INTERPRETATION STATEMENT | PUTANGA WHAKAMĀORI

Income Tax – Whether an off-market share cancellation is made in lieu of the payment of a dividend

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IS 25/19

This interpretation statement considers the application of s CD 22(6) and (7) of the Income Tax Act 2007 in relation to the factors to be taken into account in determining whether an off-market cancellation of shares is made in lieu of the payment of a dividend.

All legislative references are to the Income Tax Act 2007 (the Act) unless otherwise stated.

REPLACES | WHAKAKAPIA

- **IS 2966**: Exclusion from the term "Dividends" – whether distribution made in lieu of dividends' payment

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Summary | Whakarāpopoto

1. This interpretation statement examines how the anti-avoidance rule in s CD 22(6) and (7) of the Act (commonly known as the "in lieu of dividend" test[1]) applies to an amount a company pays to a shareholder on an off-market cancellation of shares.

2. Subpart CD provides a wide definition of the term "dividend". On the face of it, all distributions from a company to its shareholders in their capacity as shareholder are dividends unless a dividend exclusion provision applies. This includes any amount distributed on the cancellation of shares in a company. However, an amount distributed on an "off-market cancellation" of shares may be excluded from the dividend definition where the relevant requirements in s CD 22 are satisfied.

3. Broadly, the dividend exclusion for an off-market share cancellation payment applies where:

   - one of the bright line tests in s CD 22(3) is met;
   - there is sufficient available subscribed capital (ASC) per share calculated in accordance with s CD 22(2) or CD 22(4) (whichever is applicable); and
   - no part of the payment is made in lieu of the payment of a dividend, ie, the anti-avoidance rule does not apply.

4. The bright line tests are intended to establish an objective means to determine when a company is undertaking a genuine capital reduction through a share cancellation. The anti-avoidance rule in s CD 22(6) reinforces the bright line tests and applies in circumstances where the purpose of a share cancellation is to avoid paying a dividend and therefore defeats the purpose of the bright line tests.

5. The Commissioner is required to consider a number of factors, set out in s CD 22(7), when determining whether an amount is paid in lieu of a dividend. The factors are:

   - the nature and amount of dividends the company pays before or after the cancellation;
   - the issue of shares in the company after the cancellation;
   - the expressed purpose or purposes of the cancellation; and
   - any other relevant factor.

6. Each of these factors is discussed separately in detail from [32].

[1] This statement uses the terms "anti-avoidance rule" and "in lieu of dividend" test interchangeably.

Scope

7. This interpretation statement focuses on the anti-avoidance rule prescribed in s CD 22(6) and (7) only. It **does not** provide detailed commentary on the calculation of ASC or the application of the bright line tests.

Analysis | Tātari

8. Section CD 22 provides a dividend exclusion for an amount that a company pays to a shareholder in consideration of an "off-market cancellation" of a share in the company.[2]

Background and history of s CD 22

9. The meaning of legislation must be ascertained from its text and in light of its purpose and context.[3] It is therefore useful to first examine the history of s CD 22 and its legislative purpose.

10. Section CD 22, in its current form, can largely be traced back to an amendment to s 4A(1)(c) of the Income Tax Act 1976, which took effect from 1 July 1994. The amended section was a result of a broad review of the dividend rules that the Government undertook in the early 1990s,[4] with the assistance of the Valabh Committee.[5] This review coincided with (and was therefore influenced by) the enactment of the Companies Act 1993.

11. The Companies Act 1993 made it easier for a company to repurchase or redeem its own shares. In essence, the share repurchase provisions in the Companies Act 1993 are a means of returning capital to shareholders, which previously had only been possible through an application to the High Court. This change meant that income tax rules of that period also had to be formulated to cover the tax implications of funds that companies distributed to their shareholders by way of share repurchases or share redemptions.

[2] In accordance with s CD 22(1), the section does not apply where the share is cancelled on liquidation of the company. For completeness, in the event of a liquidation, a separate dividend exclusion may be available under s CD 26.

[3] Section 10 of the Legislation Act 2019; *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36, [2007] 3 NZLR 767.

[4] The definition of dividends under the Income Tax Act 1976: A discussion document (Office of the Minister of Finance, July 1990).

[5] The Consultative Committee on the Taxation of Income from Capital.

12. The Government and the Valabh Committee were concerned that the increased flexibility to return funds to shareholders could significantly reduce the amount of tax from dividends.[6] In their view, distributing retained earnings as an ordinary dividend is fundamentally no different from doing so through a share repurchase.[7] However, the Government also did not wish to unduly hinder commercial decisions to restructure companies' balance sheets.[8]

13. As a result, the Income Tax Act 1976 introduced a series of tests known as the "bright line tests" and the "in lieu of dividend" test, which permitted ASC to be returned tax-free on share repurchases or redemptions if specific criteria were met. In summary, the bright line tests treated repurchases of small parcels of shares (where the repurchase was less than 10% of the market value of all shares) as dividends, and repurchases of larger parcels as tax-free. This was necessary to prevent companies from distributing their earnings to their shareholders by way of tax-free repurchases instead of dividends. In addition, when a share repurchase defeated the purpose of the new rules, the Commissioner had a residual discretion to treat a distribution on the repurchase of shares as being in lieu of the payment of dividends.

14. For the most part, these rules have survived the various rewrites to the Act. However, the legislative requirement that the Commissioner "is satisfied that neither the whole nor any part of the relevant cancellation was made in lieu of the payment of dividends"[9] was rewritten. Now, there is a requirement that the anti-avoidance rule does not apply for a share cancellation to qualify for the dividend exclusion in s CD 22.[10] This amendment did not change the role of the in lieu of dividend test, which is to counter behaviours that defeat the purpose of the bright line tests.

15. For reference, the table below sets out the corresponding provision in each subsequent Act.

Income Tax Act	Corresponding provision
Income Tax Act 1976	s 4A(1)(c)
Income Tax Act 1994	s CF 3(1)(b)

[6] Taxation Reform (Companies and Other Matters) Bill: Submissions on significant issues (excluding international tax avoidance) – officials' report to Finance and Expenditure Select Committee, at [17].

[7] The Taxation Implications of Company Law Reform – a discussion document (December 1993) (the 1993 discussion document), at 10.

[8] Taxation Reform (Companies and Other Matters) Bill: Submissions on significant issues (excluding international tax avoidance) – officials' report to Finance and Expenditure Select Committee, at [3].

[9] Section 4A(1)(c)(iii) of the Income Tax Act 1976 and s CF 3(1)(b)(iii) of the Income Tax Act 1994.

[10] Section CD 22(2)(c).

Income Tax Act 2004	s CD 14
Income Tax Act 2007	s CD 22

Bright line tests

16. To qualify for the dividend exclusion in s CD 22, an amount distributed under an off-market share cancellation must first meet one of the five bright line tests in s CD 22(3), which are as follows:

- The cancellation is part of a "pro rata cancellation" that results in a "fifteen percent capital reduction" for the company.[11]
- The cancellation is part of a "pro rata cancellation" that results in a "ten percent capital reduction" for the company and the Commissioner has given a notice under s CD 22(8).
- The cancellation is not part of a "pro rata cancellation" and results in the shareholder suffering a "fifteen percent interest reduction".
- The company is an unlisted trust and the cancellation is not part of a "pro rata cancellation".
- The share being cancelled is a "non-participating redeemable share".

17. Broadly, the bright line thresholds are intended to establish an objective test to determine when a company is undertaking a genuine capital reduction. Where the cancellation is part of a pro rata offer to all shareholders, the capital reduction must be at least 10% of the market value of all participating shares in the company.

18. For a reduction that falls between the 10% and 15% thresholds, the company must apply for a notice from the Commissioner. The Act includes a "rebuttable presumption" that such a reduction is a dividend unless the Commissioner agrees with the company that it is not.[12]

19. The 15% bright line test was set at that level (considered to be approximately three times the typical dividend yield) to provide reasonable scope for a company, for reasons such as downsizing of operations, to fund a one-off distribution to its shareholders from its ASC without approval from the Commissioner.[13]

20. Shares that qualify as "non-participating redeemable shares" do not need to meet a bright line threshold due to their debt-like nature. But the redemption of such shares

[11] Terms within speech marks in this list are defined in s CD 22(9).

[12] Hansard (540 New Zealand Parliamentary Debates, 2 June 1994, at 1372–1373).

