imputation over many years. Any calls for tax reform would require considerable support, a strong business case, and an outcome that is not inconsistent with wider tax policy. Government fiscal policy is also paramount, and this alone suggests change may be unlikely. Figure 6.2 below highlights our view of the consistency of those calls with current imputation policy settings, and estimates their likely cost – all would be likely to reduce the government tax take. The less consistent with current settings and the higher the cost, the less likely we consider that changes to New Zealand's imputation regime will occur. Table 6.3 provides greater analysis on these suggestions in more detail.

We attribute a low fiscal cost to mutual recognition on the basis that recent financial modelling suggests a five year average of NZ\$111 million to the Australian government using Australian data (NZ\$164 million using New Zealand data), with even lower costs to the New Zealand government. This modelling, carried out by the Australian-New Zealand Leadership Forum (and submitted to Australia's White Paper process in May 2015), could breathe new life into the mutual recognition debate.

Table 6.3 Changes suggested by Corporates and Investors to New Zealand's imputation system

Suggestion for improvement	Our comment
Mutual recognition of imputation and franking credits between New Zealand and Australia companies, and shareholders (n= 36)	<p>All corporates surveyed expressed support, but were highly sceptical that it would ever be implemented. Comments included the issue was a “dead duck”. One corporate supported mutual recognition, but would prefer imputation credit streaming.</p> <p>Support stemmed from corporate belief that it would encourage more Australian investment in New Zealand's companies and provide overall benefits for companies on both sides of the Tasman.</p> <p>We believe that the more modest fiscal costs now attributed to a change to mutual recognition justify a renewed push for reform as part of Australia's White Paper process.</p> <p>While mutual recognition was raised frequently, the trans-Tasman imputation grouping rules barely received a mention. The rules appear to add little value despite the political and technical firepower that went into their development.</p>
<p>Cash refunds of imputation credits that are unable to be fully utilised by shareholders (e.g. low rate investors, and tax exempts/ charities) (n= 12 )</p> <p>(Currently excess, unutilised ICs can be carried forward by individuals to future years. The benefit here depends on shareholders filing tax returns, and shareholders generating other sources of income that are untaxed).</p>	<p>Australia has allowed limited refundability for many years and this feature is of particular importance to the low taxed superannuation industry. In New Zealand, this issue is a real challenge for tax exempts and entities with a large number of lower income shareholders, and is an issue for at least one of our sample. From a policy perspective, this is more consistent with a fully integrated system and therefore has some basis in tax equity. The Australian experience is that this has a marked uplift in the value of imputation credits. However, this measure will have a fiscal cost to the government.</p>
<p>Imputation credit streaming (n= 9)</p> <p>(Being the ability of companies to stream imputation tax credits in favour of those shareholders who could obtain most value from them, and away from those shareholders who could least benefit.)</p>	<p>As with mutual recognition, we consider any moves towards streaming improbable. The government argued in its Discussion Document - Streaming and refundability of imputation credits (2008) - that streaming was inconsistent with imputation's policy objectives – it would undermine the ability to apply a single layer of tax to company profits. It also argued that the cost of streaming could be up to \$3.2 billion. While this seems extreme, even a fraction of that amount is likely to be viewed as unaffordable in the current fiscal environment.</p>
<p>That companies be permitted to carry forward their imputation credit balances, rather than forfeiting them (as is the case now) when material changes of shareholder occur (n=5)</p>	<p>Given that many imputation credits are distributed as a matter of course prior to any breach of continuity, this suggestion has merit as a compliance reduction measure. The Australian system allows companies to carry their franking credit balances forward despite ownership changes.</p>
<p>Over-imputation (n=2).</p> <p>(That companies be allowed to impute up to 33% on dividends, up from the current maximum 28% [being the corporate tax rate] thereby removing any residual liability for domestic shareholders.)</p>	<p>This idea has some merit as a compliance cost saving since it would eliminate any residual personal tax liabilities on dividends (and with this the RWT). We observe that less than 3% of imputation credits are claimed by individuals on marginal tax rates below 33%, and so a case exists here. The flip side however, is that this would disadvantage non-residents and non-filing lower rate taxpayers.</p>
<p>Recognising foreign withholding taxes as eligible imputation credits (n= 2).</p> <p>(Foreign WHT would be suffered when a New Zealand company derives interest, royalties, and dividends from abroad.)</p>	<p>In policy terms, this would undermine the government's aim of applying a single level of New Zealand tax. In its favour, this change would counter the imputation tax bias against foreign investment by New Zealand businesses. However, any change in this direction is unlikely.<sup>86</sup></p>

<sup>86</sup> In contrast to New Zealand, this initiative has attracted more focus in Australia, with some major corporates calling for change to allow foreign withholding taxes as eligible franking credits (on a diluted basis). This greater push reflects a higher level of outbound investment in Australia, with a corresponding higher level of significance on this matter.

# In our view, Re:think weights the argument that imputation subsidises domestic capital well beyond its limits.

## Our imputation and FITC/supplementary dividend regime for foreign shareholders is confusing

While not directly a part of the imputation system, the foreign investor tax credit (FITC) and supplementary dividend rules remain poorly understood. The level of understanding of these rules was quite mixed across all our surveyed parties, with no party fully grasping the detail. There exists a perception that overseas investors would prefer a straight exemption from non-resident withholding tax where dividends are fully imputed (similar to Australia) as this is simpler to explain. The design of the FITC and supplementary dividend regime was to provide foreign investors in New Zealand shares with a step-up benefit (over Australia and other countries) by generating a greater level of New Zealand tax as a creditable foreign tax in the investor's home jurisdiction. The regime is clever, perhaps too clever, and the design benefits appear to carry little weight, although the FITC regime does at least provide foreign investors with this opportunity to benefit.

