Mutual recognition of imputation credits

Background paper and questions for the technical workshop

Strengthening trans-Tasman economic relations

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Submissions to the Commissions' joint study on strengthening trans-Tasman economic relations have raised the issue of whether each country should recognise the tax imputation credits of the other.[1] This paper provides an overview of the imputation regime as it operates in both countries and identifies issues that the Commissions are considering in determining whether, or not, to recommend mutual recognition of imputation credits (MRIC).

1. Background

1.1 Overview of the current position

Australia and New Zealand both operate full imputation domestically but apply the equivalent of the classical system for cross-border investment (leaving aside the limited relief provided by the trans-Tasman triangular arrangement).[2] The result is double taxation of cross-border, including trans-Tasman, company income. Both governments claim taxing rights to what is, in effect, the same pool of income.

This double taxation of company income occurs, however, not because *dividends* that cross the border are double taxed (both the Australian and New Zealand governments have taken steps to prevent that), but because the source country

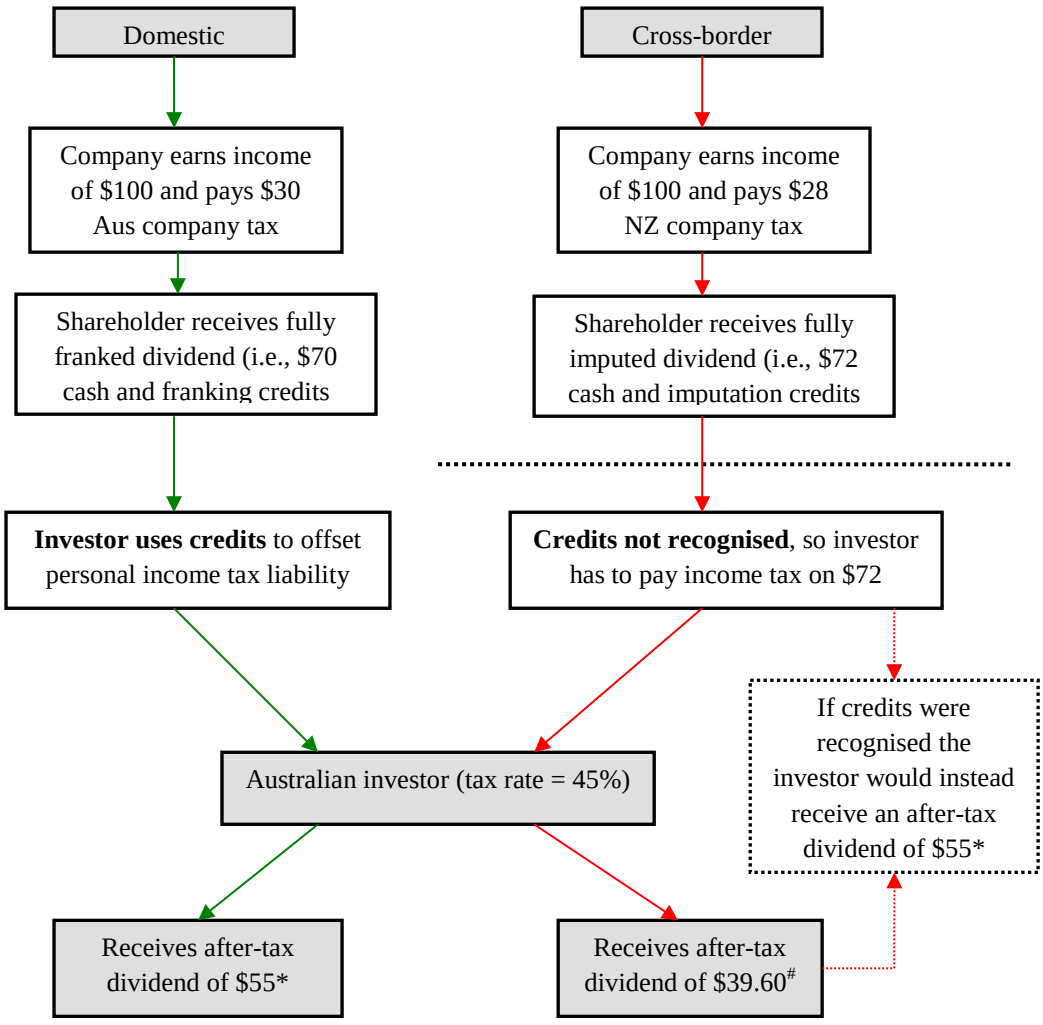
[1] The terminology is different in each country. New Zealand refers to imputation, while Australia refers to franking. The process, however, is the same in each country. In this paper, the term imputation is used to refer to both.

