



AUSTRALIA NEW ZEALAND LEADERSHIP FORUM

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Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

SUBMISSION ON DIVIDEND IMPUTATION AND TRANS-TASMAN MUTUAL RECOGNITION (TTMR)

1. This submission is made on behalf of the Australia New Zealand Leadership Forum (ANZLF). ANZLF is an annual high level gathering of senior government, business and community leaders. The most recent ANZLF meeting took place in Auckland on 27th February 2015. The ANZLF has a keen interest in the continuing development of stronger economic relationships between our two countries, and in particular in deepening the Single Economic Market. While much progress has been made in the markets for goods and services there remain barriers to the free flow of capital. The most crucial of these has been the double taxation of dividends on trans-Tasman investment. This has been an on-going concern for businesses on both sides of the Tasman and has repeatedly been brought to the attention of Ministers by the Forum.
2. The Commonwealth Government's tax white paper issued in March 2015 discusses dividend imputation and trans-Tasman mutual recognition culminating in the following questions:
 - a. (#20) To what extent does the dividend imputation system impact savings decisions?
 - b. (#25) Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?
 - c. (#26) To what extent would Australia benefit from the mutual recognition of imputation credits between Australia and New Zealand?
3. We submit that Australia is better off retaining the imputation system, which was also the ultimate recommendation of the Henry Review. For similar and other reasons, we also submit that both New Zealand (NZ) and Australia should implement TTMR.



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The Australian Dividend Imputation System

4. The tax white paper identifies various strengths and weaknesses with the dividend imputation system. The identified strengths are that it:
 - a. better integrates the company tax with the personal tax for Australian companies and Australian shareholders.
 - b. reduces tax differences between the treatment of Australian equity and debt.
 - c. reduces tax distortionary effects on distribution decisions arising from differences in tax rates between the Australian company and its Australian shareholders.
 - d. claws back tax preferences, such as foreign tax credits and tax expenditures (on the general assumption that government's so prefer). An added aspect of this advantage is that imputation motivates Australian companies to substitute Australian tax for foreign tax via transfer pricing and thin capitalisation techniques.

5. The identified weaknesses are that:
 - a. franking credits are only available to Australian shareholders in Australian companies for Australian company tax, which causes Australian equity investors to prefer shares in Australian companies rather than foreign companies.
 - b. because foreign shareholders obtain no benefit from imputation, imputation does not attract foreign equity investment into Australia. The Murray FSI review extends this point by stating that the marginal investor in Australian equity markets is a foreigner, implying that imputation does not affect the quantity nor price of total equity investment in Australia. If imputation does not affect total equity investment or pricing, why refund company tax to Australian shareholders?
 - c. if an Australian company minimises Australian company tax by way of foreign tax credits or tax preferences (tax expenditures), the resulting lower level of franking credits makes them less attractive to Australian shareholders. Conversely, because franking credits are not available to foreign shareholders, such shareholders prefer equity investments in such Australian companies that reduce their effective Australian tax rates.
 - d. the combined company and shareholder Australian tax paid by Australian shareholders as a percentage of underlying income is about the same as that



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paid by companies and shareholders in non-imputation countries with less complex company tax systems. It is suggested that imputation is more complex than the company tax systems operating elsewhere, such as rules around dividend and credit recording and streaming.

6. We consider that the criticism in 5a is a deliberate and desirable feature of imputation, being the prejudicial treatment of foreign tax compared with Australian tax. Countries following the principle of “national welfare maximisation” correctly prefer that foreign taxes should reduce taxable income: not Australian tax payable dollar for dollar. Imputation achieves this preferred result.
7. To explain why, consider two corporate direct investments of AUD1m with identical risk and pre-tax returns of 10%: investment A is in Australia and investment B is in a foreign country. Both countries impose company tax of 30%. The annual return to Australia on investment A is AUD100k (AUD70k to the Australian taxpayer and AUD30k to the Australian government). The annual return to Australia on investment B is AUD70k (AUD70k to the Australian taxpayer and nil to the Australian government), assuming foreign tax reduces Australian tax dollar for dollar. Without imputation, the Australian taxpayer is indifferent between the two investments, despite Australia as a whole preferring investment A. Imputation motivates the Australian shareholder to prefer investment A because the Australian company tax reduces shareholder tax on the subsequent distribution of retained profit of AUD70k. Investment B on the other hand does not reduce Australian shareholder tax on this subsequent distribution.
8. The criticism in 5b cannot be visited on imputation because imputation is not designed to motivate nor prejudice foreign equity investment. Imputation is designed to integrate the Australian company and shareholder tax: to reduce differences in the taxation of Australian debt and Australian equity; and to motivate companies to make investment decisions that recognise the special status of Australian taxes as a return to Australia. Tax policy should differentiate Australian and foreign shareholders and pursue an integrated tax rate paradigm for Australian shareholders. Australian taxes are a transfer or wash within the Australian economy in contrast to foreign taxes paid by Australians (which is an economy wide loss).
9. We consider that the related observation by the Murray Review that imputation does not affect marginal equity investment and therefore total equity investment is not only incorrect but irrelevant for the same reasons in the above paragraph. We