## 6.3 The Australian context

In recent developments across the Tasman, doubts are being raised about the relevance and merits of their imputation regime. While many Australian businesses have spoken up in defence of imputation, as yet there is no word on its future.

### 6.3.1 Australia is questioning its imputation regime

Australia is currently part way through a tax reform process, with White Paper proposals anticipated before the next Federal Election in 2017. Influenced by concerns about the extent to which imputation benefits domestic investors compared to overseas investors, the Australian government's Re:think discussion document<sup>87</sup> (released April 2015), preceding *Murray Financial Systems Inquiry*<sup>88</sup> and Henry Review<sup>89</sup> all cast doubts on the future of imputation in Australia.

All state that imputation distorts Australian residents' investment decisions, creating preferences for domestic (over foreign) investment. They argue that equity prices are set by the marginal foreign investor, who gets no benefit from imputation credits.

None of the Australian reviews offer definitive future reforms, with the Australian government recently seeking feedback to help form its views before releasing the White Paper.

We are not convinced that imputation distorts many investment decisions. In our view, Re:think weights the argument that imputation subsidises domestic capital well beyond its limits. Taken to its logical conclusion, it suggests that a share held by a foreigner sets a reference market price for all shares in Australian companies. We think that is a very questionable proposition across all companies and markets, such as unlisted markets.

<sup>87</sup> <http://bettertax.gov.au/publications/discussion-paper/>

<sup>88</sup> Financial System Inquiry Final Report, released December 2014  
<http://fsi.gov.au/>

<sup>89</sup> Australia's Future Tax System Review Final Report, released May 2010  
<http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/home.htm>

# While we would never deny the merits of a corporate tax cut for business, speculation across the Tasman has suggested that a company tax rate reduction to as low as 20% could be achievable. We suspect this contains a degree of wishful thinking.

Another complicating issue is the extent to which the decisions of corporate directors and executives focus on a marginal shareholder. Company law typically promotes the interest of the company as a whole rather than classes of, or individual shareholders. A company with a mix of shareholders confronts group rather than individual interests. Voting coalitions can also be unstable and a minority shareholder can sometimes secure de facto control at the margin of two or more larger shareholders.

We also note that some foreign shareholders do benefit from imputation because franked dividends are exempt from Australian NRWT, whereas unfranked dividends bear this 15% tax (a point seemingly overlooked by the Financial Systems Inquiry).

## 6.3.2 A lower corporate tax rate for Australia?

Re:think reveals the Australian government's apparent preference for a lower corporate tax rate over retaining the dividend imputation regime.

It emphasised that a lower corporate tax rate could have benefits:

- ▶ Increasing Australia's appeal to foreign investors – emphasised foreign investors' existing inability to utilise imputation credits
- ▶ Capital deepening resulting from increased foreign investment, with increases in productivity, innovation, employment, and wages
- ▶ Reduced tax planning by big corporates, with fewer profits being shifted from Australia

A cut in the corporate tax rate would be funded by removing concessions, with imputation classed as a concession.

While we would never deny the merits of a corporate tax cut for business, speculation across the Tasman has suggested that a company tax rate reduction to as low as 20% could be achievable. We suspect this contains a degree of wishful thinking. If Australia's imputation system were to be replaced by a classical tax system, that creates a strong incentive for corporates to retain profits, rather than distribute them.<sup>90</sup> As would be the case in New Zealand, once the likely behavioural changes to dividend paying behaviour are taken into account, moving from imputation to a classical tax system would likely fund only a modest reduction in the company tax rate unless complex and distortionary excess profit retention provisions were also introduced. A classical system would also reintroduce the debt/equity biases that imputation was designed to remove. Our view is that a revenue neutral corporate tax reduction in Australia could be as little as 4% off the current rate (ie., from 30% down to 26%). This reduction would still be more than we think is possible for New Zealand given that unlike New Zealand, Australia would reap the benefits of reducing existing costs associated with its concessions that provide refunds of unused franking credits to superannuation funds and certain income tax exempt organisations.

## 6.4 Effects of Australian change on New Zealand

Crucially, any changes in Australia could have flow-on effects for New Zealand because of our closely inter-twined economies and tax systems, and the large amount of trans-Tasman inbound and outbound investment.

<sup>90</sup> This follows from Australia's individual tax rates being comparatively high – currently at 49% for the top marginal rate (including the Temporary Budget Repair Levy & Medicare Levy), relative to an expected lower corporate rate – as low as 20%, more likely 25% or 26%.



### 6.4.1 Mutual recognition

The New Zealand Government has made a submission on Australia's reform process.<sup>91</sup> This submission focuses on New Zealand's continued desire for mutual recognition of imputation and franking credits, and is an unusually public effort by diplomatic standards.