[13] The 1993 discussion document at 17 and 18.

is still subject to the requirement that they are not redeemed in lieu of the payment of dividends.

Anti-avoidance rule

21. In addition to meeting one of the bright line tests, s CD 22(2)(c) requires that the anti-avoidance rule in s CD 22(6) does not apply. These provisions state:

> *Ordering rule*
>
> (2) The **amount is not a dividend** to the extent to which it is less than or equal to the available subscribed capital per share calculated under the ordering rule, **if**—
>
> (a) 1 of the bright line tests in subsection (3) is met; and
>
> (b) the company is not an unlisted trust that has chosen the slice rule for the share under subsection (4); and
>
> (c) **the anti-avoidance rule in subsection (6) does not apply**.
>
> …
>
> *Overriding anti-avoidance rule*
>
> (6) Neither subsection (2) nor (4) excludes an amount paid by a company on cancellation of a share from being a dividend if **any part of the payment** is **in lieu of the payment of a dividend**.
>
> [Emphasis added]

22. The phrase "in lieu of the payment of a dividend" in s CD 22(6) is broad and could mean that the anti-avoidance rule applies whenever a share cancellation is in place of a dividend payment. However, the use of the term "anti-avoidance" in the subheading of s CD 22(6) suggests that the rule's application is limited to situations where the purpose of a share cancellation is to avoid paying a dividend when distributing an amount to a shareholder. Although the rule operates to reinforce the bright line tests, there is no presumption that it will apply in all circumstances involving a share cancellation. Nor is there a presumption that this rule is less likely to apply to share cancellations that meet the bright line tests. It is a rule that operates in tandem with the bright line tests. Whether or not it will apply will depend on the facts presented.

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

23. The anti-avoidance rule stipulates that no part of a payment made on the cancellation of a share can be in lieu of the payment of a dividend. In other words, if any portion of the payment is in lieu of the payment of a dividend, the entire payment will be treated as a dividend (see Example | Tauira 1).

24. This interpretation is evident from the language used in s CD 22(6). Specifically, the term "payment" used in this section clearly corresponds to the "amount paid" on the cancellation of a share, as mentioned in the same sentence. Therefore, if any part of the "amount paid" is a substitute for a dividend, the whole amount will be considered a dividend.

Example | Tauira 1 – Where part of a payment is in lieu of a dividend

TrueFaux Solutions Limited (TSL) undertakes an off-market share cancellation. The share cancellation is for $100,000 and precisely meets the 15% bright line test under s CD 22(3)(a). TSL does not treat the share cancellation payment as a dividend because it considers the dividend exclusion in s CD 22 applies.

Two years later, the Commissioner reviews the transaction and determines, after considering the factors listed in s CD 22(7) (to be discussed from [26]), that half of the $100,000 share cancellation payment is in lieu of the payment of a dividend. Given this view, the Commissioner considers the entire payment is a dividend.

25. Notably, the situation described above in paras [23] and [24] is different from a scenario where part of a share cancellation payment is a dividend simply because there is insufficient ASC to cover the entire cancellation amount. In the latter case, the portion of the payment that exceeds the ASC is already characterised as a dividend under the relevant tax rules, and cannot also be considered "in lieu" of a dividend for the purposes of the anti-avoidance rule. Therefore, as long as the company can demonstrate that no part of the remainder of the cancellation amount (ie, the portion covered by ASC) represents a substitute for a dividend, the anti-avoidance rule in s CD 22(6) will not apply to that part.

Factors that must be considered in applying the anti-avoidance rule

26. The Act expressly sets out the factors that must be considered when applying the anti-avoidance rule. Section CD 22(7) states:

> *Factors relevant in applying anti-avoidance rule*
>
> (7) For the purposes of applying subsection (6), the following factors **must** be considered:
>
> (a) the nature and amount of dividends paid by the company before or after the cancellation; and
>
> (b) the issue of shares in the company after the cancellation; and

> (c) the expressed purpose or purposes of the cancellation; and
>
> (d) any other relevant factor.

27. The use of a conjunctive list in s CD 22(7) requires that the four listed factors are considered collectively. It is possible that, in each case, some factors may:

- either support or contradict other factors;
- imply that the cancellation is a substitute for a dividend, while others may not; or
- provide a clearer indication as to the nature of the cancellation than others.

28. The relative importance of each factor and how the Commissioner views them collectively will depend on the specific facts and circumstances of each case. Several examples from [75] illustrate how the Commissioner might consider and weigh up the factors listed in s CD 22(7) when applying the anti-avoidance test in particular situations.

29. It is not possible for the Commissioner to explicitly outline the weight of each factor, as the Act does not assign a specific weight to any of the listed factors. Logically, an anti-avoidance rule must be flexible to achieve its intended purpose.

30. Further, the Commissioner considers that if Parliament intended for some factors to carry more weight than others in all scenarios, that would have been reflected in the wording of the section. The broad scope of s CD 22(7), particularly para (d), suggests Parliament's intention is to grant the Commissioner sufficient power and flexibility to challenge a share cancellation that is in lieu of a dividend.[14]

31. Each of the factors listed in s CD 22(7) is discussed separately in detail below. Determining whether an amount is paid in lieu of a dividend requires a careful consideration and balancing of all relevant factors.

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[14] Parliament's intent is also evident in Hansard records (542 New Zealand Parliamentary Debates, 25 August 1994, at 3130–3131). On 25 August 1994, the Select Committee reported the Bill back to Parliament. In his speech presenting the Select Committee report to Parliament, Mr Max Bradford (Chairman of the Select Committee) stated:

> The proposals in the Bill were introduced following extensive consultations with the commercial community and reflect a desire not unduly to discourage balance sheet restructurings while at the same time protecting the tax base. The Committee received several submissions advocating the removal or confinement of the Commissioner's power to deem a distribution on a repurchase that exceeds the thresholds to nevertheless be a dividend. **However, the committee considered the Commissioner's discretion to be an integral part of the package, and has recommended only minor changes in this area** … [Emphasis added]

The nature and amount of dividends paid by the company before or after the cancellation – s CD 22(7)(a)

32. This factor requires an analysis of the company's dividend-paying practice both before and after the share cancellation. Its purpose is to identify any evidence in the company's practice or history of paying dividends that indicates the share cancellation is a dividend substitute. The test therefore focuses on:

- the frequency and amounts of dividends the company paid before and after the share cancellation, if any;
- any unexplained change in dividend paying practices or policy; and
- how earnings in the company, if any, have been or will be used.

33. The following are common scenarios where a company's dividend history or practice might indicate that a share cancellation is a dividend substitute:

- The company has not paid dividends before or after a share cancellation, but has instead accumulated earnings over time and distributed these on the cancellation.
- The company has adopted and followed a low or no-dividend policy, or has made an unexplained change in policy to reduce dividends, as well as accumulating cash earnings.

34. There are, of course, valid business reasons for holding on to funds instead of paying regular dividends. For example, a company in a growth phase might reinvest all earnings and surplus cash into business expansion. When it is clear that earnings are retained for sound business reasons, the absence of dividend payments alone does not indicate that the share cancellation is in lieu of a dividend.

35. The Act refers to "dividends paid". It does not refer to expectations, purpose, intentions or policy. The test therefore is not based on the company's dividend policy but is stated explicitly in terms of its practice or history of paying dividends. Nevertheless, the company's dividend policy may be useful in explaining its distribution decisions in some cases. For example, if no pattern in the distribution of dividends is apparent, but the company can show that it has adhered to an explicit policy that refers to objective criteria, the Commissioner may be able to draw conclusions that would not otherwise be available.

36. Where the Commissioner is asked to rule, or give a s CD 22(8) notice, on a proposed share cancellation, a practical issue arises given, at the time of making the decision, the Commissioner will not have visibility over events occurring after cancellation. In such cases, the Commissioner may rely on any relevant information or knowledge that can be gained prior to the cancellation. Such information might include dividends declared

but not paid, and knowledge of the directors' intentions and expectations (including knowledge of the company's dividend policy).

The issue of shares in the company after the cancellation – s CD 22(7)(b)

37. This factor is relevant where a company issues or intends to issue shares after it undertakes a share cancellation. The main focus here is to identify instances where companies take artificial steps in order to meet one of the bright line tests.

