MUTUAL RECOGNITION OF FRANKING CREDITS AND NEW ZEALAND IMPUTATION CREDITS

A New Zealand Submission to the review *Australia's Future Tax System*

Summary of Submission

This submission presents a case for Australia and New Zealand mutually recognising imputation and franking credits for income tax paid to the other country. It concludes that establishing mutual recognition would improve the welfare of Australia and New Zealand collectively through greater trans-Tasman investment efficiency and increased product market competition. Mutual recognition would also be an important step toward both governments' shared goal of a Single Economic Market.

1. Introduction

On 17 July 2008 the New Zealand Minister of Finance and the Australian Treasurer agreed that the Australian and New Zealand governments were open to the idea of moving towards the mutual recognition of imputation and franking credits. Hon Swan invited New Zealand officials to make a submission on this issue to the review *Australia's Future Tax System*. This submission is in response to that invitation.

New Zealand and Australia have imputation rules as integral parts of their tax systems. Imputation is a mechanism which provides credits against personal taxes on dividends received by shareholders for taxes paid at the company level. However, in common with standard international practice for such systems, the relief is generally restricted to company taxes paid within the jurisdiction. Foreign taxes are not 'recognised' as giving rise to imputation or franking credits.

This means that there is a single layer of tax on domestic profits but two layers of tax on foreign-source profits when they are distributed to domestic shareholders. This submission examines the case for New Zealand and Australia to depart from this practice and provide imputation or franking credits to their resident shareholders for the company taxes paid to the other jurisdiction. That is, between Australia and New Zealand there would be mutual recognition for imputation purposes of company taxes paid to the other jurisdiction ('mutual recognition').

The New Zealand government has been interested in examining the possibility of introducing mutual recognition for some time. We see mutual recognition as the next logical step in enhancing and enriching the Australia-New Zealand Closer Economic Relations Trade Agreement (CER) and working toward the vision that Australia and New Zealand share of a Single Economic Market. Mutual recognition would provide economic benefits through greater trans-Tasman investment efficiency and increased product market competition in our two economies. The lack of mutual recognition has been a concern for both Australian and New Zealand businesses because of the double taxation of trans-Tasman profits which currently occurs. This reduces

economic efficiency as it discourages trans-Tasman investment and can deter otherwise productive cross-border investments. Mutual recognition would remove tax barriers to investment flows in much the same way as CER removed tariffs on flows of goods.

The absence of mutual recognition can also distort the form of investment and introduce tax base risk for both countries. There are incentives for New Zealand subsidiaries of Australian parent companies to stream taxable profits to their Australian parent in order to maximise the franking credits available to attach to dividends paid to Australian-resident shareholders. There are similar incentives for Australian subsidiaries of New Zealand parent companies to stream profits to their New Zealand parents. Techniques for profit streaming are complex and costly, and are inconsistent with the source principle of taxation of profits arising from an activity carried on in a jurisdiction. Mutual recognition would remove the incentive for such tax planning by putting the company taxes paid in each jurisdiction on an equal footing for imputation purposes. This would have real economic benefits as it would reduce the deadweight costs of tax planning. It is also likely to increase the stability of our tax systems.

Section 2 of the submission provides a background on the highly integrated nature of our two economies and tax systems and on the trade liberalising environment of CER and the SEM within which mutual recognition would sit. Section 3 discusses imputation systems and company tax reform. Section 4 considers the advantages of mutual recognition. Section 5 (together with attached appendices) discusses implementation of a mutual recognition system. Finally, section 6 concludes.

We would be happy to meet to discuss any of the issues raised in this submission.

2. The trans-Tasman economic and trade relationship

New Zealand and Australia already have highly integrated economies. We take similar approaches to many policy issues and enjoy a high degree of labour and company mobility. There are also many similarities between our tax systems. We are both notable within the OECD for our absence of social security taxation, considerable reliance on company and personal income taxation as a revenue source and our full imputation systems. Both countries have reasonably broad income tax bases.

More broadly, Australia and New Zealand are committed to an ongoing process of economic integration. This process builds upon the foundation instrument of the bilateral trade and economic relationship – CER, finalised 25 years ago this year.

Since its inception, CER has been based on the principles of comprehensiveness and simplicity. The goal was originally to free up trade in goods (and, subsequently, services) between Australia and New Zealand. Over the last quarter-century, the basic trade liberalising construct of CER has evolved to a more sophisticated, ‘next generation’, vehicle: the Single Economic Market. This is a shared goal of both Australia and New Zealand, grounded in the recognition that integrating both economies more closely will deliver significant benefits to businesses operating

domestically, to levels of GDP in both countries, and as a platform for strengthening the way that both countries interact with the rest of the world. As Prime Minister Rudd noted during a recent visit to New Zealand, "*the challenge before governments on both sides of the Tasman is to drive forward the creation of a Single Economic Market, building a seamless economy between Australia and New Zealand*".[1]

It is against the background of that shared commitment and aspiration that New Zealand makes this submission on mutual recognition.

The goal of the Single Economic Market is ultimately to create a seamless trans-Tasman business environment, not one distorted by different incentives or different policy settings in different jurisdictions, by allowing goods, services, and factors of production, including capital and people, to flow freely across the Tasman.

CER has already delivered major benefits in terms of trade flows and economic growth in both countries. As Australian and New Zealand Ministers agreed at the 2008 CER Ministerial Forum, CER has played an exceptionally important role in driving a mutually beneficial expansion in trans-Tasman economic links. In the 25 years since CER was signed, New Zealand exports to Australia have increased by 493 percent while exports to the rest of the world have increased by 230 percent. Australia remains by far New Zealand's largest trading partner, taking, in the year to December 2007, nearly 22 percent of our merchandise exports, worth NZ$8.0 billion, and providing nearly 21 percent of our merchandise imports, worth NZ$8.6 billion. In turn, New Zealand is both Australia's fifth largest individual export market and Australia's fifth largest merchandise trading partner overall. New Zealand is Australia's largest market for exports of elaborately transformed manufactures.

As for services trade, in the year to December 2007, Australia imported AUD$2.4 billion worth of services from New Zealand, over 5 percent of Australia's total services imports. Australia's service exports to New Zealand were worth AUD$3.4 billion, over 7 percent of Australia's total services exports.

Between 2002 and March 2007, New Zealand's total foreign investment in Australia grew by 54 percent, to NZ$30 billion, representing the fourth largest investment in Australia. Of New Zealand's total investment abroad, Australia is the top destination, at 27 percent. Over the same period, Australia's total foreign investment in New Zealand grew 44 percent, to a figure of NZ$79 billion. Australia is the number one investment source for New Zealand, providing 31 percent of total foreign investment (at March 2007)[2]. Total two-way investment currently stands at NZ$109 billion. Given the breadth and scale of trans-Tasman investment, any distortions associated with the current taxation arrangements are likely to have significant economic costs.

The total gains the two countries have derived from CER are likely to be very much greater than those directly associated with additional trade. Additional trade creates competition in product markets in the two countries. Over time it leads to dynamic benefits by encouraging our businesses to be internationally competitive.