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do not agree that the marginal investor in all Australian equity markets is a foreigner (such as unlisted markets). Furthermore, even in cases where an Australian company has foreign shareholders, the presence of Australian shareholders will mean that company will not ignore the effects of imputation. Such companies do not act with a single focus on a “marginal” shareholder.

10. We consider that the criticism in 5c also cannot be visited on imputation but rather on those tax rules that allow Australian companies to lower their effective tax rates. Further, this criticism remains whether Australia has an imputation system or not: it is unaffected by imputation. Foreign shareholders will prefer their underlying companies to minimise company taxes whether imputation applies or not. Furthermore, even Australian shareholders will not act prejudicially towards investing in companies that minimise their Australian tax liabilities because such companies have correspondingly higher post tax retained earnings as a result of the reduced tax. We need to remember that companies are the economic agents of their shareholders and that tax paid by companies are paid on behalf of their shareholders.
11. In terms of 5d, we do not disagree that alternative systems of corporate taxation cannot (nor do not) converge on similar overall average tax rates on equity. However, we question the relevance of that to tax policy. Clearly, a classical system could emulate the overall tax rate of imputation by an arithmetic calibration of the company and shareholder tax rates, but the question is whether that is a relevant yardstick. The tax white paper links this observation to the complexity of imputation systems implying that Australia gets no additional benefit compared with simpler tax systems overseas producing the same overall average tax rate. We do not agree that alternative systems of corporate taxation are inherently simpler or preferable.

The White Paper Questions

Impact on Savings

(#20) To what extent does the dividend imputation system impact savings decisions?

12. The above question focuses on the impact of imputation on savings decisions. Imputation will affect the form or mix of savings held by individual Australian investors, as it is designed to. Since foreign investors do not benefit from imputation, imputation will not affect the quantity of equity investment by foreigners, nor is it designed to.



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13. It is uncertain whether imputation affects total national savings by Australians even though imputation will affect the mix of those savings by having more of it comprising Australian equity rather than some other category. For example, some savers will target a given level of savings and consume the balance.

Imputation and its Comparisons

(#25) Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?

14. The above question asks whether imputation continues to serve Australia well compared with other alternative systems of company taxation. We submit that it does. We consider that the fundamental point to recognise is that imputation focuses on the Australian shareholder and correctly differentiates the tax treatment of that shareholder from foreign shareholders. The key points of difference are that:
- a. the Australian shareholder and the Australian company are an economically integrated unit and should be taxed on an integrated basis from the viewpoint of both efficiency and fairness.
 - b. Both the Australian shareholder and company are under the tax design control of Australia and not foreign countries, unlike the position of foreign shareholders and foreign companies.
 - c. Australian tax has a very different economic status to foreign tax in that the former is a return to Australia whereas the latter is a loss to Australia.
15. The above differences mean that tax policy should seek to calibrate the tax treatments of the two categories of shareholder, company and tax. Imputation allows that calibration, whereas other systems of company tax do not. There is a tendency to lump all shareholders into one behavioural bucket, which the reference to a more open Australian economy in the above question belies. For example, amongst foreign shareholders, there is a subset that derives economic rents from Australia, who are not marginal investors and whose investments are insensitive to the company tax rate. Alternatively, there are other categories of foreign investors who are sensitive to the company tax rate. For example, if Australia wishes to impose a higher tax rate on foreign shareholders as a result of them deriving economic rents or claiming foreign tax credits, that can be calibrated under imputation with a higher company tax rate while relieving that rate to Australian shareholders. The company tax rate operates very bluntly across a wide range of shareholders that belong to different behavioural buckets. The removal of



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imputation will render the company tax rate even more blunt by disconnecting it from shareholder taxation.