With one exception, all our survey participants strongly favour a change to allow mutual recognition. We sympathise with this group since they are worn out with this very protracted debate, and now have little hope about the prospects for success. Australia first needs to decide on the future of its franking system, as discussed above. Business reaction across Australia, however, clearly favours franking's retention, and so this hurdle may possibly be cleared. Even so, there have been a string of Ministerial, official and unofficial approaches from New Zealand to Australia requesting variants of mutual recognition over the last 20 years, with little sign of any Australian movement beyond the current trans-Tasman imputation groups.

For any realistic chance of a change in the Australian position, we think that pressure would need to come from Australian businesses, rather than New Zealand businesses. The problem here is that in our experience mutual recognition is well down Australian businesses' wish lists, with many businesses there looking elsewhere at expansion to larger markets than New Zealand.

It is doubtful the New Zealand government would have adopted this low-key public submission approach if it saw a strong prospect of success. In our view, the most likely alternatives are for Australia to maintain its current system; or other corporate tax to a lower headline tax rate under a classical system; with mutual recognition a distant third.

### 6.4.2 If Australia does cut its headline corporate rate, what could this mean for New Zealand?

If Australia cuts its corporate tax rate and abandons imputation, there will be pressure on New Zealand to follow suit.

New Zealand has few concessions to remove, so any headline rate cut here would likely require compensating increases elsewhere in the tax system – whether that be through imputation, or elsewhere.

New Zealand's imputation system works well and has strong support as shown above. Even so, if Australia moves away from imputation, New Zealand will need to look at whether to follow suit. It would be difficult for New Zealand to maintain an imputation system in a world dominated by classical or other tax systems, which have corporate rates of tax well below 30%, if our largest investment partner follows this trend.

The real pressure may be that it will be increasingly difficult for New Zealand to attract investment (and to tax profits here) if headline corporate tax rates are significantly lower elsewhere. New Zealand will be faced with tough choices around the future of our imputation system, our company tax rate, and our tax base.

<sup>91</sup> Submission of the Government of New Zealand, 28 May 2015, [http://twp-staging.tspace.gov.au/files/2015/06/New\\_Zealand\\_Government.pdf](http://twp-staging.tspace.gov.au/files/2015/06/New_Zealand_Government.pdf)



### 6.4.3 It's vital that we think through the impact on New Zealand's capital markets

**"When things look ugly for the local share market there will always be a set of investors drawn in looking for yield and a decent dividend."**

**Philip Baker, Australian Financial Review, 2 April 2015**

*Philip Baker is Associate Editor at the Australian Financial Review.*

We believe any move away from imputation would have a negative effect on New Zealand's capital markets. A study<sup>92</sup> of the effects of the United Kingdom's repeal of its imputation system shows a significant fall in the value of dividends and the attractiveness of high yielding stocks to investors disadvantaged by its abolition, notably pension funds. Extrapolating from this study's findings, we warn that removing imputation could risk some capital flight from the NZX.

#### Many NZX listed companies depend on domestic capital

For large firms with good access to global equity capital, dividend imputation may have limited effect on their cost of capital.<sup>93</sup> For smaller firms, however, which are particularly important to the New Zealand economy, much of their capital will be sourced domestically. Domestic equity providers will price the benefit of imputation credits into their decision to provide finance.<sup>94</sup> Without imputation, that capital may well go elsewhere, or demand a higher return. This would make it more expensive for many New Zealand businesses to raise funds and risks investment being curtailed.

#### Imputation boosts retail presence in capital markets

We speculate that any move to abolish imputation would lead to an increased cost of equity, reduced dividend yields, and domestic investment both directly and indirectly becoming less attractive.

With debate about the future of Australia's imputation system, similar arguments have been raised there. Philip Baker,<sup>95</sup> for example, comments that:

- ▶ Imputation opened up the sharemarket to retail investors, in that the consistent, reasonably taxed, dividend stream facilitated by imputation made direct investment a viable proposition for individuals
- ▶ Imputation also forced companies to generate positive cash flow to fund that dividend stream, rather than paper profits or poorly thought-out expansions

In Australia, since imputation started in 1987, the size of the sharemarket has grown from around AUS\$140 billion to AUS\$1.65 trillion. Sharemarket participation has risen from less than 20% to more than 50%. Of course, much of this growth is due to Australia's substantial managed funds industry, which has benefited from a concessional low rate of tax combined with an entitlement to refunds of excess (unutilised) imputation credits.<sup>96</sup>

In New Zealand, the introduction of KiwiSaver has helped to reinvigorate New Zealand's domestic markets, although evaluation of this effect is limited. The majority of KiwiSaver funds are invested offshore. As of March 2015, scheme providers held \$28.2 billion in KiwiSaver schemes, of which it is estimated around 8% has been invested in domestic equities.<sup>97</sup> In the medium-to-long term, KiwiSaver funds are expected to grow, and in the absence of imputation we would anticipate even more of the KiwiSaver funds will flow offshore. Similar arguments can be made for other managed fund providers and even bodies such as the New Zealand Superannuation Fund.

<sup>92</sup> Bell, L and T Jenkinson (2000) <http://www.economics.ox.ac.uk/research/WP/PDF/paper024.pdf>

<sup>93</sup> Total market capitalisation of the NZX is \$103.5 billion (as at 7 August 2015), with 162 listed companies. However, this headline number disguises a paucity of large companies. As of 31 July 2015, the median capitalisation of an NZX-50 company was \$1.085 billion, with the bottom cut off only \$226 million. The vast majority of listed stocks in New Zealand are too small to appeal to many global sources of capital.