[1] Speech to Auckland Chamber of Commerce, 19 August 2008.
[2] Stats New Zealand statistics (www.stats.govt.nz/store/2007/09/balance-of-payments-and-intl-investment-position-ye31mar07-hotp.htm?page=para004Master)

In the same way, the real incentive to make progress towards a Single Economic Market is the opportunities it will clearly provide for businesses to expand and succeed. Enhancing mobility within and across the Australian and New Zealand markets, and allowing those markets to operate more effectively, will increase levels of real income and welfare in both countries. It will also position both countries to deal most effectively with an increasingly globalised world by strengthening domestic productivity, growth and competitiveness. Opportunities therefore remain to enhance the benefits of the trans-Tasman economic relationship.

Considerable work is already in train by Australia and New Zealand on the behind-the-border trans-Tasman business environment. This year alone will probably see the conclusion of a renegotiation of the Double Tax Agreement (which will address another important trans-Tasman tax concern, one raised by Australia, namely non-resident withholding tax rates), and the continuation of negotiations on an Investment Protocol to CER with a view to completion by mid-2009.

Earlier this year, a new Treaty on Trans-Tasman Regulatory Enforcement and Court Proceedings was signed, a scheme for the Mutual Recognition of Securities Offerings came into effect, and Australia and New Zealand will soon sign an arrangement on retirement savings portability. The extensive ongoing work programme on business law harmonisation is also seeking to foster the most favourable conditions possible for trans-Tasman business.

Underlying this work is recognition by both parties that a key part of maximising the benefits to both countries is to ensure that differences in regulations, institutions – and tax policies – do not drive a wedge between the costs or benefits that a business can enjoy in one market over another. It is clear that different treatment of imputation credits does have a distortionary effect on business and investment decisions and given the breadth and scale of trans-Tasman investment, any distortions associated with the current taxation settings are likely to have significant economic costs. Under the Single Economic Market, Australia and New Zealand are committed to minimising such distortions, making the logic of mutual recognition clear.

This is not solely a New Zealand concern. Australian companies have raised the fact that in practice they generally cannot fully impute the dividends paid to New Zealand shareholders under the existing trans-Tasman triangular tax rules (signed on the occasion of the 20th anniversary of CER in 2003) even though they fully frank their dividends to Australian shareholders. The trans-Tasman triangular rules therefore have little practical value to them.

3. Imputation systems and company tax reform

New Zealand and Australia are now the only two OECD countries which have retained imputation systems and mutual recognition relies on both countries continuing with their imputation systems. While imputation systems were previously common in Europe, a number of factors, in particular legal decisions by the European Court of Justice, have led to their abandonment in Europe.

New Zealand has no current intention to move away from imputation or have tax policy settings inconsistent with imputation but could possibly re-evaluate its options if Australia were to do so.

We see a number of attractions in having an imputation system.

First, compared to the former classical company tax system, full imputation has a number of desirable neutrality properties. Because of the double taxation of dividends, a classical company tax system can discourage businesses from being set up as companies, even when this is most efficient from a non-tax perspective. So long as the gap between the company tax rate and the top personal rate is not too large, full imputation can largely remove this bias. A classical company tax system may discourage dividend payments and create a penalty on new equity issues. This can tend to lock capital into existing companies. By contrast, full imputation encourages distribution, which makes capital available to new and rapidly expanding companies. A classical company tax system can also create a bias favouring debt relative to new equity. Full imputation removes this bias for domestically-owned companies (although foreign-owned companies can have incentives to be highly geared). A classical company tax system can also discourage individual shareholders on lower personal tax rates from holding shares in their asset portfolios merely because of the tax treatment. Full imputation removes this bias.

Second, full imputation provides a 'belt and braces' approach to taxation. For companies owned by domestic residents, less company tax implies higher taxes will be paid when profits are distributed to shareholders. This can reduce incentives for tax to be avoided or evaded at the company level.

There has been a general reduction in company tax rates around the world. As company tax rates fall overseas, we both face pressures to reduce our company tax rates. One key reason is that as company tax rates fall overseas, multinational firms have incentives to push to the limits in thinly capitalising their domestic operations or transfer-pricing profits away from our countries and into lower-tax jurisdictions. There are methods of countering thin capitalisation and transfer pricing but these are never perfectly effective.

Australia's and New Zealand's full imputation systems provide some protection against the streaming of profits when firms invest out of our countries and into lower-tax third countries. This is because shareholders gain imputation or franking credits for domestic but not for foreign company tax.

This belt and braces approach may be at least part of the reason why both New Zealand and Australia have relatively high company tax collections as a fraction of GDP. At 6.3 percent of GDP, New Zealand has the second highest level of collections, and at 5.9 percent of GDP, Australia has the fourth highest level of collections.[3] This compares with an unweighted average of 3.7 percent for the OECD as a whole.

[3] Norway has the highest company tax collections as a percentage of GDP but its figures are inflated by petroleum revenues.

Quite apart from the base protection benefits, there is an economic logic in our tax settings. Other things equal, it is not unreasonable for governments to have a preference for firms to pay tax domestically rather than in foreign countries because domestic but not foreign taxes will provide revenue for financing schools, universities, hospitals, infrastructure and other government spending. This is the policy rationale for not recognising foreign taxes on a unilateral basis.

However, if Australia and New Zealand mutually recognise imputation and franking credits it would increase the efficiency of trans-Tasman investments, enhance the competitiveness of our two economies and boost the welfare of Australasia as a whole.

Full imputation systems clearly become less neutral the greater is the gap between the top personal tax rate and the company rate. If either New Zealand or Australia were at any stage in the future to make deep cuts in its company rate, the question of whether or not to continue with an imputation system might need to be re-examined.

There is an open question as to what is the best company tax rate for a small open economy like Australia or New Zealand to levy. Australia and New Zealand will need to independently assess the most appropriate company rate in their jurisdictions.

It is well known that in the absence of economic rents, any tax on imported capital is likely to be ultimately borne by domestic factors but in a less efficient way than if they were taxed directly. The argument is that company taxation can reduce the level of foreign direct and portfolio equity into an economy which can lower levels of capital such as plant and equipment. This in turn reduces the productivity of domestic factors such as labour and so reduces wage rates. In theory, wage rates can fall by more than what would have occurred if the government had taxed labour directly. By itself, this provides an argument against any rate of company tax greater than zero.

There are, however, some obvious offsetting considerations. A zero rate of company tax would allow an individual's capital income or income from professional services or from business activities conducted through companies to be sheltered from personal tax. Company taxation helps protect the integrity of the personal tax system. Also for economies such as New Zealand and Australia, economic rents may be important. The large bulk of equity investment into both countries is direct equity and the bulk of this is invested in firms which are producing goods for the local market. In this case economic rents may be important and likely more important than if either of us were a land-locked country in Europe. There may be few location-specific economic rents associated with establishing a factory in Austria if there is the alternative of establishing one in Germany instead.

