Entrust
Majority shareholder of Vector

13 August 2018

The Chair
Finance and Expenditure Committee
Parliament
Wellington

Dear Sir

Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Bill

This submission is made by Entrust with respect to the Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Bill ("the Bill").

We do not request the opportunity to appear before the Committee, but we welcome the opportunity to comment and are available to discuss this submission with officials should you wish.

Our submission is:

- The Bill be amended to allow variable dividend resident withholding tax ("RWT") rates along the same lines as the law already allows variable RWT rates on interest income. This would be elective so companies if they wish could continue under existing dividend RWT rules.

- Officials explore with Entrust a longer term more comprehensive solution allowing either excess imputation credits to be refunded to get more accurate RWT rates or using PIE rules so that Entrust beneficiaries are in the same position as KiwiSaver investors.

Executive Summary

Entrust manages an investment in Vector for some 327,000 Auckland consumers of electricity in the area that used to be served by the Auckland Electric Power Board. It receives Vector dividends and passes those through to consumers. Current tax rules are complex and result in most households overpaying tax on their Entrust distributions. Prior discussions have indicated a willingness to deal with the issue of over-taxation of the distribution of Vector dividends and we understood that this might be addressed by this Bill. The Bill, however, is likely to leave Entrust beneficiaries facing complex rules and over taxation.

In summary, our submission is:

1 The proposals in the Bill address some of the concerns of Entrust however it is not the optimal solution given the large number of beneficiaries and that beneficiaries have to wait a period of time to obtain the refund of overpaid tax. It will be difficult and for Entrust to obtain IRD numbers from over 327,000 beneficiaries given there is no immediate change in the cash received by these beneficiaries, we believe few beneficiaries will provide IRD numbers.

2 To provide immediate benefits, we believe we should be able to have a variable RWT rate applied to distributions where IRD numbers are held. This is exactly what happens with interest income, but currently is not allowed for dividends. This is a change that can be made in this Bill. We believe we will get more IRD numbers if we can offer a variable rate of RWT.

3 The ideal solution is that, where IRD numbers are held, the rate of tax is the correct rate of tax for that beneficiary namely 10.5%, 17.5%. 28%, 33% or 53%. This would require:
   a. Beneficiaries to provide an IRD number and their rate of tax
   b. Payers of dividends to have a variable resident withholding rate for dividends
   c. Refunding imputation credits where the beneficiaries tax rate is less than 28%

4 Failing the above, we have previously raised whether Entrust can apply the PIE rules which would allow the distributions to have a final tax rate similar to all other PIEs. Entrust cannot become a PIE as it owns more than 20% of a company. If the PIE rules applied, beneficiaries would have the same tax rules as they do for KiwiSaver something that is more familiar to most people.

We acknowledge the immediate above two options are probably outside the scope of the Bill.

Background to Entrust and its issues

Entrust is a trust established in 1993 and was set up originally to manage the assets of the Auckland Electric Power Board (which became Mercury Energy) on behalf of the owners of those assets – the consumers in the area that used to be served by the Power Board (Auckland, Manukau, Papakura and Franklin). It now owns 75.4% of Vector Limited, a publicly listed company that owns, amongst other things, the lines business of what was Mercury Energy. Entrust manages this investment in Vector on behalf of the beneficiaries.

Entrust receives the dividends from the Vector investment and then they distribute those dividends to beneficiaries. There are over 327,000 households and businesses that are its beneficiaries.

By its trust deed Entrust is limited to investing in Vector, New Zealand Government stock, bank deposits and A- rating agency financial instruments.

Entrust is one of about 30 energy trusts set up to own the assets of their former power boards.

Existing Tax Position

Currently Entrust is taxed as an ordinary trust. It receives fully imputed dividends from Vector. Entrust has a certificate of exemption from RWT so no RWT is deducted. Dividends are then passed on to its beneficiaries – an end consumer of Vector located within the area serviced by the Auckland Electric Power Board in 1993 whose name is on the power bill.