<sup>94</sup> We adhere to this view notwithstanding some inconsistencies with the stated attitudes by investors that shares bearing imputed dividends either do not command a share price premium, or only marginally at best. On this refer to 3.6.6 and earlier.

<sup>95</sup> Why cutting dividend imputation will hit share investors and damage the sharemarket, Philip Baker, Australian Financial Review, 2 April 2015 <http://www.afr.com/personal-finance/why-cutting-dividend-imputation-will-hit-share-investors-and-damage-the-sharemarket-20150401-1mals>

<sup>96</sup> Arguably this refund of excess franking credits generates a dividend uplift to investing superannuation funds.

<sup>97</sup> <http://www.rbnz.govt.nz/statistics/tables/t43/> indicates that KiwiSaver investment in New Zealand equities was \$2.2 billion.

# The majority of our corporate respondees view imputation as highly important in delivering optimal returns to their shareholders.

## 6.5 Final thoughts

Dividends are driven by commercial factors. Participants universally refer to capital requirements as being more significant than tax. Nevertheless, tax settings do play a major part in dividend policy. Tax efficiency (including imputation) features as one of the key dividend policy drivers for 60% of corporates surveyed.

Imputation is at the heart of our tax settings. It has enabled the high pay-outs we see as a core feature of the New Zealand capital market. In our view, the way in which imputation lubricates high dividend pay-out ratios has a positive impact on share prices. The tax "neutralising" effect of the regime has also encouraged special dividends over share buy-backs, and the growth of DRPs.

The majority of our corporate respondees view imputation as highly important in delivering optimal returns to their shareholders. In many cases this has stimulated some tax induced behaviours to bolster an imputing capability. We should acknowledge that imputation is less important to investor groups. Tax imputed returns are factored in by investors, but do not drive their recommendations. The value of imputation credits differs depending on investor tax profile.

New Zealand's imputation system is overwhelmingly supported. Imputation works efficiently within the existing tax system and is deeply entrenched. In our view, this entrenchment has spawned a "take for granted" approach across a number of corporates and investors and rendered imputation as underestimated in its importance and, in some cases, under-valued. This complacency would be shaken if the imputation regime was replaced.

The results of our survey lead us to the view that any move towards abolishing our imputation system could result in a radical challenge to accepted equity marketplace behaviour. It could lead to the less efficient allocation of capital. It would tilt the choice between debt and equity, and between onshore and offshore investment in an already thin market.

Imputation has served New Zealand well. We hope it continues to do so.







# Appendices

# Appendix A: Survey participants

NZX 10 Index	Sector (NZX unless stated)
Auckland International Airport Limited	Infrastructure & Ports
Fletcher Building Limited	Building
Fisher & Paykel Healthcare Limited	Intermed & Durables
Ryman Healthcare Limited	Infrastructure, Finance & Other
Sky Network Television	Media & Comms
SKYCITY Entertainment Group Limited	Leisure & Tourism
Spark New Zealand Limited	Infrastructure, Media & Comms

NZX 50 Index	Sector (NZX unless stated)
Air New Zealand Limited	Transport
Freightways Limited	Transport
Genesis Energy Limited	Energy
Infratil Limited	Infrastructure & Investment
Mainfreight Limited	Infrastructure & Transport
Mighty River Power Limited	Infrastructure & Energy
NZX Limited	Finance & Other
Nuplex Industries Limited	Building
Restaurant Brands NZ Limited	Consumer
Tower Limited	Finance & Other
Vector Limited	Energy

Other NZX listed corporates	Sector (NZX unless stated)
Abano Healthcare Group Limited	Finance & Other
Hellaby Holdings Limited	Investment
The New Zealand Refining Company Limited	Energy
Turners Limited (formerly Dorchester Pacific Limited)	Finance & Other

Unlisted companies	Sector (NZX unless stated)
Fulton Hogan Limited	Building*
Tru-Test Limited	Intermed & Durables*
Zespri Group Limited	Agriculture & Fishing*

Investment groups	Sector (NZX unless stated)
Castle Point Funds Management Limited	JBWere (NZ) Pty Limited
Craigs Investment Partners Limited	Macquarie Equities New Zealand Limited
Devon Funds Management Limited	Mint Asset Management New Zealand Limited
First NZ Capital Securities Limited	New Zealand Superannuation Fund
Fisher Funds Management Limited	Salt Funds Management Limited
Forsyth Barr Limited	UBS New Zealand Limited

\*EY extrapolation of sector classification

# Appendix B: Methodology

The current study was initiated following observations<sup>98</sup> of how companies identified with the corporate-shareholder value paradigm differentially. And so began a review of corporate dividend and imputation research, primarily from Australia sources, but also New Zealand.<sup>99</sup> The literature included work carried out by university academics; government organisations; industry studies and reports; and investment houses' research. Supporting data was also sourced from the IRD and the NZX (with thanks to both organisations).

Primary data collection was undertaken during the second half of 2014 and beginning of 2015, with two groups of informants:

1. Corporates – participants included directors and/or CFOs from 25 New Zealand companies, including large NZX-listed enterprises, closely held corporates and co-operatives. The industries represented were utilities, manufacturing, telecommunications, entertainment, building and infrastructure, agriculture, transportation and financial services.
2. Investors – these 12 participants included equity analysts and advisers, and fund managers (as proxies for the investor community).