[2] The terms full imputation, classical system and triangulation arrangement each describe corporate tax regimes. They are explained in Appendix 1.

taxes the underlying income at the company level and the country of residence of the shareholder taxes it at the shareholder level. A high-level overview of the current treatment of returns to trans-Tasman equity investment is provided in figure 1 below, with further details in Appendix 1.

Figure 1: How current tax settings impact trans-Tasman investment returns

Australian investor facing direct investment opportunities in New Zealand and Australia



** Equivalent to the investor's marginal tax rate of 45% in Australia, so no double tax*

 # Equivalent to an effective marginal tax rate of 60.4%.

The different tax treatment of domestic and cross-border company income can result in a bias toward domestic investment over outward foreign investment. This contrasts with the position between countries that operate the classical system,

where returns to domestic and cross-border investment are taxed consistently, albeit twice.

1.2 Recent tax reviews

Possible reform of corporate tax has featured in recent tax reviews in Australia, notably by the Australia's Future Tax System (AFTS) Review panel, otherwise known as the Henry Review (Australia's Future Tax System Panel, 2009, Sorensen and Johnson, 2009). Also, the Australian Treasury's Business Tax Working Group (BTWG) has issued a discussion document on the taxation of company income in Australia (The Australian Government the Treasury, 2012).

These reviews considered reducing company tax within the context of a fundamental reform of the company tax system, based on the Allowance for Corporate Equity (ACE) method and, in that context, posed the question whether dividend imputation should be retained. But they also concluded that reform of this kind should not proceed in the short- to medium-term, but rather were possibilities for the longer-term that warrant further public debate. That might suggest that the company tax system, including dividend imputation, currently in place in Australia will remain in place for, say, the next 5-10 years at least.

The Tax Working Group in New Zealand also considered whether the imputation regime should be retained and concluded that it should (Victoria University of Wellington Tax Working Group, 2010).

Q1. Is it reasonable to proceed on the basis that both countries will most likely retain an imputation regime for at least the next 5-10 years?

1.3 The MRIC proposal

Adopting a trans-Tasman MRIC regime would result in returns to domestic and cross-border investment being taxed consistently, and once only. It would allow shareholders resident in one country to use credits for company tax paid in the other country to offset their domestic taxes when profits are distributed as dividends. This would see imputation relieving the second layer of taxation for trans-Tasman investments in the same way as it already does for returns to domestic investment. Further details, including a worked example, are provided in Appendix 1.

2. Issues for the workshop

This section seeks to identify the issues that the Commissions will need to address in determining whether, or not, to recommend MRIC. A first issue concerns how dividend imputation affects firms' cost of capital and hence their investment decisions. A number of matters more specific to mutual recognition of imputation credits in the trans-Tasman context are then raised. Section 3 provides estimates of the revenue cost of MRIC to each country.

2.1 Dividend imputation and the cost of capital

The Australian and New Zealand economies are both well integrated with global capital markets. The savings of each economy can generally be invested either domestically or abroad, and capital can be raised from abroad, although subject to constraints which are mentioned below. This means that the global cost of capital – the return that savers, globally, require in order to provide resources for investment – is an important determinant of the cost of capital for Australian and New Zealand firms.

Tax also contributes to firms' cost of capital. If there was no tax in New Zealand and Australia on returns to foreign capital, then, following on from the preceding point, the local cost of capital would be the global cost of capital. But if Australian/New Zealand tax has to be paid by foreign investors, that tax is added to the return they require, so that their post-tax return remains equivalent to the global rate of return (the post-tax return they could get elsewhere). Thus the higher is Australian/New Zealand tax on returns to foreign capital (for instance, the higher the company tax borne by foreign-owned companies), the less capital will be available and the less investment will occur in the domestic economies.