38. A company may cancel sufficient shares to meet the 10% or 15% bright line levels and, by doing so, effect a tax-free distribution. The company may then issue more shares to raise capital, thereby reducing the effective capital reduction below the bright line levels. If the purpose of the subsequent share issue is to replace cash needed for the company's operational or capital expenditure, this raises a question as to whether the company really had the intention of reducing capital and was in a position to do so.

39. The length of time between the cancellation and the subsequent capital raise (by way of an issue of shares) is also relevant. The shorter this period is, the more likely it might indicate the company made the cancellation in lieu of the payment of dividends (see Example | Tauira 2).

Example | Tauira 2 – Share issue following cancellation

Bulbaflora Botanicals Limited (BBL) has 1 million shares on issue. The market value of each share is $2 (ie, the shares have a total market value of $2 million).

The following transactions occur:

- On 30 June 2024, BBL buys back 150,000 shares from its sole shareholder, Ashton, for a total price of $300,000. It cancels the shares immediately following the buy-back.
- On 15 July 2024, BBL issues 100,000 shares to Ashton to raise $200,000 to fund the acquisition of a significant asset.

When viewed as a whole, the result of the two transactions is that the net capital reduction in BBL is $100,000. This amount represents only a 5% capital reduction, which falls below the minimum bright line test of 10%.

The circumstances, including the short duration between transactions, indicate that BBL has in reality effected a distribution that is more indicative of a dividend than of a bona fide capital reduction. However, this factor forms only part of the test in s CD 22(7) and it therefore needs to be viewed in the wider context rather than in isolation.

40. If a company does issue shares after a share cancellation, the following factors will likely be relevant for the Commissioner to take into account in applying s CD 22(7)(b):

- the length of time between the share cancellation and the additional share issue;
- the company's reason(s) for issuing additional shares;
- the amount of capital returned under the share cancellation;
- the amount of capital raised from the additional share issue, if any; and
- the company's financial position, at both the time of cancellation and the time of the subsequent share issue, which might indicate whether the company was in the position to return capital in the first place.

41. A common scenario where a company might issue additional shares after a share cancellation is where the cancellation occurs close to the grant date of an existing employee share scheme. The Commissioner considers shares issued under such a scenario are not detrimental when applying the "in lieu of dividend" test, provided the company has no arrangements intended to defeat the purpose of the provision.

42. In cases where the company issues new shares after a cancellation to replenish its capital, it generally does not matter who receives the new shares. For example, instead of issuing shares on a pro rata basis, a company may issue shares only to some shareholders or to entirely new shareholders. This will generally not affect the potential application of s CD 22(7)(b), if other relevant factors suggest the reissue is to circumvent the bright line tests. The provision does not distinguish between situations based on which shareholders receive new shares.

43. Again, if the Commissioner is asked to rule on a proposed share cancellation or give a s CD 22(8) notice, the Commissioner is placed in the difficult situation of having to consider the company's issue of shares after the cancellation. The Commissioner then has to rely on knowledge available before the cancellation in respect of share issues planned for after the cancellation. That knowledge might include share issue offers the company made or received, and any information that the directors and the shareholders supplied about their intentions or expectations related to share issues, including any commercial reasons provided for the subsequent issue of shares.

The expressed purpose or purposes of the cancellation – s CD 22(7)(c)

44. This factor requires a consideration of the stated purpose or purposes of the share cancellation. If there is strong objective evidence showing the cancellation is undertaken to achieve a commercial outcome, the cancellation is less likely to be treated as a dividend substitute.

45. The "purpose" of a particular arrangement refers to what that arrangement seeks to achieve. The "expressed purpose" of a share cancellation therefore refers to

statements made by the company regarding what the cancellation is intending to achieve. These may be statements made directly to the Commissioner, or through the company's board papers and external communications around the cancellation. Notably, the provision enables the Commissioner to request and consider such statements. It does not require the Commissioner to accept, at face value, subjective statements that do not reflect the objective purpose of the cancellation.

46. Therefore, when considering this factor, the Commissioner will test a company's statements against any available objective evidence. The evidence could include the company's funding requirements, costs of funding, industry norms, market interest rates and so on.

47. The more intuitive and compelling the reason for the cancellation of the shares, the stronger this factor will be in reaching the overall decision. Therefore, the presence of an objective commercial reason for the transaction should assist in indicating that the distribution is not in lieu of dividends.

48. The following are some examples of shares being cancelled to achieve commercial objectives. **These are not intended to serve as an exhaustive or definitive list of what the Commissioner may accept as commercial objectives.** Instead, they are examples that have previously been submitted to the Commissioner as commercial reasons for cancelling shares. Whether any purpose, objective or reason helps to demonstrate that the relevant transaction constitutes a genuine share cancellation will also depend on the availability of supporting objective evidence (as noted above at [46]) and its appropriate weighting along with the other factors listed in s CD 22(7).

Group restructure or reorganisation

49. A share cancellation may be a necessary step in reorganising the ownership and corporate structure of a group. Some examples might be:

- transferring the overall strategic control of the group to the hands of its principals and certain senior employees, rather than outside shareholders;
- demerging a group of companies before listing part of the group through an initial public offering; or
- facilitating the exit of a major shareholder where it is infeasible for the other shareholders to acquire the exiting shareholder's stake.

Return of surplus capital

50. When a company has more capital than necessary for its operations and investments, it might opt to return the excess through a share cancellation. Common sources of surplus capital, as reported to the Commissioner, include:

- proceeds from selling substantial assets or a significant segment of the company;
- funds from earlier capital-raising efforts that the company did not use because the planned investment did not materialise; and
- other one-off capital or windfall receipts such as an insurance settlement that will not be reinvested due to a permanent reduction of the business.

51. This consideration must, of course, be assessed alongside other relevant factors. A dividend also serves the purpose of returning surplus capital. Therefore, it is essential to identify specific characteristics that distinguish a share cancellation, particularly a pro rata cancellation, from a dividend. If the surplus capital merely represents earnings accumulated to satisfy the bright line thresholds, when viewed objectively, this factor will support the view that the share cancellation is a substitute for a dividend.

52. On the other hand, if a company with surplus capital, despite its history of high dividend payments, wishes to cancel its shares for a sound commercial reason, it is unlikely to be seen as attempting to defeat the purpose of the bright line tests.

Balance sheet restructure

53. A company may also wish to restructure its balance sheet to achieve financial goals. For example, a company might borrow from an arm's length lender to fund a return of capital through cancelling shares, in order to (among other reasons):

- align its debt-to-equity ratio more closely with industry peers;
- reduce funding costs by opting for less expensive debt over equity;
- cut administration costs associated with managing a broad shareholder base; or
- increase its earnings per share, in the case of a company that tracks this metric (eg, a publicly listed company).

54. As noted at [48], the examples set out above are not exhaustive. There may well be additional commercial reasons for cancelling shares that, together with the other factors listed in s CD 22(7), demonstrate the relevant cancellations are not in lieu of a dividend.

Any other relevant factor – s CD 22(7)(d)

55. The Commissioner must also consider any other relevant factor that might indicate whether an amount is paid in lieu of a dividend. The Act does not specify what factors could be relevant in applying this test. However, based on published policy documents, the Commissioner is likely to consider the following factors:

- Is the capital reduction part of the downsizing of the company? If so, this would be an indication the cancellation is not in lieu of dividends.[15]
- Has the company sold part of the business, while returning a sizeable amount to the shareholders in addition to a dividend? If so, this would suggest the cancellation was not in lieu of a dividend.[16]
- Has the company been retaining earnings and then distributing them without any accompanying reduction of the business? A distribution arising from a cancellation of shares in this case would probably be in lieu of dividends.[17]
- Is the capital return an unusual one-off event? If it is, this could suggest that the cancellation is not in lieu of a dividend.[18] Conversely, if the company has previously made several successive share cancellations that leave the respective interests of the shareholders unchanged, this may indicate that the reductions are in lieu of dividends.[19]

56. The Commissioner may also consider the following factors to be relevant.

Change in shareholder interests

57. Will the share cancellation affect the shareholders' interests (in terms of their shareholding percentages or the quantum of their invested capital) significantly, or will their interests remain mostly the same after the capital reduction? In other words, will the overall shareholder capital be greatly reduced? A substantial change in ownership interests or invested capital could suggest that the cancellation serves a different purpose from just distributing funds. Conversely, a minimal change could indicate that the payment resulting from the cancellation was in lieu of a dividend.

