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Our ref KPMG submission – PUB00469: Income Tax – Whether an off-market share cancellation is made in lieu of the payment of a dividend

6 June 2025

Dear Sir | Madam

KPMG submission - PUB00469: Income Tax - Whether an off-market share cancellation is made in lieu of the payment of a dividend

We welcome the opportunity to comment on the draft interpretation statement providing Inland Revenue's updated guidance on when off-market share cancellations are made in lieu of the payment of dividends.

The draft item updates Inland Revenue's current guidance on the "in lieu of a dividend" rule (the "ILOD rule") and covers several different topics. We have not attempted to comment comprehensively on the item. Rather, our submission focuses on select items we consider important to raise with the Tax Counsel Office ("TCO") for consideration in updating and finalising the item.

Our submissions are set out in the **Appendix** to this letter.

Further information

Please do not hesitate to contact Robert Grignon on 09 304 5295, Tim Shearer on +64 4 816 4650, or Simon Percival on +64 4 816 3228 should you wish to discuss this submission in greater detail.

Yours sincerely

Robert Grignon
Director

APPENDIX – DETAILED SUBMISSIONS

The draft interpretation statement provides general guidance on how the Commissioner will apply the ILOD rule in s CD 22(6) of the Income Tax Act 2007 (the "Act"), and how the Commissioner will apply the factors outlined in s CD 22(7).

We make the following submissions on the item.

1 Meaning of "…if any part of the payment is in lieu of a dividend…"

At paragraphs [24] to [25], the draft item provides new guidance on the Commissioner's interpretation of the words, "if any part of the payment is in lieu of the payment of a dividend."

Example 1 outlines how the Commissioner's interpretation could work in practice. It concerns a return of capital which precisely meets the 15% bright line threshold under s CD 22(3)(a) of the Act. However, because the Commissioner finds that half the return of capital is paid in lieu of a dividend, the entire return of capital is treated as a dividend.

We generally agree that this may be the correct interpretation, because a return of capital is *prima facie* a dividend unless excluded, s CD 22(2) only permits apportionment if the ILOD rule does not apply, and s CD 22(6) expressly states that an amount is *not* excluded if any part of the payment is in lieu of a dividend. The conclusion in the example also may not be absurd in a way that would warrant a reading down of the provision, because the cancellation effectively failed to meet the 10% bright line threshold.

However, we consider that there are limits on the application of the words, "if any part of the payment is in lieu of a dividend." If the company in example 1 carried out a return of capital that resulted in a 25% capital reduction but 2.5% of the market value (or 10% of the actual payment) was found to be paid in lieu of a dividend, then a purposive approach (taking into account the purpose of the ILOD rule and the potential absurdity of a literal application) could prevent the entire amount from being treated as a dividend. Alternatively, the Commissioner may be able to conclude that the 2.5% of the market value was not paid in lieu of a dividend in the first place, perhaps with reference to other factors.

We would welcome a further example that considers the limits of the words in question. We also consider that this point may give rise to a policy issue that may be more appropriately dealt with through remedial legislation.

2 Accumulated losses

Example 4 concerns a company, LuckyCoin Investments Limited ("LIL"), which has incurred annual losses and has, therefore, been unable to pay dividends. The analysis on the "dividends paid" factor states, "[t]his factor is neutral because historically LIL has had no earnings or excess cash to distribute as dividends and therefore has been unable to pay any dividends."

We do not understand why this factor would be neutral. The fact that LIL has no retained earnings, and that it has been unable to pay dividends, should strongly suggest that the share cancellation is not made in lieu of dividends. The conclusion on this example (that the company "has not been in a position to pay dividends") also seems to acknowledge this as a factor that confirms the ILOD rule does not apply.

We consider that the analysis of the "dividends paid" factor in example 4 should be updated, to state that it indicates that the cancellation is less likely to be in lieu of a dividend. The conclusion already seems to acknowledge this, so, in our view, changing the analysis would simply ensure that it matches the conclusion.

3 Relevance of a "higher tax liability on dividends"

The item argues that if the shareholders in a company would face a higher tax liability on dividends, this may indicate that a share cancellation is made in lieu of a dividend. Example 3 makes this point with regard to a company's "minimal balance of imputation credits," and example 7 makes this point with regard to an increase in the shareholder (a trust)'s tax rate, from 33% to 39%.

While we accept that a high marginal tax rate at the shareholder level could create incentives to distribute capital amounts rather than taxable dividends, the shareholder's applicable tax rates do not alter the character of the distribution. Put differently, that a company is motivated to distribute an amount as a return of capital does not mean that the amount is not in fact capital.

In example 3, it appears that the ILOD rule is thought to apply because of factors other than the lack of imputation credits and not because a cancellation would be more tax-efficient than paying out unimputed dividends. It is not clear to us that Inland Revenue would arrive at a different conclusion if there had been available imputation credits.

There are other issues with example 7 that we discuss further below, but we question the way that example presents the share cancellation as a mechanism to avoid the increase in the trustee tax rate. Again, would Inland Revenue come to the same view in the absence of the rate change? The increase in the tax rate is not itself a helpful indicator of dividend substitution. We consider that example 7 should not refer to the increase in the trustee tax rate.