16. Critics of imputation argue that it is not the international norm and that it distorts dividend decisions. When the company rate is below shareholder tax rates, dividends are discouraged because of a liability to top up. If it is the other way round, companies are encouraged to distribute dividends and franking credits. The latter problem can be solved by allowing bonus shares to be treated as franked dividends. The former problem can only be mitigated by bringing the company and top shareholder tax rates closer together. Currently, the gap between the highest Australian personal marginal tax rates and the company rate is very large, increasing incentives to use companies to shelter personal income and discouraging dividend distributions. Note that the excess retention criticism also applies to the classical system. In private companies, the classical system encouraged shareholders to extract earnings as salaries to avoid one layer of additional tax.
17. Critics of imputation also argue that a classical company tax system would enable the revenue loss from imputation (or put another way, the additional shareholder tax under classical) to fund a lower company tax rate. This may be one reason why OECD company tax rates under a classical system have been historically lower than those under an imputation system. Another reason may be that given in the above paragraph.
18. These arguments were considered by the NZ Capital Market Development Taskforce in 2009. It concluded that once likely behavioural changes to dividend paying behaviour was taken into account, moving from imputation to a classical tax system would fund only a very modest reduction in the company rate of around 2 percentage points unless complex and distortionary excess profit retention provisions were also introduced. It would also reintroduce the debt/equity biases in Australian companies that imputation removed. The Taskforce concluded that a switch from imputation to a classical company tax system was undesirable.
19. The White Paper discusses a dual income tax (as implemented in a number of Nordic countries but most consistently and coherently applied in Norway). We provide our comments on this system in the attached Annex.



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20. Another recently discussed system is the ACE company tax system (as advocated by the 2010 UK Mirrlees Review). We provide our comments on this system in the attached Annex. Note that the Gillard government raised the spectre of the alternative ACE system, which was not supported by the Business Tax Working Group in 2012.
21. Any discussion of whether imputation should be abandoned requires the alternatives to be identified and critiqued. We prefer imputation relative to known rival systems of corporate taxation. Imputation subsumes much of the classical system design but subject to a crediting of company tax to domestic shareholders. Economically, the company tax is an in-substance shareholder tax, which imputation seeks to materially integrate. The classical system systematically double taxes equity providing a relative concession to debt as a substitute for equity.

Trans-Tasman Mutual Recognition (TTMR) of Imputation Credits between Australia and NZ

(#26) To what extent would Australia benefit from the mutual recognition of imputation credits between Australia and New Zealand?

How does Imputation currently apply to cross border dividends?

22. Subject to a limited exception, both the Australian and NZ imputation systems do not allow foreign company tax as an imputation credit. This means that dividends passing between Australia and NZ are subject to the classical rather than imputation tax system, as follows.
23. Assume an Australian and a NZ company with only domestic shareholders each earns domestic income of \$100 and pays a fully tax paid dividend. The company tax rate in Australia is 30% and in NZ is 28%. We assume the marginal tax rates of Australian shareholders is 40% and NZ shareholders is 33%.



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Current DI System	Ausco	Nzco
Company income	100.00	100.00
Company tax	30.00	28.00
Retained Earnings	70.00	72.00
Dividend	70.00	72.00
NRWT	0.00	0.00
	NZ S/h	Aus S/h
Individual shareholder tax	23.10	28.80
Total taxes	53.10	56.80
Total Aus Taxes	30.00	28.80
Total NZ Taxes	23.10	28.00

The first column is all in AUD and the second column is all NZD. DI=dividend imputation.

How would TTMR change the above 4 example to taxing cross border dividends?

24. Using the same numbers in the above paragraph, TTMR would apply as follows:

TTMR System	Ausco	Nzco
Company income	100.00	100.00
Company tax	30.00	28.00
Retained Earnings	70.00	72.00
Dividend	70.00	72.00
NRWT	0.00	0.00
	NZ S/h	Aus S/h
Individual shareholder tax	3.00	12.00
Total taxes	33.00	40.00
Total Aus Taxes	30.00	12.00
Total NZ Taxes	3.00	28.00

The first column is all in AUD and the second column is all NZD.

What are the fiscal (cash) implications of a switch from Imputation to TTMR for Australia and NZ?