58. For example, a company might purchase all of a shareholder's shares with the result that the shareholder exits from the company. This could be the company's first share repurchase and, to that extent, would be an "unusual event". This suggests that the payment is not made in lieu of any dividend, but rather to facilitate a shareholder's exit.

59. On the other hand, a company making multiple redemptions of small quantities of non-participating redeemable shares could suggest the redemptions are replacing dividends in some cases, as each redemption represents a small change in the holder's interests in the company.

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[15] The 1993 discussion document at 17.

[16] The taxation of distributions from companies: final report (Valabh Committee, July 1991) at 31.

[17] The 1993 discussion document at 18.

[18] The 1993 discussion document at 11 and 17.

[19] The 1993 discussion document at 18.

Non-participating redeemable shares

60. While the anti-avoidance test does not explicitly state that non-participating redeemable shares should be treated differently from ordinary shares, the nature of non-participating redeemable shares inherently leads to a reduced scope for the application of the anti-avoidance rule.

61. Among other characteristics, a non-participating redeemable share generally:

- is redeemable at the option of the company or the shareholder, or at a specified date;[20]
- can only be redeemed for its subscription price (if the share is not a "fixed-rate share");[21] and
- carries only a protective right in respect of shareholder decision-making rights.[22]

62. This means that, in many cases, there is no ability to extract earnings using non-participating redeemable shares, particularly where the holders of such instruments do not also share in the profits of the same company in other ways (eg, holding ordinary shares).

63. Non-participating redeemable shares may also be issued to raise funds on a short-term basis. In such instances, the shares may be issued for a specified period and therefore limits the opportunity to redeem the shares in substitution for a dividend.

64. Conversely, as noted at [59], non-participating redeemable shares could be used as a mechanism to replace dividends in other cases. For example, a company could structure its initial equity funding with each shareholder having non-participating redeemable shares in the same proportion as their ordinary shareholding. This provides an avenue for the company to undertake regular small proportional redemptions of the non-participating redeemable shares in lieu of paying regular dividends. Therefore, the anti-avoidance rule continues to be relevant in this situation.

Accumulation of funds and earnings in subsidiary or subsidiaries

65. In cases involving a group of companies where a company acts as a holding company while its subsidiary conducts business operations, the Commissioner may consider any inexplicable accumulation of earnings in the subsidiary to be relevant. This is especially so in cases where the holding company utilises such accumulated earnings from the subsidiary to finance a share cancellation.

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[20] Paragraph (b)(i) of the definition of "non-participating redeemable shares" in s CD 22(9) and s 68(b)(i) to (iii) of the Companies Act 1993.

[21] Paragraph (c) of the definition of "non-participating redeemable shares" in s CD 22(9).

[22] Paragraph (d)(i) of the definition of "non-participating redeemable shares" in s CD 22(9).

66. The Commissioner is unlikely to accept an argument that a share cancellation is not in lieu of a dividend simply because the holding company has no retained earnings, where it is clear a subsidiary has been accumulating earnings and deferring dividends as part of an arrangement to assist the holding company meet one of the bright line tests (see Example | Tauira 7).

67. However, it is also acknowledged that the mere presence of retained earnings in a subsidiary is not sufficient in itself to suggest a cancellation is in lieu of a dividend. For example, if a holding company owns shares in two subsidiaries and sells the shares in one of them, a subsequent capital reduction that is funded by the sales proceeds is unlikely to be affected by the fact that the remaining subsidiary has a retained earnings balance.

Leaving amounts payable under a share cancellation outstanding

68. When a company cancels its shares but leaves the amount payable on the cancellation outstanding, it can create an opportunity for the company to substitute taxable dividends with tax-free loan repayments. This situation is particularly evident when a company has no surplus funds to return to shareholders but cancels enough shares to meet one of the bright line tests, leaving the amounts payable on the cancellation outstanding on open and interest-free terms. This arrangement creates a mechanism for the company to pay future earnings to shareholders in small instalments, as loan repayments, where each instalment individually would not otherwise meet one of the bright line thresholds.

69. The same effect could also be achieved by returning capital to shareholders and then immediately accepting it back as interest-free shareholder advances. Such transactions do not naturally align with the purpose of s CD 22 which is designed to help facilitate the return of shareholder capital[23] because, unlike a cancellation funded by third party debt, such transactions do not return capital on the cancellation of shares.

70. In some cases, relevant parties might use these arrangements to circumvent the purpose of the bright line tests. For example, a company might cease its historical dividend paying practice and opt to cancel its shares, leave an outstanding payable balance, and then distribute earnings through tax-free loan repayments instead (see Example | Tauira 8). Such arrangements could be a relevant factor under the anti-avoidance rule, if they are not supported by objective commercial purposes, and the Commissioner may enquire into, and assess:

- Whether leaving the outstanding balance aligns with the stated purpose of the cancellation.

[23] Refer to the heading of s CD 22: "**Returns of capital**: off-market share cancellations" and the background section of this interpretation statement.

- Whether there are objective commercial reasons for both the company and its shareholders to enter into such arrangements.

71. As with the factor under s CD 22(7)(c), the presence of an objective commercial reason for leaving the amount payable under a share cancellation outstanding should assist in indicating that the transaction is not in lieu of dividends. For example, following the sale of a significant asset, a company might wish to return the full sale proceeds to its shareholders as it no longer has a use for that money. However, part of the sale proceeds may be held in escrow temporarily until the relevant sale terms are satisfied. In this case, cancelling shares and leaving part of the balance outstanding until the escrowed sum is paid to the company is unlikely to cause the cancellation to be seen as in lieu of the payment of a dividend.

Is an initial intention to pay a dividend required?

72. From time to time, the Commissioner receives arguments that the term "in lieu" in the phrase "if any part of the payment is in lieu of the payment of a dividend" implies that the anti-avoidance rule can only be applied where a company initially intended to pay a dividend but opts to cancel shares instead. According to this argument, the anti-avoidance rule cannot apply if the company never intended to pay a dividend in the first place.

73. The Commissioner considers that neither the language nor the purpose of s CD 22(6) supports this interpretation. The Shorter Oxford English Dictionary[24] defines the term "in lieu" as "in the place" or "instead" (of). The term simply indicates a substitution of one thing for another without suggesting any prior intention. A person may choose one course of action over another without having any prior intention to do the substituted act.

74. Additionally, s CD 22(6) serves as an anti-avoidance provision. In practice, some companies might, for tax avoidance purposes, deliberately choose not to distribute earnings as dividends. Instead, they accumulate earnings with the intention of meeting one of the bright line thresholds, allowing them to distribute these earnings as tax-free share cancellation payments. Interpreting s CD 22(6) to exclude such situations from the anti-avoidance rule, simply because such companies never intended to pay dividends, would contradict the rule's purpose.

Examples | Tauira

75. The following examples are provided to illustrate how the Commissioner might approach the application of the "in lieu of dividend" test. These examples are intended

[24] *Shorter Oxford English Dictionary* (6th ed, New York, Oxford University Press)

solely for illustrative purposes and **should not be seen as definitive guidelines** for determining what constitutes a payment in lieu of a dividend. Each case must be evaluated on its own facts and circumstances.

Example | Tauira 3 – Returning capital following a significant asset sale

Evergreen Capital Assets Limited (ECAL) is a company that invests in commercial real estate properties. The company was established 10 years ago and raised $60 million in ordinary equity and borrowed $30 million from the bank to purchase four separate commercial properties, each worth $20 million.

Over the past 10 years, ECAL has paid annual dividends amounting to 50% of its after-tax profits. The remainder has been reinvested to expand ECAL's business operations.

ECAL recently sold one of its commercial properties for $40 million. After repaying $10 million of its bank loan, the directors choose to return the remaining $30 million to shareholders due to a lack of suitable investment opportunities.

ECAL does not plan to issue any additional shares after the cancellation as the directors believe it has sufficient capital to continue its operations. It also intends to continue its dividend policy after the cancellation, distributing profits from its remaining properties and operations.