There may be other possible unusual outcomes if Inland Revenue takes the view that the shareholder's tax liability or profile influences the character of the distribution. For instance, if there are two shareholders in receipt of a distribution – a company, and a trust which has just become subject to the 39% trustee rate – is the distribution to the trust more likely to be in lieu of a dividend? We do not consider that this could have been the intended interpretation, and in our view the references to tax rates and liabilities for the shareholder should be removed.

4 Non-participating redeemable shares

Generally, we welcome the item's new guidance on non-participating redeemable shares ("NPRS") and example 8, which provides guidance on redeemable preference shares ("RPS") (which meet the NPRS definition in the Act) whose cancellations comply with the ILOD rule.

However, paragraphs [57] and [62] argue that RPSs could be used as a mechanism to replace dividends in some circumstances, although the reasoning for this is not clear. Paragraph [60] states that there is usually no ability to extract earnings using RPSs and paragraph [20] acknowledges their debt-like nature. The analysis at example 8 also notes that the RPSs in that case can only be redeemed for their issue price, meaning "it would be very difficult for the redemption [of those shares] to be in lieu of a dividend." While paragraph [62] addresses some of the difficulties with extracting earnings by redeeming RPSs (such as a lack of voting rights), it does not explain how shareholders would use RPSs to extract earnings when they can only be redeemed for their issue price.

It is, however, difficult to argue that the ILOD rule could not *potentially* apply given it is clearly one of the criteria in s CD 22 that applies to NPRS. Further to the previous comments, however, we are of the view the circumstances in which it may be invoked should be quite narrow indeed. The fact that NPRS might be redeemed semi-frequently should not, in our view, be determinative (or even particularly relevant or persuasive), given the debt-like nature and, in situations like example 8, may only be redeemed for their issue price. We consider that further discussion and examples should be added to the item to clarify the boundary and how each of the factors in s CD 22(7) apply to NPRS.

5 Looking through to subsidiaries and "any other relevant factor"

Example 6 concerns a holding company (HoldCo) with ASC of $10m. HoldCo has an operating subsidiary (OpCo) that has $10m of ASC and $10m of retained earnings. OpCo has cash of $12m, proposes to distribute $9m, and does so by cancelling shares and distributing a capital amount to HoldCo. HoldCo then carries out a share cancellation and returns the cash of $9m which is thought to be in lieu of dividends.

When applying the factors in s CD 22(7):

- The item considers that the absence of prior dividends provides no indication as to whether the cancellation is in lieu of a dividend. We consider that the absence of prior dividends should indicate that the distribution is not a dividend substitute.

- In testing the cancellation's expressed purpose, the example (and paragraphs [63] – [64] of the item) argues that, when applying the ILOD rule, the Commissioner can look through HoldCo and consider its subsidiary's accumulated earnings. This seems to drive much of the remainder of the analysis, in that the distribution from HoldCo is essentially viewed as a distribution of OpCo's retained earnings. In our view this is inappropriate. Section CD 22 focuses on the characteristics and activity of "*the* company," meaning the company making the share cancellation. The factors in s CD 22(7) either expressly or impliedly maintain this focus on "the" company. We do not consider that Parliament intended the ILOD rule to involve a full "look-through" analysis, which might more appropriately be the domain of the GAAR.

- We observe that Inland Revenue's approach in this regard is likely to be at odds with the past approach that most taxpayers have applied. We also foresee practical issues with determining the 'source' of a distribution, particularly where amounts have been passed up through chains of companies and it is difficult to obtain records.

- Setting aside that OpCo is (in our view incorrectly) tested in the example, when considering the cancellation's expressed purpose, the item appears to regard the fact that the amount to be distributed is similar in quantum to the retained earnings and cash balances as indicative of a distribution of retained earnings. We observe that the amount is also similar in size to the ASC balance. However, the approach Inland Revenue appears to be proposing in this regard is that distributions should be traced to a particular source to determine their character. It is not clear to us that a 'tracing' of funds in this manner is the correct analysis. More broadly, the dividend rules do not require companies to trace distributions, rather all distributions are deemed to be dividends with returns of capital under s CD 22 (and certain other distributions) carved out. The ordering rule operates to 'stream' returns of capital under s CD 22 on a first-come-first-served basis.

- With regard to the other relevant factors in the example:

  - It is not clear what is meant by the comment that there is no evidence that OpCo's profits accumulated in a separate account for "an objective commercial reason". We refer to our comments above that companies are not generally expected to trace the source of funds for the purposes of the dividend rules.

  - The comment that the one-off nature of the buyback does not negate that the group has retained earnings that it will distribute under the cancellation presupposes that the distribution is retained earnings. It is not explained why the distribution is not share capital.

  - There is a comment that there is no accompanying reduction in the business but an acknowledgement that there is a 90% reduction in the invested capital, which is said to be "significant". Section CD 22 is generally directed at capital reductions at the company level, measured in terms of the reduction in the value of the company's equity or shareholder's interest. As such, we consider that the 90% reduction in the invested capital is likely to carry considerably more weight in the analysis.