Tax also matters for the supply of capital by domestic savers: a higher rate of tax on returns to domestic savings implies a lower supply of capital from domestic sources. How much lower depends on the responsiveness of saving to the post-tax rate of return.

So how does dividend imputation fit into this analysis? The answer differs for different types of firms depending on whether or not they have access to the global equity market.

For large Australian and New Zealand firms with access to global equity capital, dividend imputation may have limited effect on the cost of their equity. To see this, consider if the existing dividend imputation arrangements for domestic

shareholders were to be removed. This would lower the after-tax returns of domestic equity capital for these shareholders. They would then reweight their portfolios toward alternative forms of capital (debt, offshore equity, property, etc), lowering share prices and correspondingly restoring the after-tax return. However, this would make the shares more attractive to non-resident investors, who would be unaffected by the removal of imputation, and who could be expected to buy and drive share prices back up. If there was full substitutability of foreign for domestic capital, the end result should be that the share price, and therefore the firm's cost of capital, would be unaffected. What imputation affects, rather, is the ownership of the firm, as between domestic and foreign shareholders.

For smaller firms, however, imputation may have a significant impact on their cost of capital. These firms, which in the aggregate comprise a sizeable part of the economy, will likely source a large amount of their capital from domestic shareholders, who benefit from imputation credits. Removing imputation, as described above, would see these shareholders shifting into other forms of capital. This would make it more expensive for small firms to raise funds and would tend to curtail investment.

Hence, the existing imputation arrangements, whether retained, extended trans-Tasman, or scaled back, could have different impacts depending on the type of firm and its access to foreign capital markets.

The above sets out what might be thought of as 'polar' cases. In the first case, where domestic and foreign capital are fully substitutable, imputation affects only who owns the firm (as between domestic and foreign investors), but not the investment decisions it makes. In the other case, imputation impacts on the firm's cost of capital and hence on the investment it undertakes. Which leaves a question about whether there are also 'intermediate' scenarios, eg, firms with both domestic shareholders (who can use imputation credits) and foreign shareholders (who cannot) and which need to weigh the competing interests of those different shareholders when making investment decisions? In such cases, the effect of imputation would fall between the two polar cases.

Q 2.1

- What is the overall effect of dividend imputation on firms' cost of capital? And on their investment decisions?
- What is the effect of dividend imputation on saving?
- How do these considerations bear on the particular issue at hand – whether Australia and New Zealand should recognise the imputation credits of the other?

2.2 Economic efficiency

The double taxation of trans-Tasman company income appears likely to result in domestic capital owners skewing their investment toward the home economy relative to the trans-Tasman partner. This means that firms in each country may be investing in activities in their domestic economy that yield lower economic returns than they could achieve in the other economy.

If MRIC were to open up greater opportunities for firms in each country to invest more productively in the other, this would increase allocative efficiency – for each country, and therefore for the 'joint' economy. The extent of the opportunities for more efficient deployment of trans-Tasman capital is a key question. To what extent are there firms on each side of the Tasman that have capabilities to earn a higher rate of return in the other country but are being deterred by the current double taxation of trans-Tasman earnings?

Greater two-way investment, and penetration by the firms of each economy of the markets of the other, could also deliver wider gains in dynamic efficiency – the gains that come from greater competition; dissemination of new ideas, products and services; improved business processes, and the like. There is also a question about how large these potential gains might be relative to the gains in allocative efficiency resulting directly from the trans-Tasman investment itself.

Q2.2

- Is it the case that MRIC would deliver joint net benefits for Australia and New Zealand?
- How much potential trans-Tasman investment is being held back because of the absence of MRIC? Of what nature (FDI or portfolio investment)?
- What might be the magnitude of the gains in allocative efficiency? And in dynamic efficiency?
- Over what time path might joint net benefits be expected to accrue?

2.3 Trans-Tasman income transfers

MRIC could result in tans-Tasman transfers of income in two ways.