25. Compared with the current imputation system, TTMR reduces tax in both countries on dividends from the other country because underlying company tax in that other country become imputation credits in the shareholder country. The fiscal impact depends on differences in tax rates, dividend flows, and transfer pricing incentives.



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26. Australia invests more equity in NZ and receives more dividends from NZ than vice versa (ignoring differences in repatriation policies). This would mean a first round (or static) effect of a higher reduction in taxes collected in Australia than NZ.
27. Second round (or dynamic) tax revenue effects are more complex to measure. TTMR will change the quantities (and resulting taxes) of the six capital flows between Australia, NZ and the rest of the world. TTMR alters the expected returns to Australasian equity investments, which will change capital allocation decisions within Australasia and between Australasia and the rest of the world.

What are the policy arguments for Australia and NZ implementing TTMR?

28. The current system preserves a classical company double tax system for cross border equity investments, meaning those investments are tax prejudiced relative to direct or other investments. This results in less trans-Tasman equity investment than is optimal, as well as increasing the cost of trans-Tasman equity via an effective tariff on that capital.
29. TTMR is consistent with dividend imputation, it is consistent with the provision of foreign tax credits to cross-border non-corporate direct investment, and it is consistent with SEM and CER. If Australia and NZ were one country operating an imputation system, TTMR would be the standard from both equity and efficiency viewpoints. A key argument therefore is that Australia and NZ should adopt trans-Tasman welfare rather than national welfare as the lead policy principle under SEM and CER, as agreed by the Australian and NZ Prime Ministers in their joint statement of March 2009. This is particularly the case given the reasonably free flow of labour across the Tasman. National welfare adopts the standpoint of each country, whereas trans-Tasman welfare adopts the standpoint of both countries collectively.
30. The relevant focus is the economic benefits of TTMR, being the avoided economic costs of the taxes relieved by TTMR. The economic benefits of TTMR are the avoidance of distortions to trans-Tasman equity investments made by Australian and NZ investors. TTMR would reduce tax induced differences between the relative rates of equity return from equity investments in NZ versus investments in Australia.¹ Modelling done by the NZIER/CIE and the Joint Productivity ANZ Commissions (JPC) confirms this.

¹ Rates of return comprise the relevant costs of capital.



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31. The fiscal (cash) effect of TTMR is one impact: the other is the GDP (national income) impact. We commissioned a study by the NZIER and CIE to model the effects of an integrated dividend imputation system (TTMR) under which each country recognises company imputation credits arising in the other country. That study confirms that both Australia and New Zealand (NZ) would materially benefit from adopting TTMR in terms of Australasian GDP. In economic terms, the welfare gains accrue from lowering the cost of capital on trans-Tasman investment. While the static efficiency gains are material, the dynamic productivity gains arising from removal of distortions, which were not modelled by NZIER/CIE, are likely to be more significant.
32. Abstracting from taxes collected, the NZIER and CIE findings were that Australasian GDP would rise by NZ\$5.3b by 2030 (\$3.1b for NZ and \$2.2b for Australia) in net present value terms. The NZIER and CIE estimated reduced annual tax revenue of NZD494m in Australia and NZD156m in NZ. The productivity commissions of both Australia and NZ also jointly attempted to quantify the fiscal impact and estimated an annual fiscal cost to Australia in the range of NZD190m to 750m and to NZ in the range of NZD135m to 220m.
33. On the basis of these various studies, we asked the NZ Inland Revenue Department to run further figures based on more realistic assumptions that were developed following two workshops in late 2014 in Sydney and Melbourne hosted by EY and Deloitte with a number of large trans-Tasman companies. The NZ IRD model, based on these figures, gave an indicative fiscal cost to Australia of NZD111m.²
34. These fiscal effects can be addressed by (a) increasing tax revenue elsewhere (via a new tax or a rate increase), (b) increasing borrowing, (c) or reducing spending. The standard policy approach to any tax reduction measure is to assume replacement of the lost revenue by an efficient alternative tax.
35. For the reasons set out above, we strongly support the implementation of TTMR by both countries. The key reasons are:
- a. a special bilateral relationship reflected in the SEM initiative,
 - b. improved GDP to both countries,
 - c. consistency with imputation principles,
 - d. consistency with the cross border treatment of direct investment (rather than via a company),

² We discuss the detail of these costings in the attached Appendix.



