

CONSOLIDATED BALANCE SHEETS

Assets	2011	2010
Current assets:		
Cash and cash equivalents	1,080,531	2,110,832
Accounts receivable - net	24,932,467	28,066,744
Inventories	12,513,265	12,115,234
Deferred income tax benefits	820,240	22,952,411
Prepaid expenses and other current assets	1,423,271	772,811
Total current assets	20,660,774	65,238,032
Property, plant and equipment, net	13,454,559	13,011,571
Investments in affiliate	-	4,877
Intangible and other assets	1,381,806	185,500
	490,003,527	1,301,231,132
Liabilities and Stockholders' Equity		
Current liabilities:		
Notes payable		
Banks	8,044,454	1,028,426
Affiliates	1,423,571	1,352,171
Accounts payable	6,123,791	5,552,171
Accrued expenses		
Group advertising	6,111,263	2,014,320
Compensation	2,771,407	1,710,400
Other	831,100	65,500
Income taxes payable	1,122,000	1,122,000
Total current liabilities	27,527,586	13,793,088
Long-term debt	4,541,498	4,735,039
Commitments		
Minority interests in subsidiaries	4,016,246	1,076,271
Stockholders' equity:		
Common stock, shares issued and outstanding		
1,134,117 and 1,102,022, respectively	141,923	141,923
Additional paid-in capital	271,190,962	23,037,237
Retained earnings	15,723,060	15,666,498
Cumulative translation adjustment	1,935,111	84,869
Total stockholders' equity	64,229,438	45,995,745
	490,003,527	1,301,231,132

Taxable

Operating Activities:

Net income (loss) per share

Non-cash items affecting net income:

Minority interest in subsidiaries

Depreciation and amortization

Equity in net income of affiliate

Increase in allowance for doubtful accounts

Increase in allowance for doubtful net of related inventory of affiliate

Deferred income tax benefits

Gain/loss on disposal of subsidiary

Cash from/used in investing activities:

Acquisition of intangible

Investments

Property, equipment, and other acquisitions

Acquired goodwill

Acquired intangibles

Income taxes payable

Net cash used in investing operations

Net cash used in financing operations

Income tax expense

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imputation credits distributed to shareholders reduce their personal tax liability, unless that liability is already zero. Growing companies, however, may not be able to distribute imputation credits via the normal method of paying cash dividends.

Such companies tend to retain a large proportion of earnings to fuel their growth. This can lead to the accumulation of imputation credits.

Another way of distributing accumulated imputation credits is to issue taxable bonus issues. This accelerates the distribution of the credits to shareholders, which increases the present value of the tax benefits associated with the credits. For example, a \$1 credit today is worth more than the same credit five years from now.

In this paper, we outline New Zealand's company and imputation tax environment and the impact this has on investors with differing marginal tax rates. We then make a case for the value of taxable bonus issues and examine the possible impact of the recent increase in the top marginal tax rate to 39 per cent on both bonus issues and cash dividends. ▶

bonus issues

a good way to distribute
 accumulated imputation
 credits?

By Hamish Anderson,
 Steven Cahan and
 Lawrence Rose

Investors would prefer a dividend if its after-tax value is greater than the after-tax value of the capital gain

NEW ZEALAND'S COMPANY TAX ENVIRONMENT

New Zealand introduced an imputation system in April 1988 designed to eliminate the double taxation of corporate profits. Before that, profits were taxed at the corporate level and then again as dividend income at the personal level.

In an imputation environment, any domestic tax paid by a company is passed on to its shareholders as a tax credit.

In addition, in New Zealand capital gains are generally tax-free except for investors deemed to be traders. They must treat capital gains and losses as part of normal operating income, so their capital gains are taxed at their marginal tax rate¹.

Under New Zealand's imputation system, corporate tax is not really a company tax but rather the collection of personal tax at the company level (Officer, 1994, p4). Therefore, assuming all imputation credits are distributed and can be used by shareholders, the total government tax take on corporate profits is effectively at shareholders' personal marginal tax rates.