If economic rents are important for foreign direct investment, a large part of any reduction in company tax would flow to foreign investors rather than being reflected in higher levels of plant and equipment.

On the basis of the preceding arguments, New Zealand officials have concluded that there appears to be, on balance, little cause for deep cuts in New Zealand's company tax rate. At current tax rate levels, imputation remains a sensible basis for taxing income earned through companies.

One final issue is the question of whether imputation credits should be provided on a unilateral basis for taxes raised in third countries.

As was discussed above, there is a logic behind New Zealand's current tax settings. We do not see a unilateral recognition of foreign taxes for imputation credits as likely to be in New Zealand's best interest.

4. Advantages of mutual recognition

We would see a number of advantages in mutual recognition. These include the following:

- greater bilateral efficiency of investment;
- greater product market efficiency;
- more flexible trans-Tasman investment by small and medium-sized enterprises(SMEs);
- logical next step in the CER relationship and Single Economic Market agenda;
- remove artificial bias for profit streaming;
- more stable tax system.

(i) Gain in bilateral efficiency of investment

At the domestic level, Australia's and New Zealand's full imputation system provides an approximation to a full integration ideal under which profits are taxed only once in the hands of the ultimate shareholder. Both imputation systems achieve this but only to the extent that profits are distributed.

Both systems, however, intentionally work very much like a classical (double tax) system when a New Zealand resident receives dividend income from an Australian company or when an Australian resident receives dividend income from a New Zealand company. The ultimate result is that the shareholder in the foreign company is double taxed on the same item of income, once in the company's jurisdiction, and then on the net distributed amount in the shareholder's jurisdiction.

The outcomes are illustrated in the following general calculations of Australian and New Zealand shareholders investing in companies resident in their own or the other jurisdiction, and when tax is paid by the company only in the jurisdiction where it is resident. All company profits are distributed, as shown in Tables One and Two.

TABLE ONE

TAX TREATMENT OF AN AUSTRALIAN RESIDENT INVESTING IN AN AUSTRALIAN OR A NEW ZEALAND COMPANY

	Australian company	*New Zealand company*
Company income	100	100
Tax paid [4]	30	18
Income after tax[5]	70	82
Less New Zealand NRWT		(12)
Cash dividend to shareholder	70	70
Imputation credit	30	
Foreign tax credit		12
Assessable income	100	82
Tax on assessable income	46.50	38
Less franking rebate	(30)	
Less foreign tax credit		(12)
Tax payable	16.50	26
Net dividend received	53.50	44
Effective tax rate	46.5%	56%

[4] Based on all income being sourced in the home jurisdiction and fully taxable and allowing for New Zealand's foreign investor tax credit (FITC) system (this is under review as part of New Zealand's ongoing review of its international tax rules).

[5] Including the supplementary dividend required under the FITC rules.

TABLE TWO

TAX TREATMENT OF A NEW ZEALAND RESIDENT INVESTING IN A NEW ZEALAND OR AN AUSTRALIAN COMPANY

	New Zealand company	*Australian company*
Income earned	100	100
Tax paid	30	30
Income after tax	70	70
Less Australian NRWT		0
Cash dividend to shareholder	70	70
Imputation credit	30	
Foreign tax credit		0
Gross income	100	70
Tax on gross income	39	27
Less imputation credits	(30)	
Less foreign tax credit		0
Tax payable	9	27
Net dividend received	61	43
Effective tax rate	39%	57%

As a result of this double-taxation, trans-Tasman investment flows will need to generate higher pre-tax returns in order to be as attractive as domestic investments on an after-tax basis. Suppose for example, that an investment in Australia earning 10% was marginally profitable for the Australian 46.5% investor. After payment of tax, the shareholder receives 5.35%. A New Zealand investment would need to generate a pre-tax return of 12.2% to provide the same return for the investor. Conversely, suppose an investment in New Zealand earning 10 percent is marginally profitable for the New Zealand 39% shareholder who earns 6.1% net of personal tax on such an investment. Investment in Australia would need to generate 14.2% to provide the same after-tax return.

The fact that trans-Tasman investment needs to be generate a higher pre-tax return implies investment inefficiencies. By removing this bias, mutual recognition would increase the productivity of investment within Australia and New Zealand and boost our international competitiveness.

In practice, there are a number of factors which will influence the size of any investment distortions. Shareholders are taxed at a variety of marginal rates. Also, if profits are retained for a period this will reduce the effective impost of shareholder taxation. This will affect the size but not the general direction of this trans-Tasman investment bias.

The aim of mutual recognition would be to remove these biases.

(ii) Greater product market efficiency

Both New Zealand and, to a lesser extent, Australia are small economies with more limited product market competition than is likely to be the case in larger economies. Our CER agreement increased product market competition in areas where goods or services can be directly imported from the other country.

In many cases, however, product market competition may require a physical presence in a country. For example, competition in the telecommunications industry requires Telstra to have a physical presence in New Zealand and Telecom New Zealand to have a physical presence in Australia. The double taxation of trans-Tasman investment flows can constrain such competition. Mutual recognition would remove this bias and is likely to have a longer-term dynamic benefit through promoting productivity, growth and international competitiveness in both countries.

(iii) More flexible trans-Tasman investment by small and medium sized enterprises (SMEs)

We understand that the lack of mutual recognition currently encourages SMEs that invest across the Tasman to be set up in ways which are not intrinsically efficient. For example, taxes may drive New Zealanders to establish an Australian business through a more complex structure rather than as a company even though, taxes aside, a company may be a more efficient form of business organisation. Mutual recognition would remove this bias.

(iv) Logical next step in the CER relationship and toward a Single Economic Market

Over the years, CER has evolved to focus more strongly on removing barriers *behind* the border – not just barriers to free flows of goods and services, but also seeking to facilitate flows of factors of production such as capital and people between the two countries and to improve the business environment in which they operate by streamlining regulatory and other burdens – in essence, to create a Single Economic Market. This integration process has generated momentum for further integration. But there is potential to derive even greater benefits from the trans-Tasman economic relationship.

The extension of CER to a Single Economic Market model requires deep rather than shallow integration. It is not always necessary to replicate measures in the two countries – differences of circumstances will imply that each country needs to retain flexible policy levers. The goal is to co-ordinate, to the fullest extent possible, economic policies and regulation across both markets[6], in order to remove impediments to mutually beneficial activities. Mutual recognition of imputation and franking credits is one way that this could be furthered.

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[6] A fuller discussion of this concept can be found in the (Australian) Productivity Commission research report, *Australian and New Zealand Competition and Consumer Protection Regime*, Canberra, 2004.

By its very nature, a Single Economic Market points to mutual recognition. There are no tax barriers to investment flows among Australian states and territories, or between different regions in New Zealand. Just as it makes sense that income tax paid by a company in Victoria can be credited to its shareholders in, for example, New South Wales because of the efficiency gains that come with treating Australian states as a single market, so it makes sense for trans-Tasman investors in a single Australia-New Zealand market to operate an equivalent system of tax credits.