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- e. the higher excess burden of doubly taxing trans-Tasman dividends compared with the excess burden on more efficient tax bases.

Yours sincerely,

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Co Chair

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Co Chair



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APPENDIX

Costing the fiscal impact of TTMR

1. The fiscal cost of TTMR focuses on the taxes collected under the current system compared with the taxes collected under TTMR.
2. The taxes collected under the current imputation system is determined by the following factors:
 - a. The quantity and timing of dividends distributed by Australian companies to ultimate non-corporate NZ shareholders and vice versa. This quantity of dividends is determined by the amount of underlying income from trans-Tasman equity investment.
 - b. The stock of franking credits in each of the two countries.
 - c. The extent to which dividends are franked.
 - d. The extent of shareholders that cannot use franking credits (mainly foreign shareholders).
 - e. The tax rates applying to the relevant Australian and NZ companies and shareholders.
 - f. The interaction with other tax bases, such as capital gains tax.
3. The taxes relieved by TTMR are determined by the same factors in 2 above. A costing distinction is drawn between the fiscal impact of TTMR assuming unchanged behaviour (a static fiscal assessment) and the impact of TTMR on the basis of changed behaviour (a dynamic fiscal assessment).
4. The fiscal costs of TTMR comprise actual taxes reduced in each country by “newly available” franking credits. These tax reductions occur at the time dividends are received by shareholders, and are mainly driven by:
 - a. the amount of new franking credits from taxes paid in the other country.
 - b. The capacity of the receiving shareholders to absorb the franking credit. For example, in NZ surplus franking credits are not refundable whereas they are in Australia. Surplus credits arise where the shareholder’s tax liability on the franked dividend is less than the amount of the franking credit.³

³ For example, a NZ company receiving a fully franked dividend from an Australian company, say a net dividend of AUD70 with credit of AUD30, would only be able to credit AUD28 to its franking account under current NZ rules.



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5. Either country may introduce transitional rules which will also affect the fiscal cost.
6. NZ Revenue officials did modelling work on this matter for the Australian and NZ Productivity Commissions, which produced a joint report for both governments.⁴ As mentioned, we asked NZ Revenue officials to re-run updated figures on more realistic assumptions that we have provided following two workshops in Australia late last year. We refer to the new worked figures herein as the “Updated Model”. This Updated Model ignores exogenous or policy-induced growth in investment beyond the available data years and also excludes any dynamic effects other than the assumed additional dividend payments. The Updated Model therefore does not contain any impact on fiscal costs resulting from TTMR increasing trans-Tasman investment, which is a major goal of the TTMR policy.
7. Approaches to estimating the franking credits potentially available under TTMR include using historical average equity investment stocks and rates of return from the latest available statistics and then applying the appropriate company rate⁵, or using the relative share of equity investment as a proxy for the relative share of company tax⁶. The former approach was used by NZ Revenue officials, including the Updated Model, whereas the latter was used by NZIER & CIE.
8. The Updated Model starts by assuming that Australian companies are distributing 0% of trans-Tasman profits to final shareholders and that 46% of shares in Australian companies are owned by foreigners. Based on a decomposition of Australian companies receiving NZ imputation credits, and their shareholders, we estimate that TTMR would raise the percentage of trans-Tasman profits distributed by Australian companies to 75%.
9. The Updated Model calculates that the costs to Australia are much smaller than previous estimates (between a 5 year average of NZD111m based on Australian data and a 5 year average of NZD169m using NZ data). The equivalent costs for NZ are NZD71m based on Australian data and NZD100m based on NZ data). These are materially smaller figures than NZ Revenue officials provided to the NZ and Australian Productivity Commissions. The differences in costs to the two countries also converge on a much narrower range. The Updated Model results are shown below.

⁴ This report is referred to in the Tax White Paper in the context of TTMR.

⁵ This anchors to historic returns to the investment itself, and makes no judgement on subsequent performance.