Based on their role in the corporate or investment sector, participants were contacted directly by us and invited to take part in the research. The response rate was 100%.

A survey questionnaire was devised for each of the two groups, utilising open-ended and yes/no questions, and rating scales. Questions explored dividend policies, special distributions, investment advice, investor preferences, the impact of New Zealand's imputation regime on decision-making, the real value of imputation credits, possible regime improvements, and the implications of change.

The survey questionnaire was sent to each participant prior to a face-to-face interview and discussion (typically lasting 60 minutes) with a key EY staff member.

Data was then collated and analysed to show trends within and between groups. All responses have been anonymised in the current report.

<sup>98</sup> Such observations were accumulated from many years assisting clients, as well as company transactions, in our capacity as commercial minded tax practitioners.

<sup>99</sup> These sources are acknowledged in our references.



# Appendix C: Analysis of imputation tax credit value across different Investor classes

Different classes of investor receive different value for imputation credits depending on their own tax profile. Fig. C.1 highlights these differences.

**Fig. C.1: Imputation credit value by investor category - based on a fully imputed dividend (with 28% tax credit), taxed at the investor's marginal tax rate**

Investor category	Marginal tax rate	Average tax rate	Value of imputation credits	Excess/shortfall of imputation credits	Comments
Foreign	15%	15%	15%	13% excess	Being the NRWT saving (albeit via New Zealand's FITC regime). Note that while 15% is the standard rate of NRWT, some of New Zealand's recent double tax agreements reduce this rate.
Charities/ not-for-profits	Nil	Nil	Nil	28% excess	No value as ICs are not refundable.
Low rate investor (Earning less than \$14,000 p.a.)	10.5%	10.5%	10.5% +	17.5% excess	If a low rate investor has "other taxable" income, the excess ICs can be used to credit this tax (provided the investor files tax returns).
Mid-rate investor (Example earning \$48,000 p.a.)	17.5%	15.4%	17.5% +	10.5% excess	If a mid-rate investor has "other taxable" income, the excess ICs can be used to credit this tax (provided the investor files tax returns).
Upper rate investor (Example earning \$70,000 p.a.)	30%	20%	28%	2% shortfall	Balance likely covered by RWT withheld at source.
High rate investor (Earning more than \$70,000 p.a.)					
Example: \$100,000	33%	23.9%	28%	5% shortfall	Balance likely covered by RWT withheld at source.
Corporate investor	28%	28%	28%		At a flat tax rate of 28%, corporate ICs will fully relieve corporate investors tax liability.

Source: EY research

Note that salary and wage earners in particular, especially if they do not have any other income, may be unlikely to file tax returns, and therefore will not be redeeming the full amount of any imputation credits they receive. This could potentially give rise to wasted imputation credits.

The waterfall charts below show the effects of imputation and other tax changes on shareholder returns for selected investor classes on receipt of a \$100 gross dividend.

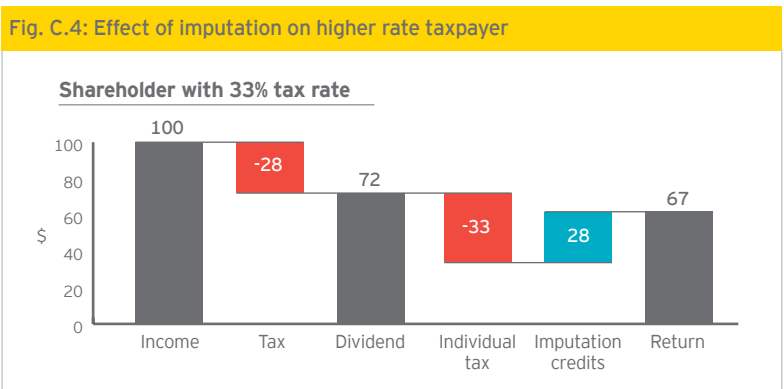
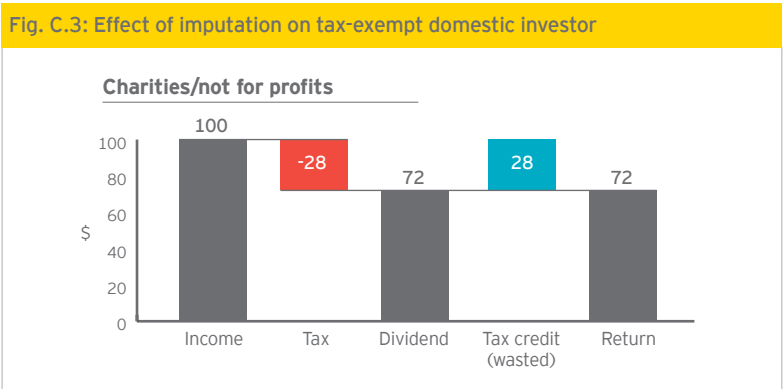
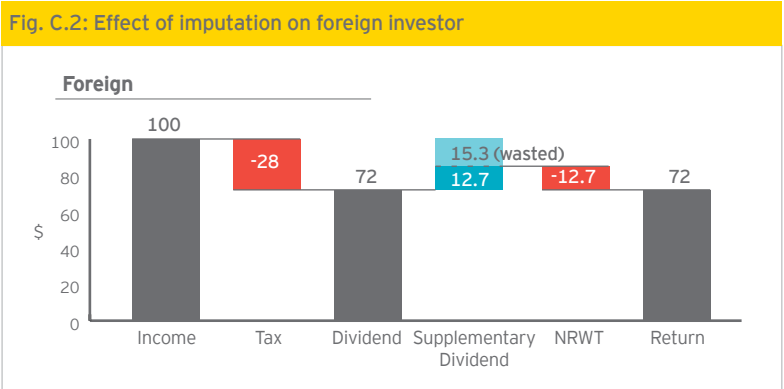