In both cases (whether *within* a country, or between Australia and New Zealand), the mutual recognition of imputation or franking credits would remove a disincentive for otherwise efficient investment and business transactions – something which the Single Economic Market aims to remove. Mutual recognition would allow the underlying economics rather than artificial tax barriers determine decisions on company location and organisation. This will support that broader strategic goals of the Single Economic Market, such as promoting the Australian and New Zealand markets as a single entity 'home base' from which to extend outwards to third markets.

Mutual recognition also presents an opportunity to obtain wider benefits in the way New Zealand and Australia interact with the wider international community. The Single Economic Market concept recognises that strengthening and deepening trans-Tasman economic links improves the ability of New Zealand and Australian firms to deal with the risks and opportunities presented by the growing globalisation of business, trade, rule-making and markets. Equally, the Single Economic Market gives both countries a stronger platform to look outward – to strengthen regional (Pacific and Asian) relationships and institutions, and to act as 'thought leaders' in the international convergence of rules and norms in many areas.

The *Australia's Future Tax System* discussion document notes that the purpose of the Australian review is, *inter alia*, to ensure 'appropriate incentives for investment and the promotion of efficient resource allocation to enhance productivity and international competitiveness'; and to reduce the 'complexity and compliance costs' of the tax system. On both counts, as noted above, these objectives are fully consistent with the broader Australia-New Zealand goals for the Single Economic Market.

(v) Remove artificial bias for profit streaming

Currently New Zealand's and Australia's full imputation systems provide incentives for tax to be paid in the country where the final shareholders of a company reside. This will often provide incentives for a New Zealand subsidiary of an Australian parent company or for an Australian subsidiary of a New Zealand parent company to attempt to stream profits across the Tasman. It may also provide incentives for trans-Tasman firms to attempt to shift profitable functions. These tax-driven behaviours result in real losses to the Australasian economy. Mutual recognition would reduce or eliminate these losses.

(vi) Increased stability of tax systems

Mutual recognition would be also likely to increase the stability of our tax systems.

In the absence of mutual recognition, there can be incentives to stream profits across the Tasman even when our company tax rates are aligned. For New Zealand to remove these incentives for a New Zealand subsidiary of an Australian parent requires us to have a lower company tax rate than Australia. Likewise, for Australia to remove these incentives for an Australian subsidiary of a New Zealand parent requires Australia to have a lower company tax rate than New Zealand. Thus, the incentives this provides are unstable.

Clearly, other considerations such as the integrity of the personal tax system may be more important when deciding on our company tax rates. Moreover, to date both New Zealand's and Australia's company tax collections have been robust. But it is unattractive for either country to have to question whether undercutting the other's company tax rate is necessary to protect its domestic company tax base.

5. Implementation and status of arrangements

Ways in which mutual recognition can be implemented

While New Zealand and Australia have many aspects of their tax concepts in common, including being the only OECD members that have retained imputation, important differences exist. Appendix One examines in more detail whether these differences lead to obstacles to mutual recognition which would require adjustments to the tax systems of either country.

These differences can arise in two main areas: specific provisions implementing the imputation mechanism; and, the general provisions of the taxation of income including tax rates and the determination of the tax base.

There are important differences in the imputation rules between the two countries, particularly in the approach employed to ensure that imputation credits cannot be diverted from their economic owners. Analysis does not suggest that these differences would prevent the implementation of a mutual recognition arrangement.

There are also a number of differences in the tax bases of both countries which may result say in imputation credits being generated on income in New Zealand when similar income, if derived by an Australian company, would not generate franking credits. The converse would happen in Australia in circumstances where the Australian tax base is broader than New Zealand's. In addition, while currently the company tax rates are 30% in both countries, policy changes may result in the rates shifting out of alignment. While a wide disparity in company tax rates could call mutual recognition into question, analysis suggests that minor differences in tax rates and differences in tax base calculations would not prevent the implementation of mutual recognition.

There are two broad approaches to implementing a mutual recognition system. One would be to implement a detailed separate set of rules in each jurisdiction to be applied to credits arising in the other. A second, simpler approach would require New Zealand to treat franking credits as imputation credits, and Australia to deem imputation credits to be franking credits.

The second approach seems more practical although there may need to be some adjustments in particular circumstances. As a general proposition, our initial thinking is that eligibility of imputation/franking credits, including which entities pay them, should be determined by the rules of the country in which the dividend payer is located. A dividend with New Zealand imputation credits attached should have the same Australian tax consequences for an Australian shareholder as if the same shareholder received an Australian dividend with franking credits attached, and vice versa for a franked dividend received by a New Zealand shareholder.

Status of mutual recognition arrangement

Although mutual recognition would be an important extension to the economic integration between our two countries, neither country should be bound to a permanent bilateral commitment to it. This would allow either country to alter its taxation commitments in the future. However, it is standard practice in CER instruments to include a consultation mechanism. The 2003 exchange of letters on the triangular trans-Tasman tax reforms provides a useful example. A similar approach could be used for mutual recognition of imputation credits.

Under such a provision, Australia and New Zealand would be encouraged to discuss (but not to seek the other's approval for) any major changes to tax policy that could impact on the integrity of the mutual recognition arrangement. Consultation should also take place should one country make changes to its taxation law that would impact significantly on mutual recognition, such as, for example, one country unilaterally providing credits for non Australian and New Zealand taxes, or a wide disparity between the countries in the corporate tax rate as a result of a policy change.

The best form of consultation is for there to be regular discussions as required between the tax policy officials of both countries.

6. Conclusions

We submit that Australia and New Zealand mutually recognising imputation and franking credits for income tax paid to the other country would improve the welfare of Australia and New Zealand collectively, and would be an important step towards our shared goal of a Single Economic Market. We recommend that the Australia's Future Tax System Review support this position, and that it should propose a mutual recognition regime for imputation and franking credits between Australia and New Zealand.

John Whitehead
Secretary to the Treasury

Robert Russell
Commissioner of Inland Revenue

DEVELOPING A MUTUAL RECOGNITION SYSTEM

Comparison of New Zealand and Australia's tax systems

An important consideration in developing a mutual recognition model is for it to be consistent with other aspects of each country's tax system. We believe that our imputation systems are sufficiently similar for mutual recognition to be a practical option.

New Zealand and Australia are now the only two OECD countries with imputation systems. The New Zealand imputation system and the Australian franking credit system are based on broadly comparable principles. (A comparison of the two systems is presented in Appendix Two). To prevent double taxation of profits, both allow resident corporate tax entities that pay local tax to pass on to resident members a credit for income tax paid on profits when they distribute them.

In August 2008, the New Zealand government issued the discussion document *Streaming and refundability of imputation credits*, which was the first step in the review of the country's imputation system. As stated in the discussion document, there is no intention to change the fundamental nature of the system, but to understand whether the current rules regarding imputation credit streaming cause concerns to taxpayers and to also seek feed-back on the possibility of refunding imputation credits to certain taxpayers.