In New Zealand, cash dividends and taxable bonus issues are treated equally for tax purposes. Shareholders must gross up any dividends they receive (denoted as D) to include the imputation tax credits.

Assuming companies distribute fully imputed dividends, the gross dividend for personal income tax purposes is $D/(1 - t_c)$. Where a shareholder's marginal tax rate t_p is higher (lower)

than the corporate tax rate t_c , a personal tax liability (tax credit²) arises.

If investors had the option of receiving either a \$1 cash dividend or a \$1 capital gain (CG), they would prefer a dividend if its after-tax value is greater than the after-tax value of the capital gain. Investors' preference for a fully imputed dividend over an equivalent capital gain can be calculated as follows (where t_{cg} represents capital gains tax):

$$\frac{D}{(1 - t_c)} (1 - t_p) > CG (1 - t_{cg})$$

Table 1 uses the above formula to demonstrate that investors with a low marginal tax rate ($t_p = 19.5$ per cent) and those facing capital gains tax (i.e. those deemed to be traders) prefer fully imputed distributions of either cash dividends or bonus issues.

Low-tax-rate investors will continue to prefer imputed distributions (either cash dividends or bonus issues) until the ratio of imputation credits attached, multiplied by the company tax

TABLE 1

Investors' tax-induced dividend policy preferences

Tax status of investor	Marginal tax rate of 19.5%	Marginal tax rate of 33%	Marginal tax rate of 39%
Zero capital gains tax	Dividends	Indifferent	Capital gains
Capital gains tax at investors' marginal tax rate	Dividends	Dividends	Dividends

NOTE:

Investors' tax-induced preference for either capital gains or fully imputed dividends is shown above based on the assumption that investors will prefer the option that maximises their after-tax return.

¹Although the gains and losses are treated as normal operating income for those deemed to be traders, for the purposes of this article the gains and losses are categorised to be capital gains.

²The tax credit can be used to offset tax payable on other income. If the investor has no other taxable income, the tax credit is grossed up and carried forward as a tax loss, thereby reducing future income tax payable. Investors who derive future income solely from fully imputed dividends, however, will be unable to utilise this tax loss carried forward.

rate, falls below their marginal tax rate. Those facing capital gains tax will become indifferent between dividends and capital gains only when zero imputation credits are attached to dividends, regardless of their marginal tax rate.

Until April 2000, the New Zealand corporate tax rate and the highest personal tax rate were the same, so investors on the top rate were indifferent between receiving dividends or taxable bonus issues and capital gains. However, investors earning more than \$60,000 a year are now subject to a top tax rate of 39 per cent.

As shown in **Table 1**, they will prefer capital gains over fully imputed distributions such as cash dividends and bonus issues, unless they pay capital gain taxes.

Investors subject to capital gains tax face the equivalent of the classical tax system (i.e. before the imputation system) for companies retaining all profits. Under this scenario, corporate profits are taxed first at the corporate level and then again at the personal level through capital gains tax. Therefore, they will always favour the distribution of imputation credits through cash dividends.

The proportion of investors facing capital gains tax can be substantial. For example, the management of Nuplex Industries Ltd stated at the announcement of its October 21, 1996,

taxable bonus issue that, *89 per cent of its shares were held by those subject to capital gains tax and, therefore, these investors could take advantage of the accumulated imputation credits attached to the bonus issue* (Reuters, October 21, 1996).

THE CASE FOR TAXABLE BONUS ISSUES

As can be seen in **Table 2**, bonus issues are merely cosmetic accounting changes to the number of issued shares, so announcements of bonus issues should not affect shareholder wealth.

However, studies have discovered positive abnormal returns surrounding such announcements. This is likely to be because of information content about future cashflows (e.g. dividends) and risk (e.g. share price volatility). For example, many firms maintain the same dividend per share after a bonus issue and, therefore, the total of dividends paid increases.

Bonus issues have been a popular management tool for companies trying to increase the liquidity and marketability of their shares by returning the share price to an optimal trading range. Managers have also used bonus issues to

TABLE 2

Bonus issue example

A bonus issue is an issue of new shares to shareholders. The shares are issued free in proportion to each shareholder's existing shareholding. For example, Investor Y owns 2000 shares in Company Z that has a current market value of \$5 per share. If Company Z then announces a one-for-four bonus, Investor Y will receive one new share for every four he/she owns. Investor Y will see the following changes in his/her investment.