Fig. C.5: Effect of imputation on corporate investor

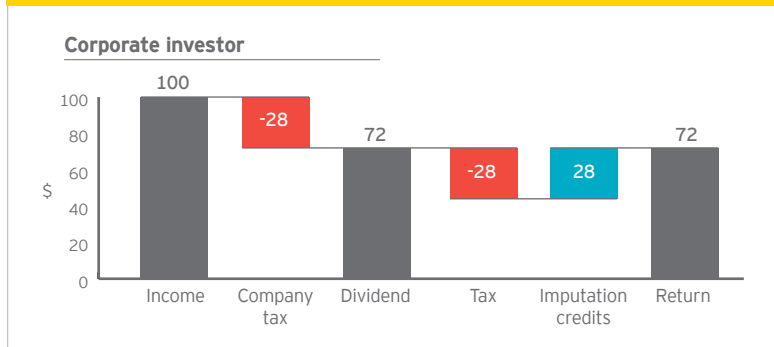
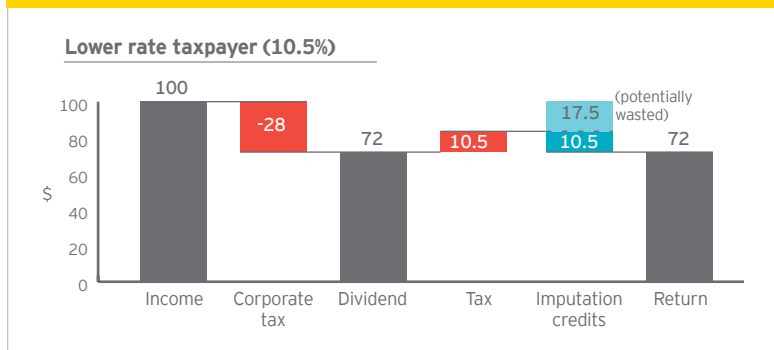


Fig. C.6: Effect of imputation on lower rate taxpayer



The lower rate investor example assumes that the investor either has insufficient income to utilise the remaining credits or has not filed a tax return.

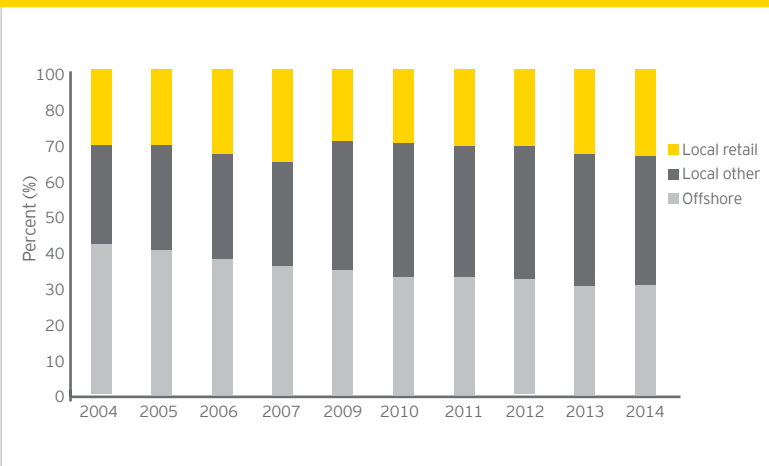
# Appendix D: Categories of investors in New Zealand equities

## Foreign ownership of New Zealand companies

Ownership/Investor Category	Percentage Ownership
NZ Managed Funds	22.1 %
NZ Retail Investors	26.4 %
NZ Strategic Stakes	18.5 %
Foreign Strategic Stakes	7.3 %
Foreign Other	25.7 %
Combined Foreign Ownership	33.0 %

Source: Goldman Sachs Equity Research, January 2015

Figure D.1: Ownership of New Zealand primary listings (percent of total, June years)



Source: Henry, Aitken and Koreman-Smit (2015).

Note: March years to 2009, June years thereafter

It is interesting to see that foreign ownership of NZX listings has trended down from 46% in 2004 to 33% in 2014. This has been driven by a number of factors. The introduction of KiwiSaver in 2007 has contributed to local managed funds increasing their participation in New Zealand equities, and currently around 8% of all KiwiSaver funds are invested in New Zealand equities. The mixed ownership model of state-owned enterprises that were recently partially privatised had a high level of participation by local investors which would have also affected foreign ownership levels, and would have likely raised public awareness of domestic shares. The trend could also have been a reflection of timing, as interest rates on bonds and bank deposits have been historically low in recent years. These low rates, combined with increased awareness of local equities through the government mixed-ownership model could have led to local investors seeking higher yielding investments and deciding to invest in New Zealand equities. Currently New Zealand retail investors own 26.4% of local equities, the highest since 2007.

# Appendix E: Imputation credit data

The data in this appendix is sourced from IRD and NZX, the support from whom we would like to place on record. Interpretations drawn are ours.