The discussion document acknowledges the attraction of aligning New Zealand's imputation system with aspects of Australia's imputation system as much as is feasible and consistent with each country's policy goals, and it seeks feed-back on the possibility of some movement in the direction of Australian anti-streaming rules.

The major substantive differences in our imputation systems appear to be in the approaches to prevent streaming of imputation credits.[7]

There are also differences in the types of entities eligible for refunds of excess imputation or franking credits. Australia permits refunds for superannuation funds and some other savings-type entities to individuals and to charities (and certain other similar entities) while New Zealand allows refunds to investors in portfolio investment entities (most superannuation funds and unit trusts) and to Maori Authorities. However, excess imputation credits can be used by other New Zealand taxpayers to offset the tax liability on other income, which has the same effect as refunding the credits. The major difference between the two jurisdictions is their treatment of credits received by charities (and similar entities). New Zealand is considering whether to allow refunds of excess credits to charities.

[7] New Zealand's approach is to have benchmark dividend rules as Australia has, but to prescribe detailed shareholder continuity requirements for companies, and to buttress these with specific anti-streaming rules and prohibitions against certain imputation selling transactions. New Zealand does not currently have rules comparable to Australia's exempting credit and holding period rules.

Designing a mutual recognition system

There are two broad options for implementing mutual recognition. Any final arrangement could be a mixture of the two.

The first broad approach assumes that imputation credits and franking credits can be made to be completely interchangeable by creating a specific regime for recognizing imputation credits in Australia and franking credits in New Zealand. A precedent exists in the current rules for trans-Tasman imputation, which incorporate Australian companies into New Zealand's imputation system (and vice versa in Australia).

A simpler and preferable approach is for both countries to amend their respective tax legislation so that franking credits and imputation credits could simply be deemed to be the same and to have similar tax consequences in both countries. When a company paid tax in both countries, there should in theory be no need to distinguish between the two when attaching the tax paid as franking credits or imputation credits. The current domestic rules for crediting of taxes to the imputation credit and franking credit accounts would remain. However, creditable taxes would be extended to include both Australian and New Zealand taxes (including withholding taxes, as is currently the case in the trans-Tasman imputation rules).

For mutual recognition to proceed, it would not be necessary for there to be complete alignment of imputation systems. There may be a need to align some aspects, such as the date at which the balances are tested, and possibly some of the anti-streaming provisions so that each jurisdiction is satisfied that credits could not be streamed in the other country in a way which is contrary to their own policy. These details could be considered in design of the regime.

Differences in both countries tax and corporation law systems should not provide insurmountable problems to implementation of mutual recognition. Some of the issues to consider include:

- *Tax base differences* – we do not consider existing tax base differences to be incompatible with mutual recognition or that there needs to be any special rules to account for them. For example, Australian franking credits may reflect tax paid under Australia's broad base capital gains tax. New Zealand should allow those credits against a shareholder's tax liability notwithstanding it does not have an equivalent tax. Conversely, Australia would provide credits in respect of profits that would not be taxable in Australia in situations where the New Zealand tax base is broader.

- *Definition of dividend* – whether a 'dividend' to which a credit may be attached be determined under the law of the payer or the recipient. Our initial thinking is that the former is preferable.

- *Arbitrage* – whether any arbitrage opportunities give rise to tax base concerns, such as potentially arises with the different rules on what constitutes debt and equity. Our initial thinking is that the law of the dividend paying country should prima facie determine imputation/franking status of a particular distribution.

- *Corporate tax rates* – mutual recognition should still apply if there was a minor divergence in corporate tax rates (and hence the calculation of credits) from their current equality. A wide disparity, however, could call the mutual recognition arrangement into question.

- *Transitional rules* – for example, treatment of pre-effective date credits versus post-effective date credits.

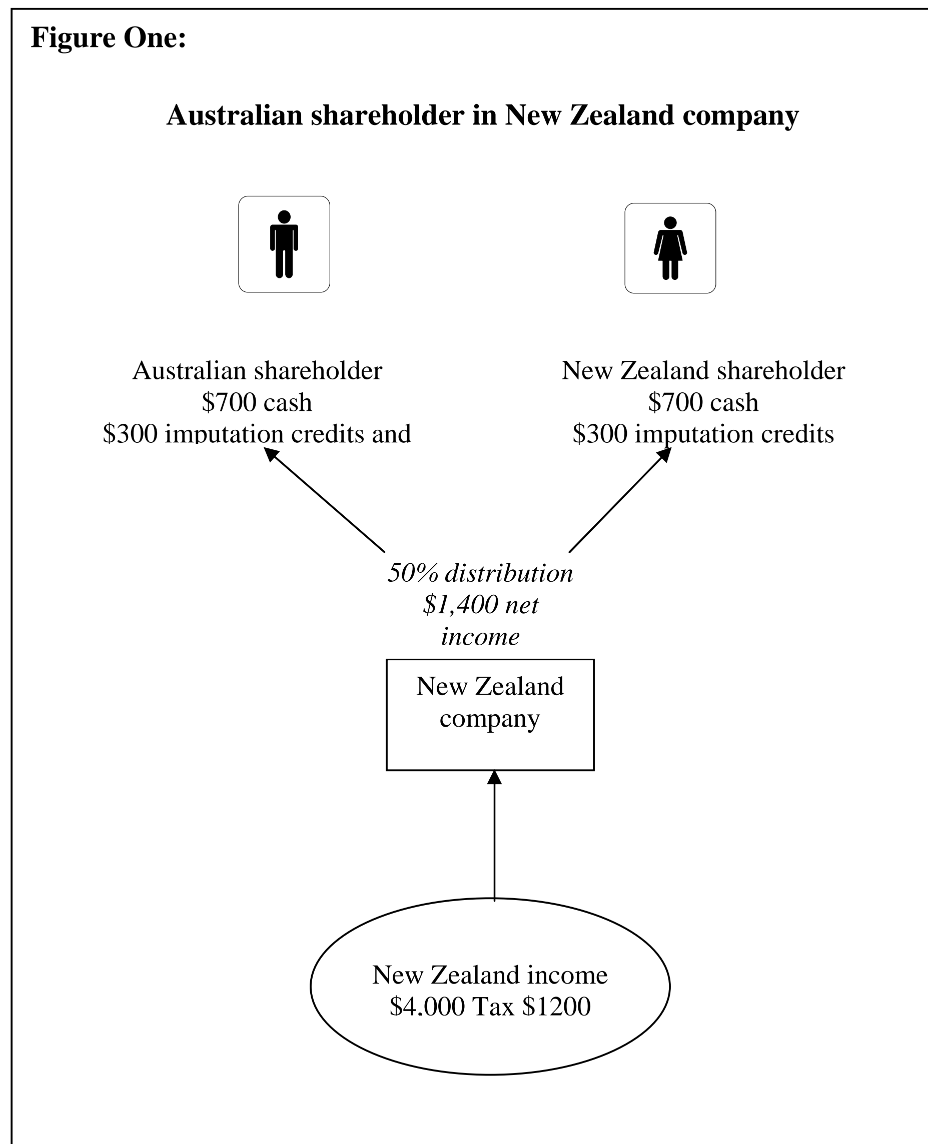
Therefore design issues should not pose major problems following a decision to proceed in principle with mutual recognition.