End consumers receive taxable income as dividends with imputation credits attached.

Under section RE 13 of the Income Tax Act 2007 ("the Act"), Entrust deducts 5% RWT from all dividend income it distributes to beneficiaries (33% being the tax rate less 28% representing the imputation credits attached to the dividend.) Most beneficiaries by number are not required to file tax returns so that in effect the 33% total tax paid by Vector or deducted by Entrust as RWT is in most cases the final tax impost. In 2017 Entrust distributed dividends of $508.55 – of this amount $142.39 were imputation credits and $25.43 RWT credits so that the cash distribution was $304.73 on which tax at 33% had been deducted. (Entrust also distributed $9.27 of tax paid trustee income). This was received by each power account holder. Where the property being supplied is jointly owned, the dividend is split between owners.

Problems with the Existing Tax Treatment

The existing tax treatment of Vector dividends distributed by Entrust creates a number of issues. The main issue of concern is that current rules result in many lower income families and individuals being over-taxed on their Entrust distributions. The rules are also costly to operate, complex and confusing to beneficiaries.

Most beneficiaries by number are non-filing individuals on a marginal income tax rate of less than 33%. Based on IRD data for 2015, of the 4,092,000 individual taxpayers in New Zealand, 86% had incomes where the marginal tax rate is 30% or less. This means that current tax rules can over-tax 86% of people. The same data shows that 32% are on 10.5% marginal tax rates, 40% on 17.5% and 14% on 30%. The median taxable income was $24,405 (a tax rate of 17.5%) and the median wage $44,140 (again a tax rate of 17.5%). Those with only New Zealand superannuation income are also on a 17.5% marginal tax rate. Assuming, as seems reasonable, that Auckland data is similar to national data; this means that most end consumers are being significantly over-taxed by dividend tax treatment of Entrust distributions on the basis that most do not file tax returns.

While beneficiaries are able to file a return and thus get any tax refunded, it is understood that few do so. National superannuitants are an example. This is a source of constant complaint.

It has been argued that some of this over-taxation may be clawing back over-payments of working for family tax credits (FTC, MFTC, PTC, IWTC, and CTC). However, of the 345,900 families receiving one or more of these tax credits almost half seem to be below the threshold family income level at which family tax credits are abated for extra income. Moreover, the amount of money involved on dividend payments in the order of $500 per annum seems minimal. We note that RWT by its nature is an inaccurate and untargeted mechanism for clawing back over-payments of family tax credits and has no operation with respect to other forms of social assistance (child support and student loans).

In addition to over-taxing a large number of lower income families the dividend treatment of Entrust distributions is very confusing to recipients of such distributions. These people in general have no experience of direct share ownership. A number of aspects cause confusion:

- Whether Entrust distributions are taxable income and if so the nature of that income
- How beneficiaries obtain taxable dividend income when they do not own shares in Vector
- What is imputation and how imputation works
- Why RWT is deducted
- How to return Entrust distributions and what to do with imputation credits and RWT deducted
- How the existing rules impact charitable consumers and other tax exempt entities (who currently provide either a certificate of exemption or seek refunds from the Inland Revenue).

Informing beneficiaries of how the tax on the dividends applies and why tax is being levied at 33% creates considerable costs for Entrust. To establish and resource a call centre to answer questions is cost prohibitive. A simpler system would reduce costs making more money available for distribution to beneficiaries. Moreover, for the hundreds of thousands of beneficiaries that have no experience of share ownership, the tax treatment of dividends is a matter of great confusion and anxiety.

We annex a copy of Entrust's tax certificate available to beneficiaries. While accurate this is very hard for most people to understand.

We understand that as a result of discussions over the past year there is now general agreement that the over-taxation problem should and needs to be fixed. We further understand that the Bill is seen as the appropriate vehicle to do so.