The Commissioner considers the relevant factors listed in s CD 22(7) and notes the following:

Relevant factor	Application to the example
The nature and amount of dividends paid by the company before or after the cancellation	The regular payments of dividends before and after the cancellation support the argument that the decision to return the $30 million is a one-off event driven by the sale of a significant property, rather than a change in the company's dividend policy or practice to meet the bright line tests.
The issue of shares in the company after the cancellation	ECAL does not intend to issue additional shares after the cancellation. This factor does not indicate that the cancellation is in lieu of a dividend, nor does it conclusively prove that it is not.
The expressed purpose or	The expressed purpose of the cancellation is to return surplus capital to shareholders following the sale of a significant property. The decision is based on the directors' assessment

purposes of the cancellation	that there are no suitable investment opportunities available that would provide an adequate return on the capital. Both the expressed purpose and the objective evidence suggest the cancellation is not in lieu of a dividend.
Other relevant factors	The cancellation is a significant one-off event, representing a return of capital from the sale of a major property rather than a distribution of accumulated earnings. The return of capital will result in a substantial reduction in the company's total assets and equity, reflecting the sale of one of its four major properties.

Conclusion: Based on the above factors, the Commissioner is likely to conclude that the $30 million returned to shareholders is not in lieu of a dividend. The cancellation is driven by an objective commercial decision to return surplus capital following the sale of a significant property, rather than an attempt to distribute earnings in a tax-advantaged manner.

Example | Tauira 4 – Returning accumulated earnings and cash through a share cancellation

EVTech Innovations Limited (EIL) proposes a pro rata off-market cancellation to return an amount equal to 10% of the total market value of its ordinary shares on issue.

The relevant facts and background are as follows:

- The proposed share cancellation involves EIL returning $200,000 to its shareholders by buying back ordinary shares.
- Immediately before the proposed cancellation, EIL has:
  - **ASC balance:** $1 million in respect of its ordinary shares;
  - **retained profits:** $200,000 accumulated over the past 3 years;
  - **imputation credits:** a very minimal balance, due to two breaches in shareholder continuity in the past 3 years; and
  - **cash balance:** $250,000 accumulated gradually, as a result of its day-to-day trading activities, over the past 3 years from a starting balance of $50,000.
- The directors of EIL state:

- EIL does not have a dividend policy and has not paid any dividends previously. This is due to their wish to maintain a cash buffer for contingencies.
- EIL has no concrete plans for its future distributions.
- EIL does not plan to issue additional shares after the proposed cancellation.
- The purpose of the proposed cancellation is to improve a "lazy" balance sheet by returning excess capital to shareholders. For this reason, the cancellation would be funded using existing cash that EIL holds.

The Commissioner considers the relevant factors listed in s CD 22(7) and notes the following:

Relevant factor	Application to the example
The nature and amount of dividends paid by the company before or after the cancellation	EIL has not paid any dividends previously, despite having accumulated profits and cash balances. While the directors cite a desire to maintain a cash buffer for contingencies, this does not reconcile with the expressed purpose of the share cancellation to improve a "lazy" balance sheet. The inconsistency between these rationales raises questions about whether the share cancellation is being used to distribute profits in a manner that substitutes for dividends.
The issue of shares in the company after the cancellation	EIL does not intend to issue additional shares after the cancellation. This factor does not indicate that the cancellation is in lieu of a dividend, nor does it conclusively prove that it is not.
The expressed purpose or purposes of the cancellation	The stated purpose is to return surplus capital to shareholders to improve balance sheet performance. However, when viewed objectively, the surplus being returned is simply accumulated profits. Therefore, this factor indicates the cancellation is likely to be in lieu of dividend.
Other relevant factors	The relevant factors are as follows: ▪ The cancellation is a one-off transaction but is not accompanied by a significant reduction in the company's business or assets. ▪ The quantum and the pro rata nature of the capital return indicate that no single shareholder will suffer a material reduction in their ownership interests in EIL.

	▪ The minimal balance of imputation credits means shareholders would face a higher tax liability on dividends, creating an incentive to distribute earnings through a share cancellation instead.

Conclusion: Given the lack of dividend payments, the accumulation of profits and cash, the irreconcilable statements relating to EIL's cash balance, and the pro rata nature of the share cancellation, it would be difficult to satisfy the Commissioner that the cancellation is not in lieu of the payment of a dividend. The facts suggest that EIL undertakes a share cancellation once it has accumulated sufficient profits to meet the 10% bright line test. Taken together with the absence of imputation credits, these factors weighed up indicate that EIL may be using the cancellation to avoid distributing profits as taxable dividends.

Example | Tauira 5 – Balance sheet restructure

LuckyCoin Investments Limited (LIL) has 20 million ordinary shares on issue and a total ASC balance of $20 million. LIL repurchases and cancels 10 million of the ordinary shares at the price of $1.50 per share. Therefore, it returns the total amount of $15 million, which represents more than 15% of the market value of all shares in LIL.

Other relevant facts and background are as follows:

- LIL has no retained earnings or significant cash balances as it has incurred annual losses since incorporation.
- LIL has never paid a dividend and does not have a dividend policy.
- At the early phases of its business, LIL had been unable to secure bank lending to fund its business and had been relying fully on shareholder capital. It has now reached the next stage of its business cycle and can begin to service debt. It borrows $15 million from a third-party lender to fund the entire cancellation.
- The purpose of the cancellation is to align its debt-to-equity funding mix with industry norms, supportable by LIL's research and analysis.
- LIL has no plans to issue additional shares after the cancellation.

The Commissioner considers the relevant factors listed in s CD 22(7) and notes the following:

Relevant factor	Application to the example
The nature and amount of dividends paid by the company before or after the cancellation	This factor does not suggest the cancellation is in lieu of a dividend. Historically, LIL has incurred annual losses and has had no excess cash to distribute and therefore has been unable to pay any dividends.
The issue of shares in the company after the cancellation	LIL does not intend to issue additional shares after the cancellation. This factor does not indicate that the cancellation is in lieu of a dividend, nor does it conclusively prove that it is not.
The expressed purpose or purposes of the cancellation	This factor indicates the cancellation is less likely to be in lieu of a dividend. The share cancellation seeks to achieve an objective commercial outcome and LIL has provided supporting evidence.
Other relevant factors	This factor indicates the cancellation is less likely to be in lieu of a dividend. The cancellation is a significant one-off event as it is the first time LIL has returned capital and the cancellation represents a significant (75%) reduction in each shareholder's invested capital in the company.

Conclusion: When considering all of the factors, the Commissioner on these facts would be satisfied that any amount paid under the share cancellation is not in lieu of a dividend. The cancellation is supported by an objective and verifiable commercial purpose, and it is clear from the facts that prior to this transaction LIL has not been in a position to pay dividends.

Example | Tauira 6 – Return of surplus capital with policy of paying high dividends

GreenTech Energy Solutions Limited (GES) is an established company in the renewable energy sector, focusing on solar and wind energy projects. Over the years, GES has benefited from favourable conditions and increased public interest in sustainable energy, which in combination have led to a steady increase in profits.

GES finds itself with surplus capital despite:

- having a dividend policy and practice of paying out 70% of its annual after-tax profits as dividends; and
- retaining the remainder to invest back into its business operations and to pay down external debt.

This surplus has accumulated due to several factors, including:

- **Efficient capital management:** GES has consistently managed its capital expenditures efficiently, completing projects under budget without compromising quality.
- **Operational savings:** Advances in technology in recent years have led to operational savings, reducing costs more than anticipated. This includes a reduction in a quarter of the GES labour headcount and the closure of one of its offices over the past 2 years.
- **Disposals of capital assets:** As a result of the office closure, some surplus assets have been sold for market value.

GES wishes to return $20 million of surplus capital to its shareholders as it believes it does not need the capital due to the reduced operations. The board proposes a pro rata share cancellation scheme where GES will repurchase and cancel a portion of shares, distributing the surplus capital (equal to 16% of the company's market value and 50% of its ASC balance) back to shareholders. This will be GES's first share cancellation.

GES does not intend to issue additional shares in the foreseeable future as it has sufficient capital. Its dividend-paying policy will continue unaltered after the cancellation.

The Commissioner considers the relevant factors listed in s CD 22(7) and notes the following:

Relevant factor	Application to the example
The nature and amount of dividends paid by the company before or after the cancellation	GES has a policy of paying regular dividends and has a record of paying 70% of its annual after-tax profits as dividends. The surplus capital has accumulated despite this policy and the reinvestment of earnings into the business, which appears to suggest that the surplus is not a result of withholding dividends to meet the bright line test.