How the mutual recognition would look in practice

Example 1: Basic mutual recognition

Australian shareholder in New Zealand company

Consider a New Zealand company that has an Australian and a New Zealand shareholder, each owning 50 percent of the shares. The company earns $4,000 of New Zealand income, with an effective tax rate of 30%, so $1200 of company tax is paid. The company distributes 50 percent of its net income as shown in Figure One.



The New Zealand foreign investor tax credit rules provide a tax credit to New Zealand companies which distribute imputed dividends to non-residents. Specifically, a New Zealand company distributing imputed dividends to non-residents will provide a supplementary dividend calculated by multiplying the imputation credits the company would usually distribute to non-residents by a factor of .411806. The supplementary dividend is equal to the amount of the non-resident withholding tax when the dividend is fully imputed. The imputation credit distributed to the non-resident is reduced by the amount of the foreign investor tax credit. The application of the FITC rules would need to be considered in a mutual recognition context. However, for the purposes of illustration, this example will assume that the non-resident withholding tax will be treated as the equivalent of an imputation credit.

Under mutual recognition, the $700 cash dividend would therefore be grossed up by the $180 imputation credit and $120 non-resident withholding tax to give a franked distribution of $1000 for Australian tax purposes. The taxation consequences for various Australia investor tax rates and investor types would follow the same consequences as if they received a franked distribution from an Australian company. as shown in Table Three.

TABLE THREE

THE TAX TREATMENT BY AN AUSTRALIAN INVESTOR OF A FULLY IMPUTED NEW ZEALAND DIVIDEND UNDER MUTUAL RECOGNITION

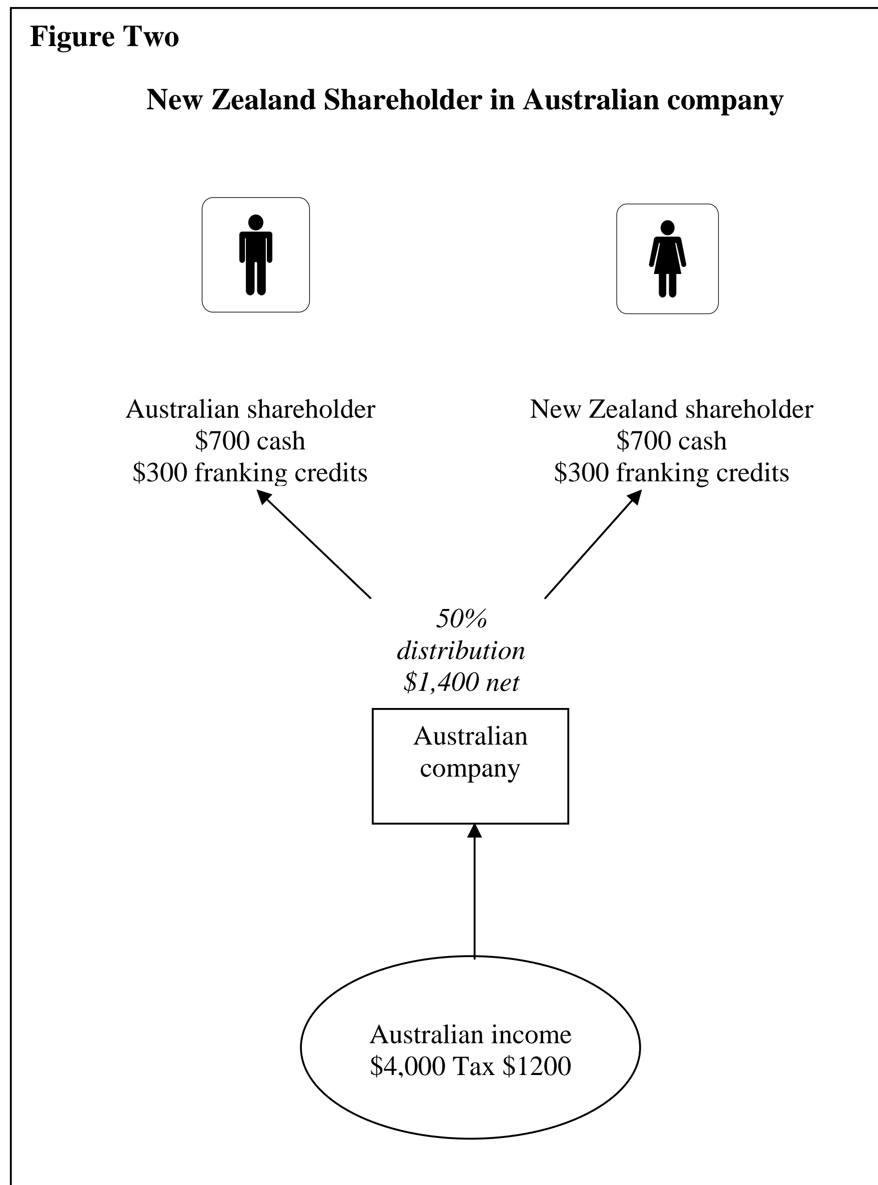
	46.5%	*15%*
Franked distribution	$1000	$880
Supplementary dividend=Non-resident withholding tax		$120
Tax due	$465	$150
Franking credits	$300	$300
Further tax payable/(refundable)	$165	($150)
Net	$535	$850
Effective tax rate[1]	46.5%	15%

This is the same tax result as if the Australian investor had invested in an Australian company with the equivalent income and tax paid.

The New Zealand resident shareholder would have the same tax consequences as under current law. There need not be any difference in the way the New Zealand company would comply with its imputation obligations.

New Zealand shareholder in Australian company

Similar effective tax consequences to both the investor and the company would occur in the converse situation of a New Zealander investing in an Australian company, deriving only Australian sourced income with tax paid at 30%, and paying fully franked dividends. The $700 cash distribution, plus $300 franking credits would result in a $100 taxable dividend for New Zealand tax purposes. This is shown in Figure Two.



The tax effects for various New Zealand investor tax rates and investor types are shown in Table Four.