Before bonus issue	
Number of shares	2000
Value per share	\$5
Total market value of investment	<u>\$10,000</u>
After one-for-four bonus issue	
Number of shares	2500
Value per share	\$4
Total market value of investment	<u>\$10,000</u>

The shareholder's total investment does not change. Only the number of shares changes. Since there are more shares outstanding, each share is simply worth less.

High-tax-rate investors subject to zero capital gains taxes will be disadvantaged by both bonus issues and cash dividends

reward shareholders during growth periods when they have been unable to distribute a large proportion of earnings as dividends.

Up until April 2000, however, taxable bonus issues in New Zealand were more valuable to shareholders because of the imputation credits attached.

The benefit of using taxable bonus issues to distribute imputation credits has been investigated by Anderson, Rose and Cahan (1999), who examined the impact on share prices of bonus issue announcements. They found positive returns on average around the announcement of all bonus issues. The return was significantly higher, however, at the announcement of taxable bonus issues than non-taxable ones.

They found an excess risk-adjusted return over the sharemarket on the day of the announcement plus the following day of 4.39 per cent for taxable bonus issue announcements. For non-taxable bonus issues, the figure was 2.05 per cent (see Figure 1).

The significantly higher excess returns around the announcement of taxable bonus issues indicate that certain shareholders are willing to pay a premium to obtain the tax benefits associated with the imputation credits³. Therefore, even those on a marginal tax rate of 33 per cent, who are tax-indifferent about receiving taxable bonus issues, benefit through a higher share price.

IMPACT OF A TOP TAX RATE OF 39 PER CENT

During the weeks before the tax rate change on April 1, 2000, many companies employed techniques to ensure that shareholders gained the maximum tax benefits from accumulated imputation credits.

Companies including The Warehouse and Restaurant Brands issued taxable bonus issues. Others, such as Independent Newspapers, paid special dividends, while Contact Energy was among those that brought forward their normal dividend payment date.

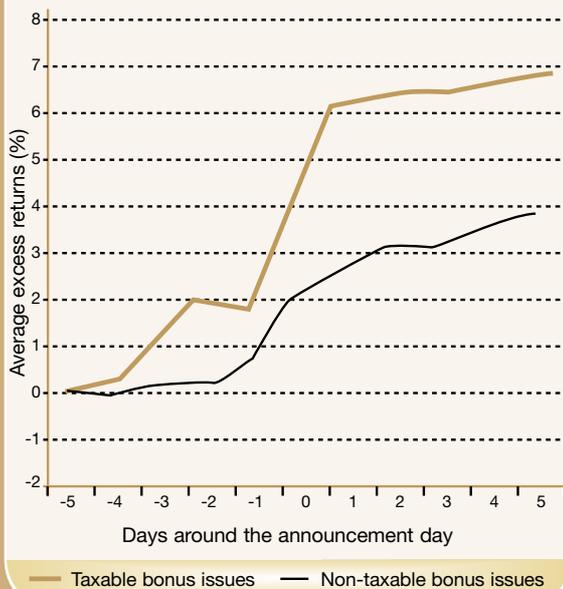
One anonymous writer noted:

"... companies did rush to get dividend imputation (credits) used before the tax rates rose, and this was very strong for unlisted companies. I know of bonus issues of '2000-for-1' made to utilise imputation credits."

³The value shareholders place on imputation credits is significant, as identified by several Australian studies. Hathaway and Officer (1992, 1996) estimate that the market value of \$1 of imputation credits is approximately 50 cents, while Bruckner, Dews and White (1994) estimate values from 33.5 cents and increasing to 68.5 cents in a later sub-period. The market value of \$1 of imputation credits will be affected by the relationship between the different personal marginal tax rates and the corporate tax rate.