## NZX Listed Companies – Imputed Dividends

Figure E.1 shows total NZD-denominated dividends paid by NZX listed companies over time, and the extent to which they have been imputed (by value). We have made certain key assumptions in analysing NZX-data:

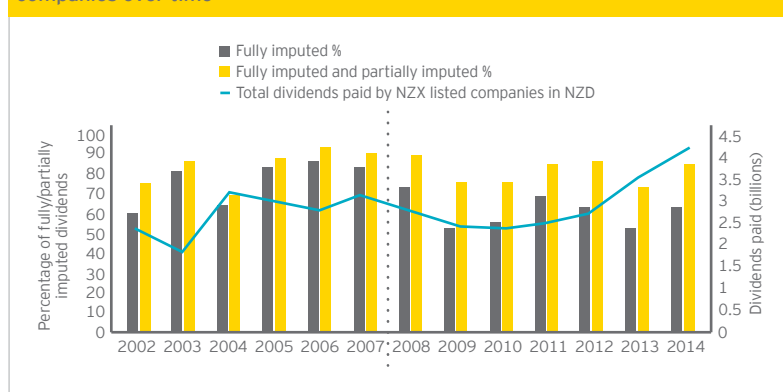
- ▶ Companies are considered New Zealand companies if dividends paid in NZD (this has the effect of excluding some major trans-Tasman corporates, such as pre-dominantly Australian owned banks)
- ▶ We have excluded dividends paid in foreign currency to determine % of dividends that are fully/partially imputed
- ▶ For transitional years,<sup>100</sup> dividends assumed fully imputed if imputation levels 30% or 33%
- ▶ Dividend payments are split into calendar years by date recorded

## Impact of the GFC is clearly apparent

Figure E.1 reflects a gradual increase in the percentage of fully and partially-imputed dividends being paid out up until a peak in 2006 where 92% of dividends paid out were at least partially imputed. With the advent of the GFC in 2007, the percentage of fully imputed dividends dropped off drastically from a high point of over 80% in 2007 to a little over 50% in 2009. Even post-GFC this has not fully recovered, settling instead around 60% instead of the 70-83% range pre-GFC.

In the early post-GFC years, a drop off in both dividend pay-outs and the extent to which those pay-outs were imputed was to be expected. Many companies generated tax losses, and so, had fewer imputation credits available: profits were sheltered by prior losses.

Fig. E.1: Total NZD-denominated dividends paid by NZX listed companies over time

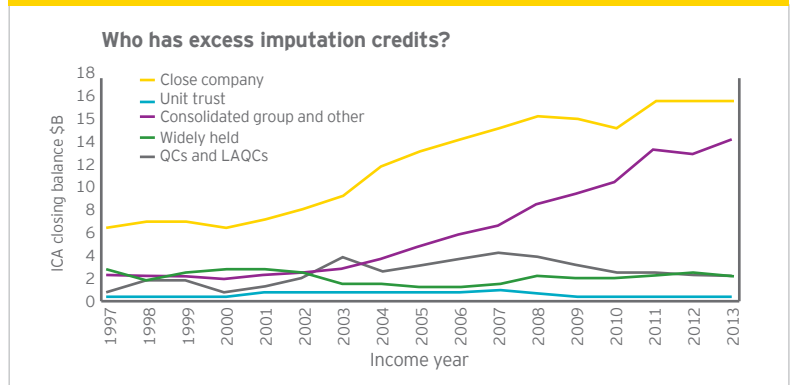


<sup>100</sup> "Transitional years" are those immediately following reductions in the corporate tax rate to 28% (from 30%) and 30% (from 33%). Companies were allowed a window of time in which to distribute credits generated at the higher rate.

What is curious is the lag in imputation rates on dividends post GFC (2010 onwards), even as pay-outs accelerated to record levels. This could have been due to a number of reasons such as:

- ▶ A flush out of losses post GFC meant companies did not have available imputation credits to attach
- ▶ Reduced use of tax pre-payments in the post-GFC era (companies potentially having less certainty around future profits and greater need to strengthen their balance sheets)
- ▶ Directors and corporates had reservations post GFC, and while they may have wanted to maintain a dividend in order to appease investors, not attaching imputation credits would reduce the amount of cash outflow
- ▶ Greater internationalisation of New Zealand corporates, with profits made and taxed overseas rather than at home  
Or
- ▶ An upwards and potentially non-sustainable increase in pay-out ratios as corporates seek to satisfy shareholders without having sufficient imputation credits to match that increased pay-out

Fig. E.2 The Stockpile of excess imputation credits



### Not all imputation credits are distributed

Figure E.2 uses data sourced from IRD, and shows around \$37.7 billion excess imputation credits in 2013. It reflects the amount of excess imputation credits held by different entity types. Again, we should highlight key assumptions and judgments. This data should be used only with caution:

- ▶ There is an element of double counting, estimated by IRD to be around \$2 billion, in this stockpile of credits. From 2004, companies have been able to elect to form imputation groups, with a consolidated return to IRD. IRD notes that individual members of imputation groups may separately file individual imputation returns, and it has not been possible to separately identify that double counting.
- ▶ The “consolidated group and other” category includes consolidated groups, Māori Authorities, local government and public authorities, life insurance companies and trans-Tasman imputation groups. This is a catch-all category, with the stock of credits mainly within widely held consolidated imputation groups.