TABLE FOUR

THE TAX TREATMENT BY A NEW ZEALAND INVESTOR OF A FULLY FRANKED AUSTRALIAN DIVIDEND UNDER MUTUAL RECOGNITION

	39%%	*21%*
Taxable dividend	$1000	$1000
Tax due	$390	$210
Imputation credits*	$300	$300
Further tax payable/(refundable or offsettable)	$90	($90)
Net	$610	$790
Effective tax rate[1]	39%	21%

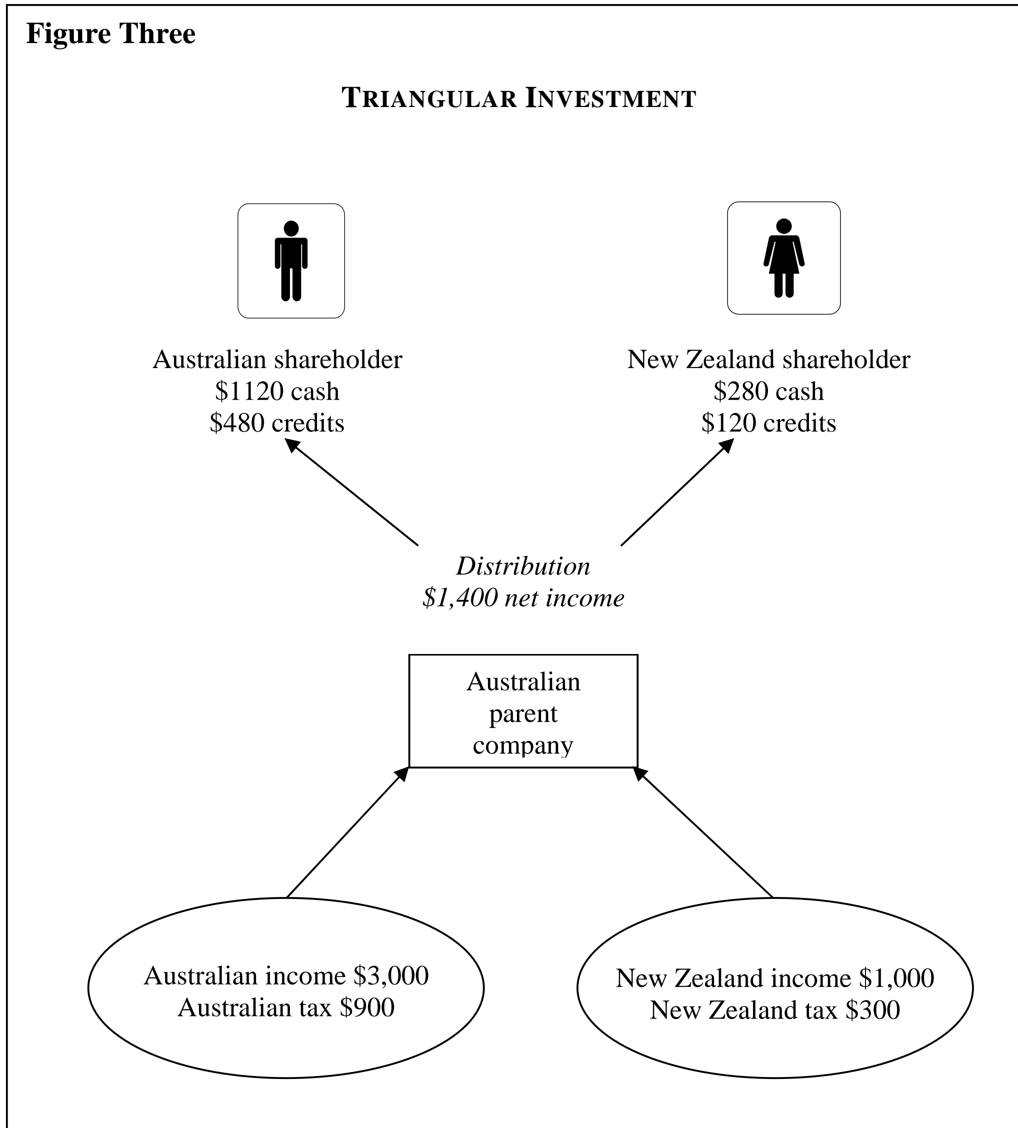
When the 21% investor is an individual, the $90 excess imputation credits can be offset against the tax liability on other income, and any remaining excess will be carried for offset in future tax years. If the 21% investor is investing in the Australian shares through a portfolio investment entity (PIE) the excess credits are rebated to the PIE for the benefit of the investor.[8]

The Australian-resident shareholder would have the same tax consequences as under current law. There need not be any difference in the way the Australian company would comply with its franking obligations.

Example 2: Triangular investment

Consider an Australian company that has an Australian and a New Zealand shareholder, holding respectively 80 percent and 20 percent of the shares. The company earns $3,000 of Australian income and $1,000 of New Zealand income, in the same unit of currency. The effective tax rate in both countries is assumed to be 30%, so $900 in tax is paid on the Australian income and $300 tax is paid on the New Zealand income. This is shown in Figure Three.

[8] For simplicity of comparison, the PIE tax rate was shown as 21%. However, PIEs do not have a 21% tax rate, although they do have a 19.5% tax rate for some investors.



The following discussion illustrates the comparative benefits to Australian and New Zealand-resident shareholders of mutual recognition over the current trans-Tasman triangular rules. The first variation looks at the situation of a 50 percent distribution of profits, and the second examines the case of a 100 percent distribution.

Table Five table illustrates what would happen under both the current trans-Tasman imputation rules and the proposed reform to the tax payable on the dividends received by the New Zealand shareholder. (Ignore supplementary dividends and non-resident withholding tax for the purposes of the example.) Under the current trans-Tasman imputation rules, the New Zealand shareholder can only claim credit for her pro-rata share of New Zealand imputation credits, that is, $60 (20 percent of $300).

TABLE FIVE

THE TAX TREATMENT BY A NEW ZEALAND INVESTOR UNDER MUTUAL RECOGNITION WITH 50 PERCENT DISTRIBUTION

	Triangular	*Mutual recognition*
Cash dividend	$280	$280
Imputation/Franking credits	$60*	$120**
Gross income	$340	$400
Tax due @ 39%	$133	$156
Imputation/Franking credits	$60*	$120**
Tax payable	$73	$36
Net dividend	$207	$244
Effective tax rate	48%	39%

*Imputation credits

**Franking credits

Under the trans-Tasman imputation rules there are insufficient credits to fully impute the dividend. Under mutual recognition, New Zealand investors are therefore in the same position as if they had received a dividend from a New Zealand company. There is also no wastage of franking credits and imputation credits that would incur under that regime.

The tax treatment of the Australian shareholder in Figure Three would be no different under either scenario, as he would receive a fully franked dividend, and use the $480 franking credits against his Australian tax liability.

If New Zealand imputation credits were deemed to be equivalent to franking credits the Australian company's franking credit account under mutual recognition could appear as follows:

AUSTRALIAN COMPANY'S FRANKING CREDIT ACCOUNT UNDER MUTUAL RECOGNITION

	Franking Account		
	Dr	Cr	Bal
Tax paid in Australia		$900	$900 Cr
Tax paid in New Zealand		$300	$1,200 Cr
Dividend	$600		$600 Cr

If the company made a 100 percent distribution of profits the impact on the New Zealand shareholder would be as shown in Table Six.