	GES' decision to continue the high dividend policy after the cancellation also indicates it has not deliberately altered its distributions to disguise a dividend.
The issue of shares in the company after the cancellation	This factor does not suggest the cancellation is in lieu of a dividend because GES does not intend to issue additional shares after the cancellation, nor does it conclusively prove that it is not.
The expressed purpose or purposes of the cancellation	The return of surplus capital appears to be driven by an objective commercial purpose. GES has objective evidence to demonstrate that the capital is in excess due to the material reduction in its business operations.
Other relevant factors	This factor indicates the cancellation is less likely to be in lieu of a dividend for the following reasons: ▪ The cancellation is part of the downsizing of the company's operations. ▪ The cancellation is an unusual one-off event as GES has never cancelled its shares in the past. ▪ There is a significant 50% reduction in the invested capital for all shareholders.

Conclusion: GES's share cancellation is not in lieu of a dividend. There is an objective commercial reason for returning surplus capital following a downsizing of the company's operations. GES has also been paying high levels of dividends which demonstrates the surplus capital is not the result of withholding earnings to satisfy one of the bright line tests.

While there are some retained earnings on GES's balance sheet, that fact needs to be considered in the whole context of the anti-avoidance test. The test is designed to stop behaviours that defeat the purpose of the bright line tests. The mere presence of retained earnings alone is not sufficient to demonstrate a taxpayer has engaged in such behaviour, hence the Act's requirement to consider all the factors listed in s CD 22(7).

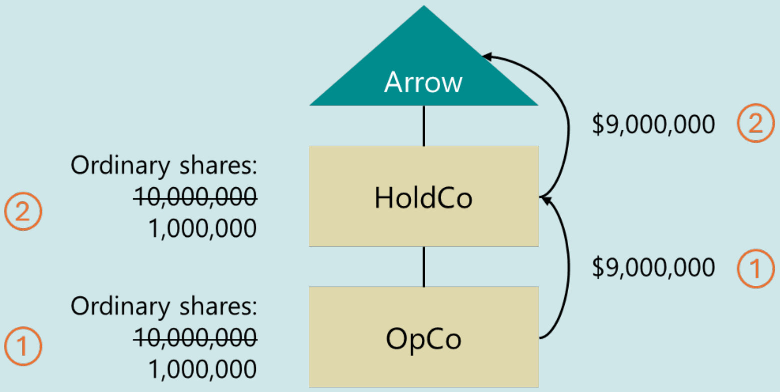
Example | Tauira 7 – Using a subsidiary's retained earnings to reduce capital

Arrowhead Capital Holdings Limited (HoldCo) holds 100% of the shares in Arrowhead Capital Limited (OpCo). HoldCo wishes to cancel 9 million shares and return $9 million to Arrow, its sole shareholder.

Before the proposed cancellation, the relevant standalone financial and tax attributes for HoldCo and OpCo are as follows:

	HoldCo	OpCo
Ordinary shares on issue	10,000,000	10,000,000
ASC	$10,000,000	$10,000,000
Retained earnings	$1,000	$10,000,000
Cash balance	$1,000	$12,000,000

The following diagram presents the group structure and the proposed cancellation.



HoldCo considers the cancellation will not be in lieu of a dividend for these reasons:

- It has not been retaining earnings to meet the bright line test as it is just a holding company with minimal income.
- The $9 million it receives from OpCo is capital in nature.

Other relevant facts and background are as follows:

- HoldCo has no dividend policy and has never paid a dividend.
- HoldCo does not intend to issue additional shares to replace the capital to be paid under the proposed cancellation.
- To fund the cancellation, OpCo will cancel 9 million of its shares and pay $9 million to HoldCo from its cash reserve.

- OpCo's cash reserve arises from its day-to-day trading activity and a total of $9 million has been gradually deposited into a high-interest savings account.
- The cancellation will not affect the group's business operations.
- The expressed purpose of the cancellation is to return the shareholder's capital that the group no longer needs.

The Commissioner considers the relevant factors listed in s CD 22(7) and notes the following:

Relevant factor	Application to the example
The nature and amount of dividends paid by the company before or after the cancellation	This factor provides no indication as to whether or not the cancellation is in lieu of a dividend. This is because there is no history of any dividend-paying practice and no funds have historically been available to distribute in HoldCo. Notably, the absence of distributable funds in HoldCo is not, in itself, persuasive evidence of a genuine capital return. In this group structure, dividends can be effectively deferred at the operating company level, and (as discussed below) that appears to be the case here.
The issue of shares in the company after the cancellation	HoldCo does not intend to issue additional shares after the cancellation. This factor does not indicate that the cancellation is in lieu of a dividend, nor does it conclusively prove that it is not.
The expressed purpose or purposes of the cancellation	HoldCo states that the purpose of the cancellation is to return surplus capital the *group* no longer needs. It is necessary to examine the source of the relevant funds for objective evidence that they represent genuine surplus capital and not simply accumulated profits. The source of HoldCo's funds is OpCo's capital reduction. As noted above, the group structure allows HoldCo and OpCo to coordinate their affairs, so it is important to assess whether OpCo's reduction reflects genuine surplus capital. If the purpose were truly to return the group's unneeded *capital*, one might expect some change such as a business divestment or at least a permanent downsizing. Here, however, the OpCo continues as before and it simply utilises a bank account of accumulated trading profits.

	Accordingly, the expressed purpose does not convincingly demonstrate that the cancellation is a genuine return of capital.
Other relevant factors	The following are some other factors that, on balance, indicate the cancellation is in lieu of a dividend: ▪ HoldCo's status as a holding company with minimal income carries little weight. The purpose of the anti-avoidance test is to counteract dividend substitutions; it is a "relevant factor" if HoldCo funds its share cancellation with a dividend substitute from its subsidiary, particularly under a coordinated scheme such as the back-to-back share cancellations in this instance. ▪ There is no explanation or any evidence that might otherwise demonstrate that the accumulation of OpCo's earnings in a separate account occurred for an objective commercial reason, rather than for the purpose of distributing those earnings under a share cancellation. ▪ The "one-off transaction" nature of the proposed cancellation does not negate the fact that the group has been accumulating earnings that it plans on distributing under the cancellation without an accompanying reduction of the business. ▪ The 90% reduction in Arrow's invested capital is significant. However, in this instance, there appears to be no "in principle" difference between distributing from the retained earnings reserve and the share capital reserve given the absence of shareholding dilution and the lack of a genuine commercial reason to cancel shares (other than to make a distribution). ▪ The \$9 million HoldCo receives from OpCo is not "capital in nature", contrary to HoldCo's assertion. The payment from OpCo does not itself qualify for the exclusion under s CD 22 for the same reasons set out above. It therefore retains its character as a dividend (albeit an exempt dividend under s CW 10) and is not "capital" in nature.

Conclusion: It would be difficult to satisfy the Commissioner that the share cancellation by HoldCo is not in lieu of a dividend. The funds used for the cancellation originates directly from OpCo's accumulated earnings, indicating that the cancellation is simply a distribution of the group's earnings.

Additionally, the cancellation does not accompany any reduction in the group's business operations, suggesting it is not driven by a need to downsize or restructure but is instead a means to distribute earnings in a tax-free manner.

Example | Tauira 8 – Swapping dividends with shareholder loan repayments

Tax Savvy Returns Limited (TSR) is a profitable company established in 2015. It has 1 million ordinary shares on issue and a total ASC balance of $1 million as at 31 March 2024.

Following the increase in the income tax rate for trustees to 39% on 1 April 2024, TSR repurchases 999,000 shares at $1 per share from its sole shareholder, trustees in the Capital Efficiency Trust (CET). TSR does not pay cash for the repurchase of its shares. Instead, the consideration is left outstanding as a $999,000 loan owed to CET. The loan is interest free.

TSR does not apply to the Commissioner for a notice under s CD 22(8) as the directors are satisfied that the cancellation meets all the relevant tests in s CD 22. Two years later, the cancellation is selected for review by the Commissioner. The Commissioner identifies the following facts during the review:

- Before the cancellation, TSR paid annual dividends equal to 70% to 80% of annual taxable profits.
- Since the cancellation, TSR has not paid any dividends and has instead applied profits towards the repayment of the shareholder loan owed to CET.
- TSR has not issued any additional shares since the cancellation.
- There have been no material changes to the size, operation and profitability of the company, either before or after the cancellation.

TSR states the purpose of the cancellation was to alter the debt-to-equity ratio of the company. However, no justification is provided for doing so.

