

Fonterra Capital Dividend: Tax-free on the way in, Taxable on the way out?

If you're a Fonterra shareholder operating through a company structure, you need to plan now to avoid unexpected tax bills and potential penalties.

Fonterra's proposed \$2 per share capital return sounds straightforward – it's tax-free when you receive it. However, what happens when you want to actually *use* that money could result in a significant tax liability if not properly planned.

The tax treatment of money coming into your business is often very different from the tax treatment when that same money goes back out. This mismatch means that a tax-free receipt can become a taxable distribution, and without advance planning, you could face penalties and interest charges.

Outlined below are four mechanisms for accessing these funds and their respective tax consequences. We strongly recommend reading through the options below and contacting us to discuss your specific situation **before** the capital distribution is received.

Why Tax-Free In Doesn't Mean Tax-Free Out

When money comes into a business, the income tax treatment that applies to that money is not necessarily the same treatment as when that same money is used in the business or passed out of the business i.e. income tax is not symmetrical.

This issue is particularly relevant in the context of the proposed sale of Fonterra's global consumer and associated businesses. From the sale proceeds, Fonterra is targeting to make a tax-free capital return to shareholders of \$2 per share. The sale is still subject to certain regulatory approval.

For Fonterra shareholders who operate through an ordinary company structure, they need to start considering now the income tax treatment of passing these funds out of the company. If this is not planned in advance then it could result in unintended tax consequences, which could in turn result in late payment penalties and use of money interest.

Fonterra has advised that the capital distribution would be tax-free in the hands of Fonterra's shareholders. For Fonterra shareholders operating through an ordinary company structure, this means no income tax would be payable by the company on the receipt of the capital distribution. In this instance, the capital distribution would form part of the company's equity as a capital reserve.

Quick Reference Guide

The following table summarises the four main options for accessing funds from your company:

Method	Tax Outcome	Shareholder Tax	Key Considerations
Distribution of Retained Earnings	Taxable dividend with imputation credits	Additional 6% tax if taxed at 39%	<ul style="list-style-type: none"> • 5% DWT required • Solvency test • Banking covenants
Distribution of Capital Reserves	Tax-free only on liquidation	Same as a distribution of retained earnings if not liquidating	Liquidation required for tax-free treatment
Share Repurchase	Potentially tax-free if requirements met	Depends on meeting complex requirements	Complex rules - seek advice first
Advance of Funds (Loan)	No tax on loan itself	Interest may have to be charged with RWT deducted	<ul style="list-style-type: none"> • Interest at IRD rate • Proposals to treat as a dividend if not repaid within 12 months

Using Funds Within the Company

If the company is to use the funds from the capital distribution within its own business, say, for capital expenditure or repaying debt, then the normal income tax consequences of this would apply i.e. no tax deduction for repaying debt to the extent it is loan principal, no upfront tax deduction for capital expenditure but a potential amortisation or depreciation claim.

Options for Distributing Funds Outside the Company

An issue arises if the funds are to be used by an entity outside of the company. For example; funds may be used by a family trust to purchase a holiday home, the other entity pays off debt it owes, or the other entity invests the funds in income-earning assets. In these circumstances, consideration needs to be given as to the mechanism that would be used to get these funds out of the company. These mechanisms have differing tax consequences.

The most common ways of getting funds out of an ordinary company are by way of a:

- distribution of retained earnings
- distribution of capital reserves
- share repurchase
- advance of funds

1. Distribution of Retained Earnings

The retained earnings of a company represent the accumulation of a company's after-tax profits, since incorporation, that have not been distributed as a dividend. A paper record of tax paid on these retained earnings is kept, known as an imputation credit account, which allows imputation credits to be attached to dividends paid by the company. This is to ensure company profits are not subject to double taxation. As long as imputation credits have not been forfeited by an ordinary company, there should be sufficient imputation credits to attach to a dividend to cover 28% of the tax liability on the gross dividend. Imputation credits can only be attached to a dividend to a maximum of 28% of the gross dividend.

When a company pays a dividend, the total tax credits attached to the dividend must be equal to 33% of the gross dividend. Provided there are sufficient imputation credits to attach to the dividend at 28% of the gross dividend, the company will be required to deduct a further 5% dividend withholding tax (DWT) from the dividend. The DWT needs to be paid to Inland Revenue by the 20th of the month following the month in which the dividend was paid by the company.