Of note is the divergence between a build-up of credits within closely held groups and distribution from widely-held companies. While widely-held is a broader category than NZX-listed, it shows the same pattern of credits being pushed out to shareholders at the earliest opportunity.



# Glossary

Terms	Definitions
Amortisation	Reducing the value of an asset over time to reflect reductions in value.
Australia Securities Exchange (ASX)	The largest securities exchange in Australia.
Available Subscribed Capital (ASC)	Available subscribed capital, basically equating to the paid up/in share capital of companies. The relevance of ASC is that companies are able to undertake tax free returns of capital "up to" the level of their ASC.
ATO	Australian Tax Office
Bonus issues	Where instead of paying dividends, a company either (a) forgives an amount on unpaid shares owed by a shareholder or (b) issues or subdivides shares to a shareholder.
Capital gains tax (CGT)	A tax on capital gains, for example on profits derived from the sale of shares where the shareholder does not ordinarily trade in shares.
Carrying forward (e.g. tax, imputation credits)	Where prior year excess, e.g. of tax or imputation credits, can be offset against untaxed income in future years.
Cents per share (cps)	The dividend that a mutual fund or publicly-traded company gives to shareholders for each share on issue.
Chief Financial Officer	Senior manager responsible for overseeing the financial activities of an entire company, and its affiliates.
Dividend reinvestment plan (DRP)	Investors sign up to a plan through which they receive shares, often at a discounted rate, instead of dividends, without incurring transaction costs involved with buying more shares.
Empirical research, studies	Research that is based on observation, or by measuring actual experiences, rather than being based on theories or beliefs.
Equity market	Synonymous with the share market – where shares are traded or issued. Notably, the NZX; the ASX.
Foreign dividend payment (FDP)	Liability imposed by New Zealand tax system on foreign dividends; abolished from 2009.
Foreign investor tax credit rules (FITC)/supplementary dividend regime	The FITC rules limit the tax paid by non-resident investors on income from New Zealand investments to 28% (the corporate tax rate), by allowing New Zealand companies to pay an additional dividend known as a supplementary dividend. This is calculated such that the additional amount equals the NRWT payable that is deductible by the company on dividends to foreign investors.
Foreign withholding tax (FWT)	A foreign tax which is withheld from income, of substantially the same nature as non-resident withholding tax.
Franking credits (FCs)	The Australian equivalent of imputation credits.
Free cash flow (FCF)	A measure of financial performance calculated as operating cash flow minus capital expenditures. Free cash flow represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base.
GFC	The Global Financial Crisis of 2007-2008
Imputation credit account (ICA)	An account used to record the amount of imputation credits gained by a company.
Imputation credits (ICs)	Credits used by companies to pass on tax via dividends so that shareholders receive the benefit of tax already paid by companies and so are not taxed twice. Companies gain imputation credits when they pay income tax or receive dividends from other NZ companies that have imputation credits attached.
Imputed dividends	Dividends with imputation credits attached.
IRD	Inland Revenue Department.
"mid cap" or "small cap" shares	Shares with a relatively small market capitalization (in New Zealand, most listed companies).
NPAT	Net profit after tax.

Terms	Definitions
Non-resident withholding tax (NRWT)	Tax deducted at source on dividends (as well as on interest and royalties) derived from New Zealand by a non-resident investor.
Normalised profit	Profit adjusted to remove unusual or one-time influences, such as a major gain on sale of an asset.
NZX	New Zealand's only registered securities exchange.
Qualifying company (QC) and loss attributing qualifying company (LAQC)	Small, closely held companies similar to partnerships.
Share-drop valuation	This is where the value of imputation credits is determined by tracking shares paying fully imputed dividends, comparing these with shares paying unimputed dividends, and then comparing the share price drop off ex-dividend. (Refer footnote 65 for an explanation of research undertaken on this basis).
Resident withholding tax (RWT)	Tax deducted at source from dividend payments (and interest) to New Zealand residents. (Refer to the RWT and imputation interplay at chapter 3.3.2) "The cash reduction effect of RWT and the imputation interplay".
Special dividends	A one-off dividend payment from a company to shareholders, outside of its usual dividend cycle.
Streaming	Allowing companies to distribute imputation credits unevenly, so that the credits are distributed to investors who are best placed to utilize them, and are withheld from investors unable or unlikely to utilize them. New Zealand currently has anti-streaming rules.
Tax pre-payments	Paying tax in advance of tax liability due dates.
Total shareholder return (TSR)	Performance from an investor perspective. TSR measures the combined return from dividends, and other distributions, and the growth in value of the company.
Trans-Tasman imputation group (TTIG)	Australian and New Zealand companies can elect to form TTIGs together, enabling the companies to pass imputation and franking credits through to their shareholders. Australian and New Zealand shareholders are allocated imputation and franking credits representing tax paid in New Zealand and Australia in proportion to their ownership of companies. Credits can only be claimed by residents of New Zealand and Australia.
Unimputed dividends	Dividends with no imputation credits attached.
Utilisation rate (of dividends)	The % of investors actually able to redeem tax credits imputed to dividends received.
Use of money interest (UOMI)	Use of money interest. Interest paid on amounts held by the IRD, for example where a company prepays tax or pays more tax than it owes at a given time.
Weighted average cash of capital (WACC)	A calculation of a firm's cash of capital in which each category of capital is appropriately weighted.
Yield	The amount of cash (e.g. dividends) that investors receive from shares.

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