MUNRO LEYS
Munro Leys, Lawyers & Notaries Public
Pacific House, Butt Street, GPO Box 149 Suva, Fiji
Phone +679 331 4188 Fax +679 330 2672
Web www.munroleyslaw.com

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29 October 2012

Tax Tribunal Decision – s. 8(2)(a)*(ii)* of the Income Tax Act and the Dividend Regulations

Introduction

1. A recent Tax Tribunal case (A *New Zealand Holding Company v FRCA)* has resulted in rulings, for the first time, on:

   (a) the meaning of *sale of a company* in s.8(2)(a)(*ii)* of the Income Tax Act [the Tribunal held a 50% share sale is still caught]

   (b) whether corporate tax paid before the 2001 tax year can be taken into account in calculating credits for qualifying dividends under the Dividend Regulations [no].

   The issue in (b) has been controversial for three years and is the first time this matter has been judicially considered.

Background

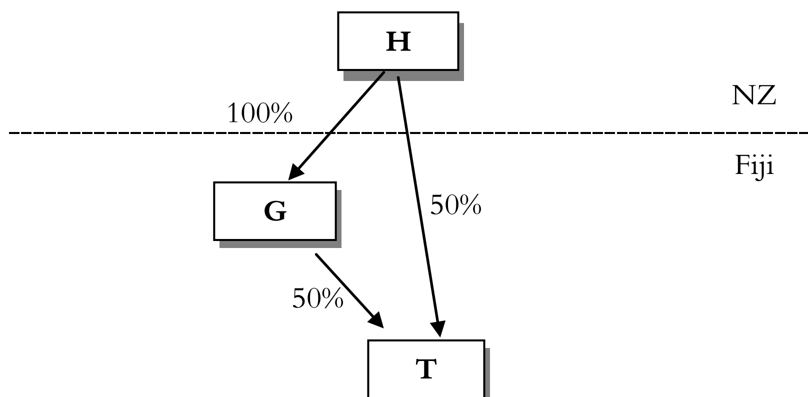
2. Before 2008-09 the Dividend Regulations 2001 were interpreted to allow all corporate tax paid (before or after 2001) to be applied in the calculation of credits (under the specific Dividend Regulations formula) against taxation on dividends.

3. In 2007 FRCA stopped applying the Dividend Regulations formulation altogether. This resulted in non-resident shareholders having no relief from double taxation on dividends. A non-resident shareholder (represented by Munro Leys) sued FRCA seeking a declaration that the Dividend Regulations applied.

4. FRCA settled the case out of court, accepting that the Dividend Regulations applied. However FRCA then took the position that corporate tax paid for pre-2001 income tax years could not be taken into account for the purposes of calculating qualifying dividend.

Facts of the *New Zealand Holding Company* case

5. The taxpayer was Company H **(H)**, a New Zealand incorporated company. It held shares in two Fiji incorporated companies, Company G **(G)** and Company T **(T)** as follows:



6. Under a share sale agreement, H sold all its shares in G and T (that is, 100% of G's shares and 50% of T's shares).

7. FRCA assessed the companies to non-resident dividend withholding tax **(NRDWT)** on the following basis:

   (a) both G and T were being "sold" - therefore s.(8)(2)(a)*(ii)* the ITA applied

   (b) 50% of T's retained earnings were deemed to be distributed to H as dividend and charged with NRDWT

   (c) 50% of T's retained earnings were deemed to be distributed to G. As an inter-company dividend, this was not charged with any tax. However this amount was added to G's retained earnings and the total (that is: (i) 100% of G's retained earnings and (ii) the 50% of T's retained earnings deemed to be distributed to G) was deemed to be dividend distributed to H. This was charged with NRDWT.

   (d) no credit was given in the calculation of the NRDWT liability for corporate tax paid by the companies for pre-2001 income tax years.

8. H objected to the assessments. The objection was wholly disallowed. H then filed an Application for Review in the Tax Tribunal.

Issues for consideration

9. The Tribunal had to consider the following three issues:

   Issue 1 – whether there was a sale of company for the purpose of s.8(2)(a)*(ii)* in the case of T (where only 50% of the its issued shares changed hands).