TABLE SIX

THE TAX TREATMENT OF TRIANGULAR INVESTMENT INCOME BY A NEW ZEALAND INVESTOR, BEFORE AND AFTER THE MUTUAL RECOGNITION WITH 100 PERCENT DISTRIBUTION

	Triangular	*Mutual recognition*
Cash dividend	$560	$560
Imputation credits/franking credits	$60*	$240**
Gross income	$620	$800
Tax due @ 39%	$242	$312
Imputation credits/franking credits	$60*	$240**
Tax payable	$182	$72
Net dividend	$378	$488
Effective tax rate	52.75%	39%

* Imputation credits

** Franking credits

The New Zealand investor in is worse off under the trans-Tasman imputation rules owing to the limitation on the number of imputation credits that she can use. She still pays tax at her marginal rate on the gross company income under mutual recognition.

The Australian investor is worse off under the trans-Tasman imputation rules as he receives a partially franked dividend, whereas he would receive full credits under mutual recognition.

The Australian company's franking credit account could be:

	Franking Account		
	Dr	Cr	Bal
Tax paid in Australia		$900	$900 Cr
Tax paid in New Zealand		$300	$1,200 Cr
Dividend	$1,200		nil

Appendix 2

THE AUSTRALIAN AND NEW ZEALAND IMPUTATION RULES COMPARED

Company tax rate

Australia	New Zealand
30%	30%

Maintenance of account

	Australia	New Zealand
Is maintaining an imputation credit account compulsory?	No	Yes (for New Zealand resident companies)

Type of instrument

What instrument can distributions have imputation/franking credits attached?	Must be a distribution from equity Detailed tax rules to distinguish debt and equity instruments. Generally, follow substance approach	Must be a distribution from equity. Tax rules generally follow a legal form approach

Entities that can attach franking/imputation credits

Entity	Australia	New Zealand
Company	Yes: "A body corporate; or any other unincorporated association or body of persons" Distribution must be from profits	Yes: "A body corporate; or other entity that has a legal existence separate from that of its members" Distribution permitted provided solvency certificate signed by Directors
Mutual life insurance companies	No	-
Life insurance company	Yes – special rules	Yes
Company trustees acting in their capacity as trustee	No	No (except group investment funds deriving Category A income)
Company whose constitution prohibits distributions to shareholders/owners	-	No
Partnership or joint venture	No	No
Unit trust	Yes- in some circumstances	Yes
Group investment fund deriving category A income	NA	Yes – special rules

Entity	**Australia**	**New Zealand**
Pooled development funds	Yes – special rules	-
Corporate limited partnerships	Yes	-
Public trading trust	Yes	-
Non-resident	No (except trans –Tasman)	No (except trans –Tasman)
Dual resident treated as non-resident by DTA	-	No
Company deriving exempt income only	-	No – special rules
Exempting company	Yes – special rules	-
Cooperative companies	Yes – special rules	Yes
Airport operator, statutory producer board, friendly society, industrial/provident society, building society	-	Yes
Local authority, Crown Research Institute, subsidiary company of ACC, Maori Authority	-	No

Account keeping

Requirement	**Australia**	**New Zealand**
Account must be maintained to record the amount of tax that can be credited to shareholders.	Yes	Yes
Currency the account must be kept in:	Australian	New Zealand

Imputation/franking period

Period	**Australia**	**New Zealand**
1 April to 31 March	No	Yes
The entity's income year (1 July to 30 June unless alternative approved)	Yes (private companies)	No
2 franking periods – 6 month period at start of income year, and remainder of entity's income year	Yes (corporate entities other than private companies). *This allows dividends to be imputed at a particular rate for 6 months at a time.*	No *Companies must impute at the same rate for a whole year unless a ratio change declaration is filed.*

Benchmarking

	Australia	New Zealand
Must fully frank dividends to extent that there were imputation credits in the companies accounts	No	No
Company can allocate tax credits to dividends paid to its shareholders by drawing from the pool of credits in their ICA/franking account	Yes	Yes
All distributions must be imputed to the same extent	Yes	Yes
Non compliance incurs penalties	Yes	Yes
A company can change its ratio partway through the year	Yes *Only in extraordinary circumstances*	Yes *Upon filing a ratio change declaration*
A company must notify Commissioner if its benchmark franking percentage changes significantly from its last franking period	Yes	No
The maximum ratio of credit to dividend that can be allocated is: Dividend x Corporate tax rate/ 100%-corporate tax rate	Yes	Yes

Streaming and trading

Australia	New Zealand
Generally if there is a streaming arrangement that allows one group of advantaged shareholders to receive a greater imputation benefit than another group of disadvantaged shareholders, the Australian Commissioner of Taxation can impose penalties. Advantaged and disadvantaged status is determined with reference to imputation benefits. Shares must generally be held 'at risk' for 45 days during a specified qualification period to be able to get the benefit of franking credits. Companies that are greater than 95% owned by non-residents or tax exempt entities can generally not convey franking benefits to resident shareholders. There are special rules to look through NZ companies who have made a franking choice. Anti-franking credit trading rules apply to schemes for the disposition of membership interests (or interests in membership interests) for the purpose of enabling a taxpayer to obtain an imputation benefit. The Australian Commissioner of Taxation can also impose penalties in these cases.	Arrangements that allow one shareholder or groups of shareholders to receive a greater tax advantage than another shareholder or groups of shareholders are void and the associated imputation credits are lost. No holding period rules.

Excess imputation credits

	Australia	New Zealand
Imputation credits are offset against current income	Yes	Yes
Excess imputation credits can be converted into carry-forward loss	Yes	Yes
Excess imputation credits are refunded	Yes Resident individuals, certain super funds, exempt entities, trustees, life insurance companies	Yes Investors in PIEs by increasing the value of the investor's investment in the PIE by the amount of the excess credit. Refunds are also available to individuals for excess foreign dividend withholding payment credits (similar to imputation credits representing payments of tax on foreign sourced income), and to Maori Authorities. The New Zealand imputation review has asked for feed-back whether certain taxpayers such as charities can obtain refunds of imputation credits.
Holding period and related payment rules	Yes	No

Continuity requirements

	Australia	New Zealand
Company must maintain 66% shareholding to carry forward ICs	No	Yes

End of year balances

	Australia	New Zealand
If account is in credit, the amount in credit at end of year is carried forward	Yes *NB: end of year is the company's income year*	Yes *NB: end of year is the imputation year*
If account is in debit at end of year, further tax must be paid	Yes	Yes (shortfall +10%)

What is credited to the imputation credit account?

	Australia	New Zealand
Imputation credits on dividends received	Yes	Yes
Income tax paid	Yes	Yes (paid for 1989 and later)
Franking deficit tax paid	Yes	No

What is debited to the imputation credit account?

	Australia	New Zealand
Imputation credits attached to dividends paid	Yes	Yes
Tax refunds	Yes	Yes

Imputation grouping

	Australia	New Zealand
Companies can consolidate with imputation/franking account deemed to be held by head entity	Yes	Yes
Wholly-owned groups of companies that are not consolidated can group for imputation or franking purposes	No	Yes
Can a company in either jurisdiction be grouped with another member of the same wholly-owned group in the other jurisdiction?	No	Yes