TSR also states:

- The cancellation was an unusual one-off transaction as the company has not previously returned capital.

- The cancellation was also significant as it reduced CET's invested capital substantially.

The Commissioner considers the relevant factors listed in s CD 22(7) and notes the following:

Relevant factor	Application to the example
The nature and amount of dividends paid by the company before or after the cancellation	The consistent practice of paying dividends at a high payout ratio before the cancellation established a predictable pattern of profit distribution to shareholders. The cancellation abruptly altered this pattern. Since the cancellation, TSR has ceased to pay out its earnings as dividends. It has instead applied profits to repay the shareholder loan. This demonstrates the cancellation has created an alternative avenue for TSR to distribute profits to CET.
The issue of shares in the company after the cancellation	TSR does not intend to issue additional shares after the cancellation. This factor does not indicate that the cancellation is in lieu of a dividend, nor does it conclusively prove that it is not.
The expressed purpose or purposes of the cancellation	Although altering the debt-to-equity ratio can be a valid commercial reason for cancelling shares, TSR has not provided any evidence to justify the necessity or commercial rationale for this ratio adjustment. Accordingly, this factor does not assist TSR's position.
Other relevant factors	While there is no evidence of TSR retaining earnings for distribution, the creation of an interest-free loan via the share cancellation is, in economic reality, a distribution to the shareholder that is evidently realised using TSR profits. The almost complete reduction of CET's invested capital is material in legal form. However, given that the capital is retained in TSR (as debt as opposed to equity) and that CET continues to be the sole shareholder, it is arguable that the cancellation has not materially changed the shareholder interests in TSR in economic reality.

Conclusion: The Commissioner is likely to conclude that the share cancellation by TSR is in lieu of a dividend. The consistent high dividend payments before the cancellation, the abrupt change in distribution pattern coinciding with the increased trustee tax rate, and the creation and use of an interest-free loan to distribute profits all indicate that the share cancellation is a method employed to distribute earnings in a tax-free manner.

The lack of any justification for altering the debt-to-equity ratio further supports the conclusion that the cancellation is in lieu of a dividend.

Example | Tauira 9 – Dividend bearing redeemable preference shares

Cerulean Capital Limited (CCL) is a well-established private financial institution. It has a new regulatory requirement to maintain a certain amount of paid-up capital. It proposes to issue redeemable preference shares (RPSs) to third-party investors to satisfy this requirement.

The RPSs are "non-participating redeemable shares" for the purposes of the Act. The terms of the RPSs include the following:

- Each RPS is issued at $1 per share, permitted under CCL's constitution.
- The RPSs do not carry a participation or voting right other than protective voting rights.
- The RPSs carry a right to a quarterly dividend based on a predetermined formula, at CCL's discretion.
- If no dividends are paid on the RPSs, CCL is prevented from paying dividends on its ordinary shares.
- The RPSs are perpetual and holders do not have a right to request redemption.
- The RPSs may only be redeemed every 5 years for their issue price.
- Alternatively, the RPSs may be redeemed for their issue price where an unanticipated change in the relevant regulation impacts on the continued use of the RPSs.
- To redeem the RPSs, CCL will also need to:
  - meet the solvency test under the Companies Act 1993; and
  - satisfy the regulator that it will have sufficient capital after the redemption.

The Commissioner considers the relevant factors listed in s CD 22(7) and notes the following:

Relevant factor	Application to the example
The nature and amount of dividends paid by the company before or after the cancellation	The RPSs are yet to be issued, so there is no dividend history to consider. However, the RPS terms do provide that the RPSs will carry a right to quarterly cash dividends. It is unlikely that dividends will be withheld on the RPSs because: ▪ they are the primary means by which the third party investors are rewarded financially; and ▪ under the terms of the RPSs, CCL will be prevented from paying dividends on its ordinary shares.
The issue of shares in the company after the cancellation	This factor is mainly about identifying cases where a company cancels shares and later issues additional shares to circumvent the bright line thresholds. Given non-participating redeemable shares such as the RPSs are not subject to the bright line thresholds of 10% or 15%, this factor is less relevant in this case. Further, while it is possible that CCL may replace the RPSs with another equity instrument in the future to meet its regulatory capital requirement, it would likely do that in the context of the regulatory environment rather than to avoid paying a dividend.
The expressed purpose or purposes of the cancellation	CCL can only redeem the RPSs under very limited circumstances. All of those circumstances involve objective commercial reasons for redeeming the RPSs and are subject to strict conditions, including approval from the regulator. This supports the view that any redemption of the RPSs is unlikely to be in lieu of a dividend.
Other relevant factors	The RPS instrument is a special product issued to satisfy regulatory requirements. The terms of the RPSs diminish any avoidance concerns. In any case, given the RPS are issued to third parties (as opposed to ordinary shareholders) and can only be redeemed for their issue price, it would be difficult for the redemption to be in lieu of a dividend.

Conclusion: Overall, none of the factors in s CD 22(7) give concern that any amount paid under the share cancellation is in lieu of a dividend.

Example | Tauira 10 – Issuing NPRS to fund shareholder buy-out

This example involves two separate transactions and is split into two parts.

Part one – Non-pro rata cancellation of ordinary shares

Very Agreeable Prices Limited (VAP) is a mature retail company operating a nationwide chain of stores. VAP has 2 million ordinary shares on issue, each valued at $50, giving a total market value of $100 million.

One of VAP's substantial shareholders, Discontent Capital Partners (DCP), wishes to exit its investment in VAP due to a disagreement over the company's future strategic direction. DCP holds 400,000 VAP ordinary shares (20% of total), which are worth $20m.

The remaining shareholders agree it is best for DCP to exit the business by way of VAP repurchasing and cancelling DCP's ordinary shares. But VAP does not have enough funds to do this. Therefore, to fund the share repurchase, VAP issues 20 million NPRS at $1 per share to:

- a new investor, Shining Armour Investments (SAI), who subscribes for 10 million NPRS only, and
- the existing shareholders who subscribe for the remaining 10 million NPRS.

The NPRS:

- do not confer the NPRS holders any voting rights in relation to VAP,
- carry a high fixed dividend rate and rank ahead of ordinary shares, and
- can only be redeemed at the issue price of $1 per share.

The other relevant factors are as follows:

- VAP has a policy and practice of paying out 80% of its after-tax profits as dividends to its ordinary shareholders.
- Due to the requirement to pay dividends on the NPRS ahead of the ordinary shares, VAP's dividend policy will be amended so that ordinary shareholders will receive a lower dividend pay-out so long as the NPRS remain on issue.
- VAP does not intend to issue additional shares.
- VAP has not previously cancelled shares.

The Commissioner considers the relevant factors listed in s CD 22(7) and notes the following:

Relevant factor	Application to the example
The nature and amount of dividends paid by the company before or after the cancellation	This factor indicates the cancellation is not in lieu of a dividend. Before the cancellation, VAP has consistently paid out 80% of its after-tax profits as dividends to ordinary shareholders. Although the dividend policy will be amended post-cancellation due to the NPRS obligations, the combined effect of the dividend policy and the fixed rate dividend payout on the NPRS means VAP is unlikely to be accumulating profits. Objectively, this change is commercially driven and does not suggest an attempt to avoid paying dividends.
The issue of shares in the company after the cancellation	This factor does not suggest the cancellation is in lieu of a dividend. VAP does not intend to issue additional shares following the cancellation of DCP's shares. Separately, the NPRS are issued in response to a genuine commercial need, and are issued prior to the share cancellation.
The expressed purpose or purposes of the cancellation	This factor supports the view that the cancellation is not in lieu of a dividend. The stated purpose is to facilitate the exit of a significant shareholder due to strategic misalignment. This purpose is supported by the facts of the arrangement.
Other relevant factors	On balance, this factor supports the view that the cancellation is not in lieu of a dividend because: ▪ VAP has not previously cancelled shares, suggesting this is a one-off "unusual" transaction for the company. ▪ The cancellation results in the complete removal of a significant shareholder, materially altering VAP's ownership and capital structure.

Conclusion: Overall, none of the factors in s CD 22(7) raise concern that the amount paid to DCP for the cancellation of its shares is in lieu of a dividend. The transaction is driven by a genuine commercial need to resolve a shareholder conflict.

Part two – Redemption of NPRS

Sometime after subscribing for the NPRS, SAI requests that VAP redeems all 10 million NPRS and return its $10 million investment. VAP decides to fund the full redemption using new borrowings from an unrelated bank.