First, MRIC could shift investment between the countries, and the tax on the earnings it generates. If the shifts were greater in one direction than the other, one country would benefit at the expense of the other.

Second, the incidence of the tax reductions that would result from MRIC could also shift, including trans-Tasman. While the initial gain would fall to the shareholders of the country granting the credits, and therefore would amount to a transfer *within* each country, the ultimate incidence of a tax change is rarely the same as its initial incidence. MRIC, to the extent it induces shifts in investment, could also shift the rate of return to capital (owned by shareholders in one country) relative to the return to labour (in the other). In that case, MRIC would transfer some of the benefit of the tax reduction from one country to the other. The size of this transfer would depend on a number of factors including the extent to which MRIC induced increased trans-Tasman investment, and the elasticities of demand for and supply of labour and other factors of production.

The extent of the trans-Tasman transfers of income, overall, that could result from adoption of MRIC, therefore, depends on the interaction of a number of factors, about each of which it is possible to make a range of assumptions. These interactions, and a number of assumptions that can be made regarding them, are explored in a small, purpose-built, model that will examined in the course of the workshop.

Q2.3

- What might be the extent of the income transfers that could result from:
  - imbalance in the induced investment, causing a net shift of the corporate tax base from one country to the other?
  - shifts relative returns to capital and labour (or any other factors of production) in each country?
- Would these income transfers, overall, likely be reasonably balanced, or could there be a material imbalance? If the latter, what is their likely direction and order of magnitude?
- How confident can we be about estimates of the size and direction of these income transfers?
- What does the analysis of the potential for income transfers tell us about the merits or otherwise of either country unilaterally recognising the imputation credits of the other?
- If the income transfers are thought to be materially imbalanced, would some form of compensation mechanism be a practical way of addressing the imbalance? Do such mechanisms exist elsewhere and, if so, how well have they worked?

2.4 Investment diversion

MRIC would be a bilateral arrangement between Australia and New Zealand. While it would remove the double tax that applies when company income is distributed across the Tasman, and put the taxation of trans-Tasman corporate investment on the same footing as domestic investment, it would not remove double taxation of Australian and New Zealand capital invested in the rest of the world. That could make it more attractive than currently to invest in the trans-Tasman partner country, relative to in third countries.

There are some parallels here with preferential trade agreements, under which two countries remove tariffs on trade in goods between them, while retaining tariffs on trade with third countries. It is well established that preferential removal of tariffs can cause trade diversion that results in economic costs, and that these, in some

circumstances, can exceed the trade-creating benefits of the tariff reduction. There is a question, therefore, whether extension of the tax imputation regime by each of Australia and New Zealand, to recognise the imputation credits of the other, similarly carries the potential for investment in third countries to be diverted to the trans-Tasman partner and, if so, whether that could result in economic cost.

A reason to think that would not be the case is that diversion of investment from third countries to Australia/New Zealand would also result in the corporate tax on the earnings generated by that investment shifting to Australasia. Given that taxes paid in third countries are, from an Australasian standpoint, an economic cost, rather than merely an internal transfer, such a shift would be an economic gain for Australasia. There is no equivalent in the case of trade diversion caused by preferential tariff reductions. Nonetheless, as with trans-Tasman shifts of investment induced by MRIC, the gain would accrue to the country whose imputation credits were being recognised and at the expense of the country recognising them. This is something more that needs to feed into consideration of the inter-country distribution of the costs and benefits of MRIC.

Q2.4

- Would redirection of Australian and New Zealand investment in third countries to the trans-Tasman partner be welfare enhancing or reducing for Australasia?
- How significant might be any redirection of investment from third countries?
- How does the potential for investment re-direction from third countries affect the calculus of inter-country income transfers?

2.5 Future tax reform

As already noted, both countries have reviewed their tax systems from time to time. In Australia the AFTS panel considered possible alternatives to traditional company tax, such as the allowance for corporate equity (ACE) approach. The subsequent Business Tax Working Group has considered the ACE approach and has proposed that it should not be pursued in the short- to medium-term, but that it may be worthy of further consideration and public debate in the longer term. It noted that ACE's interaction with the dividend imputation regime is one of the design issues that would need to be considered (The Australian Government the Treasury 2012, p.6).