FIGURE 1

Excess share price returns surrounding bonus issue announcements



The increase in the highest marginal tax rate for individuals could eliminate the only avenue – taxable bonus issues – some companies have to distribute valuable imputation credits in a timely manner.

Issuing taxable bonus issues under the new taxation scenario leads to shareholders with a 39 per cent marginal tax rate incurring a six per cent personal tax liability. And, unlike cash dividends, bonus issues have no monetary benefits to offset that extra liability.

Australia has operated under a similar scenario for a number of years, where the top personal tax rate is higher than the company tax rate. This led Brealey, Myers, Partington and Robinson (2000) to make the observation that in many cases there were tax disadvantages to bonus issues. This situation has led to a dramatic decrease in the use of bonus issues in Australia.

High-tax-rate investors subject to zero capital gains taxes will be disadvantaged by both bonus issues and cash dividends (see Table 1). They now have an incentive to avoid this disadvantage by:

- selling and buying around the ex-date; or
- encouraging a company to change its dividend policy to suit them; or
- selling and reinvesting in a company that pays little or no dividends or bonus issues.

Their choice will depend on the costs of each alternative, the likely success of the second alternative and whether an applicable investment substitute exists for the third. (If the cost of each of the three alternatives outweighs the extra tax liability, the investor should simply pay the higher tax.)

If management continues to distribute bonus issues, then under the first alternative high-tax-rate investors can sell their shares to shareholders who

can utilise the imputation credits and then repurchase the shares on the taxable bonus issue ex-date. The economic impact of this is the transaction costs of buying and selling the shares.

As shown in the Anderson, Rose and Cahan (1999) study, some investors are willing to pay a premium for the shares in order to obtain the imputation credits. The premium should partially offset the transaction costs incurred.

Australian sharebrokers allow trading in cum-dividend shares after the official ex-dividend date has passed, as the closing date on the books is seven days after the ex-dividend date (Walker and Partington, 1999).

By simultaneously selling shares with the dividend attached and then repurchasing the shares at the ex-dividend price, high-tax-rate investors avoid income tax on dividends while maintaining their investment in the company. This practice removes the risk of adverse share price movement (other than price changes relating to the dividend) between the last cum-dividend date and the first ex-dividend date.

Interestingly, this practice may become plausible for New Zealand companies should the proposed merger between the New Zealand Stock Exchange and the Australian Stock Exchange eventually proceed.

The likely success of the second alternative will depend on the proportion of shareholders on the high tax rate and/or the impact of their withdrawal from ownership. If this class of investor⁴ is able to discourage management from issuing bonus issues and/or encourage management to reduce cash dividends, imputation 

⁴With the ability to create trusts and companies for investment vehicles, the dominant marginal tax rate for investors in the sharemarket is still likely to be 33 per cent. It is possible that high-tax-rate investors will be relatively small players in the overall market and wield little power in both management decisions and market price determination.

High-tax-rate investors facing zero capital gains taxes would seek out companies with a low- or no-dividend policy

credits will accumulate. This in turn would disadvantage low-tax-rate investors, who will not receive the valuable imputation tax credits.

The third alternative relates to the creation of a clientele effect, whereby firms attract investors who find their dividend policy appealing for tax reasons. High-tax-rate investors facing zero capital gains taxes would seek out companies with a low- or no-dividend policy.

Bartholdy and Brown (1999) found the presence of tax clientele effects in New Zealand between 1982 and 1985, when companies were allowed to issue both taxed and non-taxed dividends. Further research, examining the period before and after April 1, 2000, would determine whether the increase in the top tax rate to 39 per cent has reduced dividend payout in line with the second alternative and/or created tax clienteles.

CONCLUSION

The primary purpose of the imputation tax regime was to eliminate the double taxation of corporate profits. Companies that retain a large proportion of profits for reinvestment are unable to distribute imputation credits via the normal method of paying cash dividends.



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Taxable bonus issues provide managers with an alternative method of accelerating distribution and, therefore, shareholder utilisation of valuable imputation credits. The increase in the top marginal tax rate to 39 per cent could eliminate the use of taxable bonus issues, however, and also have an impact on dividend payout policies and/or tax clienteles.

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