The receipt of the dividend is taxable in the hands of the shareholder of the company at their marginal tax rate and entitled to claim the tax credits of 33% (imputation credits and DWT) attached to the dividend against this tax liability. If the shareholder is subject to tax at the top tax rate of 39% (trust tax rate and top individual tax rate), then the shareholder will be required to pay additional tax equal to 6% of the gross dividend received.

If the funds from the Fonterra capital dividend are received by an ordinary company, but to be used by an entity outside of the company, then doing this as a distribution of retained earnings will require monies to be put aside for the DWT, and any additional tax payable in the shareholder's name.

Consideration will also need to be given to whether the company meets the solvency test under the Companies Act 1993 to make this distribution, as well as any banking covenants that could be breached.

2. Distribution of Capital Reserves

As mentioned earlier, the receipt of the Fonterra capital dividend by a company will be treated as a capital reserve in the equity of the company.

Generally, a company can distribute its capital reserves to a shareholder tax-free. However, the proviso to this is that the distribution of capital reserves is only tax-free when the distribution is made upon the liquidation of the company.

If a company is to be liquidated shortly after the receipt of the capital distribution, then steps would need to be taken to place the company into liquidation before distributing the capital reserve. If this is not done, then the distribution would be taxable in the same manner as a distribution of retained earnings (see above).

In most cases, it is likely a company in receipt of the Fonterra dividend will not be liquidated shortly after receipt of the capital dividend. Therefore, even if the distribution was done as a distribution of capital reserves, then the distribution would be taxable in the same manner as a distribution of retained earnings (see above). In other words, the tax-free capital reserve has been converted to a taxable reserve.

3. Share Repurchase

It is possible for a company to repurchase its own shares from the shareholders of the company. This could be used as a way of distributing funds from the Fonterra capital dividend to shareholders of the company.

Generally, a distribution by a company to a shareholder is taxable in the hands of the shareholder. However, a share repurchase is tax-free in the hands of a shareholder if certain requirements are met. These requirements are very complex and beyond the scope of this article, so advice should be sought before proceeding with a share repurchase to ensure you are aware of the tax outcomes.

If a share repurchase is taxable in the hands of a shareholder, then a similar tax outcome to that of a distribution of retained earnings (see above) would occur.

4. Advance of Funds

It would be possible for a company in receipt of the Fonterra capital dividend to loan these funds to the entity that requires use of these funds. The company lending the funds would not get a tax deduction for the payment of the funds, nor would the recipient entity be taxed on the receipt of these funds.

A loan from a company to an associated party is likely to result in deemed dividend or fringe benefit issues, which can have a worse tax outcome than if interest was charged on the loan. For this reason, interest is generally charged on these types of loans at Inland Revenue's prescribed interest rate for low-interest loans.

The interest charged by the company on the loan is taxable to the company.

If the associated party uses the borrowed funds for deriving taxable income, then it is likely they would be entitled to claim a tax deduction for the interest charged. In this instance, the tax outcome of having to charge interest on the loan is tax neutral.

If the associated party is not entitled to claim a tax deduction for the interest charged, then the charging of the interest is not tax neutral. In other words, tax is being paid by the company on a "paper" transaction.

The interest payable by the associated party may require resident withholding tax (RWT) to be deducted from the interest and paid to Inland Revenue.

Important: Proposed 12-month rule

Inland Revenue has recently released a consultation document whereby they are proposing that certain loans provided by a company to a shareholder on or after 4 December 2025 will be treated as a dividend if not repaid within 12 months. If these proposals proceed, then it is possible that a company providing a loan to an associated entity from the proceeds of the Fonterra capital dividend will result in the shareholder being taxed on this loan if it is not repaid within 12-months. In this instance, a similar tax outcome to that of a distribution of retained earnings (see above) would occur.

Our Advice

If you operate through an ordinary company structure, and the proceeds from the Fonterra dividend will be used by another entity, then start talking to your accountant now to plan the most tax effective way to get the funds out of the company.

Contact us on 03 211 0801 or email us at mdp@mdp.co.nz if you'd like to discuss your situation.

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