   Issue 2 - whether FRCA could for the purpose of calculating the NRDWT liability under s. 8 add to G's actual retained earnings part of T's retained earnings deemed to be distributed as dividends to G.

   Issue 3 – whether corporate tax paid for pre-2001 income tax years could be taken into account for the purpose of calculating the NRDWT liability under the Dividend Regulations.

Tribunal's decision

10. The Tribunal ruled for FRCA in Issues 1 and 3 and for the taxpayer in Issue 2.

Issue 1 – Sale of company

11. The Tribunal held that there was, in the case of T (in respect of which only a 50% shareholding was sold), a *sale of a company*. Therefore s. 8(2)(a)*(ii)* applied. The Tribunal's reasoning appeared to be that a share sale agreement was in reality the sale of a business even though (in the case of T) only 50% of the shares actually changed hands.

12. The case may have been coloured by the fact (refer diagram) that ultimately all the shares in T and G ended up in the hands of the buyer, though this was through distinct transactions.

13. This part of the ruling will be appealed.

Issue 2 – value of retained earnings

14. The Tribunal held that FRCA could not add to G's actual retained earnings the retained earnings of T deemed to be distributed to G. There was no legislative basis for FRCA to do this. The Tribunal agreed that the basis for deeming G's retained earnings as dividend for the purposes of s.8(2)(a)*(ii)* was G's **actual** retained earnings at the time of the sale.

15. The Tribunal accordingly reversed the addition of T's retained earnings to G's retained earnings for the s.8(2)(a)(*ii*) purposes, resulting in a significant reduction in H's tax payable.

Issue 3 – pre-2001 corporate tax paid

16. The Tribunal agreed with FRCA on this issue and ruled that corporate tax paid for pre-2001 income tax years cannot be used in the Dividend Regulations calculations.

17. The Tribunal appears to have placed emphasis on the general principle that laws have prospective application unless expressly stated otherwise. The date from which the Dividend Regulations applied – 1 January 2001 - was not in dispute. The taxpayer however argued that this fact did not prevent the words ***corporate tax paid*** in the relevant formula applying to corporate tax paid before 2001. The evidence was undisputed that FRCA had initially applied the formula in this way before 2008.

18. The decision blurs the line between the 'corporate tax paid' component and the 'excess tax credit' component of variable 'A' in the Dividend Regulations. FRCA accepted that the 'corporate tax paid' component included corporate tax paid for previous years (i.e. years before the year of distribution), but only to the extent this corporate tax was not for the pre-2001 tax year. The taxpayers argued that there was no basis to make such a distinction given the plain and ordinary meaning of the words *corporate tax paid*. The Tribunal decision did not specifically address this argument.

19. This part of the ruling will be appealed.

Implications

20. In our view the implications of this decision are:

    (a) that we are probably not much further ahead in understanding how the vague words *sale of a company* in s.8(2)(a)*(ii)* will be applied. The decision may be interpreted as endorsement of FRCA's practice of applying s.8(2)(a)*(ii) pro rata* in the case of sales of less than a 100% shareholding. Taxpayers may still be able to argue, however, that this decision is confined to its unique facts.

    (b) only actual retained earnings of a company may be taken into account for the purposes of s.8(2)(a)(*ii*). In any circumstances (as applied here for G) where there are deemed retained earnings to a company whose shares are being sold, those deemed retained earnings will not be taken into account.

    (c) on the critical issue of how FRCA now applies the Dividend Regulations to pre-2001 corporate tax paid, FRCA's current practice has been endorsed. This may have serious implications for companies relying on (or who have in the past relied on) pre-2001 corporate tax credits to pay tax-free (qualifying) dividends to shareholders (non-residents or otherwise).

21. Please contact the Munro Leys tax team if you have any queries or wish to discuss anything arising from this decision.

Richard Naidu Partner Direct Dial +679 322 1816 richard.naidu@munroleyslaw.com.fj	Nehla Basawaiya Senior Associate Direct Dial +679 322 1848 nehla.basawaiya@munroleyslaw.com.fj	Rajnil Krishna Solicitor Direct Dial +679 322 1814 rajnil.krishna@munroleyslaw.com.fj

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