The other relevant factors are as follows:

- Prior to the redemption, VAP has continued to consistently pay dividends on its ordinary shares under the adjusted dividend policy, while also paying the fixed dividends on the NPRS.
- After the redemption, VAP will increase its dividend policy (to the extent allowable while servicing debt obligations). It will continue to pay dividends on its ordinary shares and the remaining NPRS.
- No additional shares are issued as part of the transaction, and VAP does not intend to issue further shares following the redemption.

The Commissioner considers the relevant factors listed in s CD 22(7) and notes the following:

Relevant factor	Application to the example
The nature and amount of dividends paid by the company before or after the cancellation	While the ordinary dividend pay-out was reduced due to the NPRS dividend obligations, VAP continued its practice of distributing profits rather than accumulating them. After the redemption, VAP will keep paying dividends. This continuity in dividend payments, indicates that the redemption is not in lieu of a dividend.
The issue of shares in the company after the cancellation	VAP does not intend to issue any additional shares following the redemption of the NPRS. This factor, therefore, does not indicate that the redemption is in lieu of a dividend, nor does it conclusively prove that it is not. In any case, the concern behind this factor (replacing returned capital with new capital to defeat the bright line tests) is less relevant here because the NPRS redemption is not constrained by those bright line thresholds.
The expressed purpose or purposes of the cancellation	The redemption of the NPRS is to facilitate the exit of a shareholder. The facts of the example suggest this is a genuine commercial need and there is no objective evidence to suggest otherwise.
Other relevant factors	Several other factors support the view that the redemption is not in lieu of a dividend: - **Nature of the NPRS and investor:** The NPRS are held by an investor with no ordinary shareholding in VAP. The only value that SAI receives from VAP are the fixed

	dividends (taxed as such) and the return of its $10 million capital. These factors in the context of the facts suggest that there is no opportunity to use the redemption to disguise a dividend. ▪ **Funding of the redemption:** VAP funds the $10 million redemption by borrowing from an unrelated bank at the time of redemption. This means the company did not rely on accumulated profits to finance the payment. ▪ **One-off, required transaction:** This redemption is a one-off event. The redemption results in the complete removal of SAI's stake, and significantly alters VAP's capital structure. Such a substantial change, effectively unwinding the earlier introduction of a new investor, indicates that the redemption is a genuine commercial transaction and not in lieu of the payment of a dividend.

Conclusion: Overall, none of the factors in s CD 22(7) raise concern that the amount paid to SAI for the cancellation of its shares is in lieu of a dividend.

Draft items produced by the Tax Counsel Office represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

In draft form these items may not be relied on by taxation officers, taxpayers, or practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

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Appendix – Legislation | Āpititanga – Whakature

CD 22 Returns of capital: off-market share cancellations

When this section applies

(1) This section applies when a company pays an amount to a shareholder because of the off-market cancellation of a share in the company, other than on liquidation of the company.

Ordering rule

(2) The amount is not a dividend to the extent to which it is less than or equal to the available subscribed capital per share calculated under the ordering rule, if—

(a) 1 of the bright line tests in subsection (3) is met; and

(b) the company is not an unlisted trust that has chosen the slice rule for the share under subsection (4); and

(c) the anti-avoidance rule in subsection (6) does not apply.

Bright line tests

(3) The bright line tests referred to in subsection (2)(a) are as follows:

(a) the cancellation is part of a pro rata cancellation that results in a fifteen percent capital reduction for the company:

(b) the cancellation is part of a pro rata cancellation that results in a ten percent capital reduction for the company and the Commissioner has given a notice under subsection (8):

(c) the cancellation is not part of a pro rata cancellation and results in the shareholder suffering a fifteen percent interest reduction:

(d) the company is an unlisted trust and the cancellation is not part of a pro rata cancellation:

(e) the share is a non-participating redeemable share.

Unlisted trusts choosing slice rule

(4) If the company is an unlisted trust, it may issue a share on terms that the ordering rule does not apply and that instead the slice rule applies to the cancellation. If this happens, the amount paid is not a dividend to the extent to which it is less than or equal to the available subscribed capital per share calculated under the slice rule (but still subject to the anti-avoidance rule in subsection (6)).

Calculation concessions for foreign unlisted widely-held trusts

(5) If a company is an unlisted widely-held trust not resident in New Zealand and a shareholder cannot obtain sufficient information to calculate the available subscribed capital per share under the ordering rule,—

(a) the share is treated as if it were issued under subsection (4) on terms that the slice rule applies; and

(b) the available subscribed capital under the slice rule is—

(i) the amount paid for the issue of the share, if subparagraph (ii) does not apply; or

(ii) the value of the money or property in which a beneficial interest would have vested in the shareholder had the share not been issued, if the share is a taxable bonus issue under paragraph (d) of the definition of the term.

Overriding anti-avoidance rule

(6) Neither subsection (2) nor (4) excludes an amount paid by a company on cancellation of a share from being a dividend if any part of the payment is in lieu of the payment of a dividend.

Factors relevant in applying anti-avoidance rule

(7) For the purposes of applying subsection (6), the following factors must be considered:

(a) the nature and amount of dividends paid by the company before or after the cancellation; and

(b) the issue of shares in the company after the cancellation; and

(c) the expressed purpose or purposes of the cancellation; and

(d) any other relevant factor.

Commissioner notifying view

(8) If no part of a payment on cancellation of a share is in lieu of the payment of a dividend, the Commissioner may give notice to the company that subsection (6) does not apply to the cancellation.

Some definitions

(9) In this section –

counted associate means—

(a) a person associated with the shareholder other than merely by virtue of being a relative; or

(b) a spouse, civil union partner or de facto partner, or minor child of the shareholder, or a trustee of a trust under which a spouse, civil union partner or de facto partner, or minor child of the shareholder has benefited or is eligible to benefit

fifteen percent capital reduction means the circumstance in which the total amount paid by the company on account of the cancellation (or on account of any other pro rata cancellation of participating shares in the company occurring at the same time) is at least 15% of the market value of all participating shares in the company at the time the company first gave notice to shareholders of the cancellation

fifteen percent interest reduction means the circumstance in which, immediately after and as a result of the cancellation (together with any other cancellation of participating shares in the company occurring at the same time),—

(a) the total direct voting interests in the company of the shareholder and any counted associates is 85% or less of their total direct voting interests in the company immediately before the cancellation; and

(b) if at the time of the cancellation a market value circumstance exists, the total direct market value interests in the company of the shareholder and any counted associates is 85% or less of their total direct market value interests immediately before the cancellation

non-participating redeemable share means a share that meets the following conditions

(a) the share is issued, under the company's constitution or establishing legislation, on terms that involve the share being required or allowed to be redeemed or repaid before the company is liquidated; and

(b) the share is—

 (i) a redeemable share under section 68 of the Companies Act 1993 or an equivalent provision of foreign law; or

 (ii) issued under 1 of New Zealand's Acts relating to co-operative companies; or

 (iii) subject to sections FA 2 (Recharacterisation of certain debentures) and FZ 1 (Treatment of interest payable under debentures issued before certain date) or section FA 2B(2) (Stapled debt securities); or

 (iv) a unit in a unit trust that is not a widely-held trust; and

(c) the share is either a fixed-rate share or a share for which the amount payable on cancellation is no more than the available subscribed capital per share calculated under the slice rule; and

(d) the shareholder does not have shareholder decision-making rights in relation to the share except—

 (i) a protective right; or

 (ii) if the company is subject to 1 of New Zealand's Acts relating to co-operative companies

participating share means a share that is not a non-participating redeemable share

protective right means a shareholder decision-making right that—

(a) arises only if the shareholder's position may be altered to the shareholder's detriment or if the company defaults on its obligations under the terms of the share; and

(b) is granted to the shareholder only to assist the shareholder to prevent the alteration or to remedy the default; and

(c) when the share is issued is not expected to arise

ten percent capital reduction means the circumstance in which the total amount paid by the company on account of the cancellation, or paid on account of any other pro rata cancellation of participating shares in the company occurring at the same time, is at least 10% of the market value of all participating shares in the company at the time the company first gave notice to shareholders of the cancellation

unlisted trust means a unit trust or group investment fund, the units or interests in which are not quoted on the official list of a recognised exchange.

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About this document | Mō tēnei tuhinga

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