⁶ This anchors to company tax (or forecasts), but requires an assumption that returns to trans-Tasman equity investment match the rest of the economy



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Fiscal costs of Mutual Recognition of imputation and franking credits (\$NZ million)	IRD for Joint Productivity Commissions			ANZLF updated assumptions applied to IR model
	HIGH distribution	MEDIUM distribution	LOW distribution	
Australian Costing				
<i>Assumptions</i>				
Initial percentage of trans-Tasman FDI profits distributed	75%	50%	25%	0%
Final level of trans-Tasman FDI profits distributed	+25%	+25%	+25%	+75%
Fraction of Australian shares in NZ companies held by non-residents	0%	0%	0%	46%
Proportion of dividends going to different groups of underlying shareholders				
Super schemes @ 15%	25%	25%	25%	24%
Individuals @ 0%	6%	6%	6%	2%
Individuals @ 19%	5%	5%	5%	3%
Individuals @ 32.5%	14%	14%	14%	6%
Individuals @ 37%	18%	18%	18%	10%
Individuals @ 45%	32%	32%	32%	17%
Trusts @ 45%	0%	0%	0%	38%
Average tax rate of dividend recipients	0.3031	0.3031	0.3031	0.346859
Proportion of distributions this is applied to	100%	100%	100%	54%
Difference between average shareholder rate and the NZ company rate	2%	2%	2%	7%
<i>ABS data (\$NZ million)</i>	<i>5 year average 2007-2011</i>	<i>5 year average 2007-2011</i>	<i>5 year average 2007-2011</i>	<i>5 year average 2009-2013</i>
Portfolio dividends	85	85	85	74
FDI returns	2,984	2,984	2,984	3,061
Cost to Australian Government	-708	-508	-308	-111
<i>SNZ data (\$NZ million)</i>	<i>5 year average 2007-2011</i>	<i>5 year average 2007-2011</i>	<i>5 year average 2007-2011</i>	<i>5 year average 2010-2014</i>
Portfolio dividends	353	353	353	290
FDI returns	3,875	3,875	3,875	4,293
Cost to Australian Government	-948	-688	-423	-169
New Zealand Costing				
<i>Assumptions</i>				
Initial percentage of trans-Tasman FDI profits distributed	75%	50%	25%	40%
Final level of trans-Tasman FDI profits distributed	+25%	+25%	+25%	+35%
Fraction of NZ shares in Australian companies held by non-residents	0%	0%	0%	33%
Proportion of dividends going to different groups of underlying shareholders				
Individuals @ 0%	0%	0%	0%	0%
Individuals @ 10.5%	1%	1%	1%	0%
Individuals @ 17.5%	5%	5%	5%	2%
Individuals @ 30%	4%	4%	4%	2%
Individuals and trusts @ 33%	86%	86%	86%	87%
PIEs @ 28%	5%	5%	5%	8%
Average tax rate of dividend recipients	0.3174	0.3174	0.3174	0.3214
Proportion of distributions this is applied to	100%	100%	100%	67%
Difference between average shareholder rate and the Australian company rate	2%	2%	2%	2%
<i>ABS data - \$NZ million</i>	<i>5 year average 2007-2011</i>	<i>5 year average 2007-2011</i>	<i>5 year average 2007-2011</i>	<i>5 year average 2009-2013</i>
Portfolio dividends	397	397	397	348
FDI returns	416	416	416	43
Cost to New Zealand Government	-208	-178	-148	-71
<i>SNZ data - \$NZ million</i>	<i>5 year average 2007-2011</i>	<i>5 year average 2007-2011</i>	<i>5 year average 2007-2011</i>	<i>5 year average 2010-2014</i>
Portfolio dividends	312	312	312	439
FDI returns	263	263	263	197
Cost to New Zealand Government	-149	-129	-109	-100