The Provisions in the Bill

Entrust has had a number of discussions with Ministers and officials over the last few years. We understood that this Bill was going to provide solutions. Unfortunately, for the reasons set out below, that is not the case. The Bill would largely leave Entrust and its beneficiaries in the same position as now. Entrust distributions would remain taxed at 33% (overtaxed) at the Entrust/Vector level. We presume the intention is that Inland Revenue would then automatically refund this over taxation some time later. However, that leaves all the complexity and confusion for beneficiaries of the current rules. It also assumes Entrust has and can provide Inland Revenue with data on who the distributions went to and the IRD number of each such beneficiary.

Entrust does not currently in general have records of IRD numbers.

There would need to be a clear and simple case that Entrust can provide beneficiaries as to why they should provide IRD numbers and a compelling business case for Entrust incurring the significant expense of setting up systems for collecting, collating and supplying IRD numbers to Inland Revenue.

A case that if the IRD number is supplied and if you earn less than $70,000 you will get a higher Entrust distribution would be such a case.

A complex argument about how the tax rules work and that if the IRD number is supplied at a later date Inland Revenue will in some circumstances refund money does not seem to stack up

Our understanding of the provisions in the Bill are to:

- **simplify individuals' year end income tax filing obligations;**

- **ensure withholding tax rates and tax codes that are applied to individuals' income during the year are more appropriate**;

- **enable Inland Revenue to use income information received during the year to proactively help people to move to appropriate tax rates**;

- only require individuals who derive more than $200 of non-reportable income, are non-resident, have tax losses, are subject to the financial arrangement rules or pay provisional tax to provide income information to Inland Revenue;

- **automatically pay a tax refund to those individuals who are not required to provide income information to Inland Revenue. The refund will be paid by direct credit;**

- not require additional income tax to be paid on any income that has been undertaxed where tax has been withheld at an appropriate withholding tax rate or tax code;

- not require additional tax to be paid that arises in relation to income subject to withholding rules when less than $200 of income is not taxed correctly; and

- classify individuals as
    - Group A (automated process) where the individual earns only reportable income and Inland Revenue considers information it holds is correct;

    - Group B – the individual earns reportable income but may have other income or deductions which the individual will have to provide or confirm that the information held is correct;

    - Group C – the individual has no or very little reportable income. Individuals will have to provide information similar to current IR 3 process.

A Way of Ameliorating the Entrust Problem

We submit that in order for the problems Entrust faces to be ameliorated it is necessary that there needs to be a real time benefit to beneficiaries for them to providing IRD numbers to Entrust.

A simple but partial approach would be to allow RWT on dividends such as those paid to beneficiaries by Entrust to have variable RWT rates the same as already applies for interest RWT. In other words, simply apply the current interest RWT rules to dividends. To the extent that Vector dividends are fully imputed Vector has already deducted tax by way of company tax at a 28% rate, the tax withheld would be a minimum of 28%. The RWT rates would be 0% (in most cases), 2% (for those beneficiaries on a 30% tax rate) or 5% (for those beneficiaries on the top 33% tax rate). Inland Revenue would refund the excess tax of the majority of beneficiaries on a 10.5% or 17.5% rate.

To the extent Vector paid unimputed dividends, variable RWT rates would result in the correct amount of tax being withheld avoiding the need for any Inland Revenue refund.

Variable dividend RWT rates would be in effect elective (as with interest RWT). If they so wished companies could continue to operate under current dividend RWT rules.

This would only be a partial solution but one we submit could be enacted by amendment to this Bill.

It would provide substantial advantages over enacting the Bill in its current form. Those who do provide IRD numbers would be taxed at 28% and not 33%. There would be a clear and easily explainable reason for beneficiaries to provide Entrust with their IRD numbers – doing so would mean a higher payment from Entrust and refunds from Inland Revenue.

A more comprehensive solution does seem to be needed to provide a simple set of rules that beneficiaries can understand and that would not entail excessive tax payments being made by Entrust/Vector which are at some later date refunded by Inland Revenue. Having Inland Revenue over-collect tax for 327,000 households and then be required to refund it does not seem to be the ideal modern tax system making good use of the very significant IT investment that is being made by taxpayers.