  - There is a comment that there is no "in principle" difference between distributing from share capital or retained earnings because there is no commercial reason in the example to reduce capital other than to distribute retained earnings. However, the commercial reason to reduce capital is stated to be to return surplus cash to shareholders which, as acknowledged earlier in the example, could be achieved through a return of capital.

  - The transactions in this example appear to suggest a replacement of invested share capital such that the assets of OpCo are largely funded with retained earnings. The conclusion appears to be that retained earnings must be streamed to shareholders as taxable dividends first, and capital amounts second, but this does not seem to acknowledge that the Act generally contemplates a choice in how companies might fund their assets (including between debt and equity funding, subject to the application of, for instance, the thin capitalisation regime etc), nor the optionality of share repurchases as a mechanism to return funds to shareholders.

6 Cancellation with a debt left owed back

Example 7 concerns a company that leaves amounts paid under a share cancellation owing as a debt, with amounts repaid to the shareholders over time. The example concludes that the share cancellation is in lieu of a dividend.

When applying the factors in s CD 22(7):

- The example considers the nature and amount of dividends paid before and after the cancellation, referring to the cessation of the regular dividends before the share cancellation and the loan repayments after the share cancellation. The analysis here appears to be focussed on whether the future loan repayments are a substitute for dividends, rather than whether the share cancellation is in lieu of a dividend. In our view these are separate matters. Section CD 22 concerns whether *this payment* is in lieu of a dividend, not whether the transaction steps undertaken might facilitate *future payments* being in lieu of dividends.

- In terms of whether the share cancellation is a dividend substitute, the example appears to regard as determinative that there is a cessation of dividends and a redirection of profits towards loan repayments. The inference is that the source of the funds distributed must therefore be retained earnings that would otherwise be taxable as dividends on distribution. Similarly, the escrow example at paragraph [68] suggests a distribution sourced from the sale of an asset may not be a distribution in lieu of a dividend.

- We have commented on this 'tracing' approach above with regard to analysing the source of the funds, but it appears that the conclusion that the ILOD rule applies is focused on the source of the funds used to buy back the company's shares, rather than the use of a loan to return those funds *per se*.

- In our view, the use of a loan should not be relevant to the character of the amount paid under the share cancellation, but as noted at paragraph [67] in the item there is a question as to whether a share buyback left outstanding as a debt might circumvent the bright line tests. This is likely to be highly fact-dependent, but in any case would appear to be outside the scope of this item on the ILOD rule.

- There is a wider question as to whether Parliament intended the ILOD rule to be used to address scenarios where the bright line tests (or other parts of s CD 22) are being circumvented in a manner beyond Parliament's contemplation. While we acknowledge that the provision heading describes s CD 22(6) as an "overriding anti-avoidance rule" we see the provision as a specific anti-avoidance rule that seeks to recharacterise amounts paid of a certain character as described in the provision. If an arrangement involves a wider use of s CD 22 in an uncontemplated way, counteracting any tax avoidance would in our view be the domain of the GAAR.

- Where the concern is that the transaction could potentially facilitate *future payments* being in lieu of a dividend (although the payment itself would not otherwise be regarded as a dividend) then any concerns should be addressed by other means, to the extent appropriate. The existence of the loan (in place of equity) at best could be said to potentially give an avenue for returning future profits to shareholders, but this will not necessarily occur (for example, the company could be sold to a third party and the debt repaid prior to the company generating any further retained earnings). To recharacterize the present payment as a dividend, based on the hypothetical ability for there to be a future tax advantage, would seem to us to be beyond the scope of the ILOD test's intended purpose.

- More broadly, and with reference to the example's discussion on the expressed purposes of the cancellation, it would appear that the example essentially involves a company replacing share capital funding with a standard interest-free shareholder current account – i.e., a commercially common structure.

We also consider that this point may give rise to a policy issue that may be more appropriately dealt with through remedial legislation (if Parliament and IR Policy considers the outcome undesirable).

7 Practical difficulties with seeking notice under s CD 22(8)

The draft item does not discuss this in detail, but we think it is important to mention the issues taxpayers and advisors often face with seeking notice under s CD 22(8).

When a company seeks to make a return of capital, it may either apply to TCO for a binding ruling on the ILOD rule or seek notice under s CD 22(8) from Customer and Compliance Services (CCS) that the ILOD rule does not apply. In principle we consider that the choice is useful as applying for a binding ruling is expensive, and some returns of capital will be relatively uncontentious and simple.

However, we have previously sought notice from CCS under s CD 22(8) on what we considered to be reasonably straightforward share repurchase transactions, only to be advised that they would not give notice and that our clients should apply for a binding ruling. While there may be different considerations and approaches from the TCO and CCS teams, and a different dynamic depending on whether the rulings regime or s CD 22(8) is in play, it would be helpful for the Commissioner to provide guidance on when taxpayers can seek notice under s CD 22(8) and when they will be directed to apply for a binding ruling. Such guidance could also discuss whether the Commissioner will give notice subject to conditions and other practical considerations.