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ANNEX

The Nordic Dual Income Tax

1. Nordic countries generally have quite high levels of taxation as a percentage of GDP. This generally has required them to have high rates of tax on labour income. These rates of tax have been higher than were thought sustainable on capital income. For this reason they have sought to reduce tax rates on capital income.
2. The Nordic countries and especially Norway have attempted to do this in a coherent way by distinguishing between capital and labour income. They seek to tax capital at a relatively low flat rate (in Norway this is 28%) while having higher progressive tax rates on labour income, reflecting the view that labour is less mobile (tax sensitive) than capital.
3. Distinguishing capital income from labour income has proved difficult in practice. In Norway for an unincorporated enterprise the amount of capital employed in the business is multiplied by a risk-free interest rate. This is treated as capital income. Everything else is treated as labour income and subject to higher progressive personal rates.
4. Initially, closely-held and widely-held companies were treated differently. All income from widely-held companies was treated as capital income while income from closely-held companies was split into capital and labour components in the same way as for unincorporated enterprises. But the split was very problematic because of the very large advantage in being treated as widely held.
5. In response to these problems Norway has moved to tax all companies the same. All companies are taxed at the capital tax rate of 28%. Then dividends and capital gains over and above an exempt amount are taxed again at the capital tax rate. Double taxation at the capital tax rate is very close to single taxation at the top personal marginal tax rate of 48% ($0.28 + 0.28 \times 0.72 = 0.482$). Take a company in which there is no capital and where all income is say the labour earnings of a consultant. This would not create opportunity for tax sheltering because all of the income would end up double taxed. By contrast, if a company has substantial amounts of capital, substantial amounts of company income are likely to be taxed only at the company and capital tax rate.
6. With any tax system, the devil is in the detail. We understand that in practice anti-avoidance provisions mean that there can be considerable double taxation of capital income earned through companies. This is likely to penalise firms investing in risky



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activities. If a firm earns high levels of income, it is likely to be double taxed. If a firm earns low levels of income, it may not get any offset.

7. Foreigners investing in Norway are taxed at the company tax rate of 28% which is a final tax.
8. The coherence of Norway's system rests on double taxation at the company level being broadly equivalent to single taxation at the top personal tax rate on labour income. Otherwise earning business income through a company would either be penalised or artificially encouraged for those on the top marginal tax rate. It also works best if the capital tax rate is close to the bottom tax rate on labour income.
9. Australia already taxes labour quite heavily with high marginal income tax rates. Note also that GST is effectively a tax on labour income as are payroll taxes. Australia is a high labour cost economy, which is one of its challenges.

Mirrlees' ACE Proposal

10. The UK Mirrlees Review in 2010 suggested an ACE (Allowance for Corporate Equity) company tax system combined with an RRA (rate of return allowance) for individuals or something equivalent. The RRA allowance for individuals is aimed at effectively exempting them from tax on their capital income.⁷ Thus, the Mirrlees Review proposal is like an extreme dual income tax system with what amounts to a zero tax on capital income.
11. Under their proposal the company would be allowed a deduction for a risk-free return on corporate equity. Thus, suppose a company was established with \$100 of equity and the risk-free interest rate were 6%. The company earns \$10 of income. It would be taxed on \$4 (i.e., \$10 - \$6. the difference between its income, viz. \$10, and the equity deduction, viz., 6% x \$100).
12. Allowing an ACE deduction would not be coherent if the government were attempting to tax individuals on their capital income. Suppose that the government wanted to tax an individual who put \$100 into a bank and, say, earned \$6 of income. In this case, an ACE could lead to an obvious problem if it allowed the person to

⁷ Taxing economic income or taxing a risk-free return on invested capital has equivalent effects on savings decisions. This means that taxing economic income but allowing a deduction for a risk-free return should have no effect on savings decisions. Taxing economic income but allowing a deduction for a risk-free return is equivalent to exempting capital income. In cases where a risk-free allowance cannot be used immediately, the Mirrlees Review suggestion is that it be carried forward at a risk-free interest rate to offset future income. This will not be quite equivalent to exempting the yield because there is a possibility that the deduction will never be able to be used.



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instead establish a company and earn the interest in a company completely free of tax.

13. But the ACE system ends up being coherent under the Mirrlees proposal, because the government would not be seeking to tax the individual on their capital income either.⁸
14. The ACE proposal attempts to remove tax on marginal investment from abroad while continuing to tax economic rents.⁹ This is a theoretically efficient approach as a tax on marginal investment changes the quantity of investment whereas a tax on rents does not.

⁸ There have been other coherent ACE suggestions. Sorensen and Johnson (2009) suggested an ACE for Australia in combination with a dual income tax system and the Gillard Business Tax Working Group were asked to look at it in 2012. To ensure that the build up within a company was subject to tax at the capital tax rate, S&J suggested an accrual-basis capital gains tax or equivalent. No country has an accrual-basis capital gains tax and it would be very challenging to make one work.

⁹ If an ACE deduction cannot be used in one year, it can be carried forward at a risk-free interest rate and used to offset income in the future. If companies were certain to always be able to use these deductions, they would be truly risk free and carrying them forward at a risk free interest rate would be appropriate. In practice, some companies will be wound up and be unable to use their ACE deductions so this will not be truly neutral.