We advance two options for a more comprehensive solution:

1 Allowing Entrust to have variable RWT (including imputation credits) that ensure the correct tax rate is arrived at when the distribution is paid. This would entail variable RWT rate (as above) but also refunding excess imputation credits when the beneficiaries tax rate was below that of the imputation credits attached to the dividend.

2 Allowing Entrust to elect into the PIE regime, hence beneficiaries (who supply IRD numbers) would be taxed at their PIE tax rate (also known as their PIR – PIE Investor Rate). For Entrust beneficiaries the tax rules would be the same as those applying to KiwiSaver.

We appreciate that these solutions would need to be developed and could not be enacted by way of this Bill. However, we submit that they need to be explored in the medium term if a satisfactory solution is to be arrived at

We would be happy to meet with officials to explore the above two options noting we have previously raised this with officials.

Concluding comments

The Bill is a missed opportunity, we believe further reform should occur. We demonstrate this in the following table. This assumes the Entrust beneficiary is on a tax rate of 17.5%.

	Current rules	Proposals under the Bill	Variable RWT	Ideal	Ideal using PIE rules
Amount to be distributed	72	72	72	72	72
Imputation credit	28	28	28	28	28
Taxable amount	**100**	**100**	**100**	**100**	**100**
Taxes to be deducted					
Imputation credit	-28	-28	-28	-17.5	-17.5
RWT	-5	-5	0		0
Cash paid by Entrust	**67**	**67**	**72**	**82.5**	**82.5**
Tax rate of beneficiary	17.50%	17.50%	17.50%	17.50%	17.50%
IRD refund if IRD number provided	**-15.5**	**-15.5**	**-10.5**	**0**	**0**

The above demonstrates that currently beneficiaries can include their distribution in their tax return to obtain a tax refund if they file a return. Under the Bill, the amount they get from Entrust does **not** change and Entrust will have to incur substantial costs to obtain IRD numbers and explain what beneficiaries have to do. We suspect the uptake of obtaining IRD numbers will be low.

If we have a variable RWT rate, then Entrust beneficiaries will see an immediate benefit and this will likely increase the numbers who provide IRD numbers. We believe these changes can be made as part of the Bill.

Our ideal system provides immediate benefit to Entrust's beneficiaries. As noted above, we appreciate this is likely to be too significant to be made as part of the Bill. We would like to engage with officials to progress either of our two ideal options as we believe they are the only two methods that fully address the current over taxation.

That you for considering our submission. We would happy to discuss any aspect of it with officials and please feel free to contact us or our advisers, Olivershaw Limited.

Kind regards

William Cairns
Chairman, Entrust

APPENDIX
ENTRUST
2017 Distribution and Tax Deduction Certificate Sample

Non Taxable Distribution		
Tax Paid Trustee Income		$9.27
Taxable Distribution		
2016-2017 Taxable Distribution		
Gross Taxable Dividend	$271.94	
Less Imputation Credits	$76.14	
Less Resident Withholding Tax	$13.61	
		$182.19
2017-2018 Taxable Distribution		
Gross Taxable Dividend	$236.61	
Less Imputation Credits	$66.25	
Less Resident Withholding Tax	$11.82	
		$158.54
Total Net Taxable Distribution		$340.73
Total Net Distribution		$350.00

This statement should be retained for tax purposes. Tax credits equal to 33% have been paid on the taxable distribution. **If you are on a lower tax rate you may be entitled to a refund of tax paid on this distribution if you file a return.** Depending on your personal circumstances you may be required to file an income tax return or request a personal tax summary. If you file a personal income tax return then, in accordance with Inland Revenue's tax return guide, the gross taxable dividend should be included in the dividends section of your return for the year indicated rather than in the estate and trust income section. If you have any queries you should contact Inland Revenue on 0800 227 774 or your tax advisor.