While the BTWG did not consider the imputation system, it did support the objective of reducing Australia's company tax rate. Gruen (2006) and Gruen (2012) suggest abolishing dividend imputation and using the revenue saved to reduce the company tax rate.

Q2.5

- Would proceeding with MRIC constrain either country from future reform of its company tax system?
- Would it mean that future reform in one country would likely dictate that the other would have to follow suit?

2.6 Other criteria for assessing tax changes

Two other criteria often applied to proposed tax changes are fairness and administrative efficiency.

Adoption of MRIC would entail lower taxation of dividends received by Australian and New Zealand shareholders from companies in the other country. There is a question concerning how that should be assessed from a fairness standpoint.

Also there is a question whether adoption of MRIC would complicate tax administration, for the tax authorities or for taxpayers. For example, to what extent would it lessen use of mechanisms to avoid double taxation and the complexities that go with those? The AFTS panel placed significant emphasis on the desirability of simplifying the Australian tax system.

Q2.6

- How would the tax reductions consequent upon MRIC be distributed across the community in terms of income and wealth distribution (eg, disproportionately concentrated on high income and net worth households, or spread across savers more widely)?
- To what extent would the effect, or lack of effect, of MRIC on the cost of capital, and incidence shifting, also bear on distributional outcomes and thus the fairness of MRIC?
- Would MRIC make tax administration simpler or more complex?

3. Revenue costs

Adoption of MRIC would result in a revenue cost for each government.

Using 2011 data, preliminary estimates provided by the Australia New Zealand Leadership Forum (ANZLF sub. 58) suggest that full trans-Tasman recognition of imputation credits would reduce annual taxation revenue by NZ$250 million - NZ$1 billion in Australia, and by NZ$ 80million - NZ$ 300 million in New Zealand. (These are static estimates that do not take account of 'second-round' effects on firms' investment decisions. The latter effects, including on the fiscal costs, will be taken into account in the small purpose-built model to be considered at the workshop.)

Key assumptions which determine where within these ranges the fiscal cost might lie are the proportion of profits that is distributed, and whether they are distributed to Australasian, or third-country shareholders. Based on an assumed 50% distribution ratio, with all shareholders being Australasian, and therefore able to claim imputation credits, the ANZLF's central estimates of fiscal cost are NZ$494 for Australia and NZ$156 for New Zealand.

Estimates of the revenue losses have also been prepared by the New Zealand Inland Revenue Department (unofficial communication). These are in the same ball-park as those submitted by ANZLF. They are provided in Appendix 2, along with details of the assumptions on which they are based, and some analysis of how the results change depending on the assumptions adopted.

If MRIC were to proceed, these revenue costs would need to be covered in some way. The possibilities include less government expenditure than otherwise,

revenue from other sources, or a larger fiscal deficit/smaller surplus. There is a range of questions in this context, about:

- Whether the revenue costs are of such a magnitude that they would require specific compensating fiscal measures, or whether they are in the range that could be covered within existing fiscal policy (eg, tax rate) parameters, as fiscal circumstances allow. (Based on ANZLF central estimates, the revenue costs would amount to about 0.17% of total tax revenue in Australia and 0.32% in New Zealand.)

- How the efficiency gains from MRIC compare with the efficiency costs of the means of financing it.

These may be questions that are difficult to address in any precise quantitative manner. If that is the case, another means of informing the judgements involved is to consider the revenue costs and benefits of MRIC alongside other tax measures that have been taken, or proposed, to improve economic efficiency. Some examples include:

- Reductions in Australia of a range of stamp duties between 2006/07 and 2010/11 (other than on conveyances) resulting in annual revenue loss for the states of about A$1 billion. (Abolition of stamp duties on conveyances would involve a much larger loss of revenue for the states, of about A$12 billion annually.)

- The elimination by Australian states, between 2001/2 and 2006/7, of financial institutions' transactions taxes. In 2001/02 these taxes raised nearly A$1 billion of revenue.

The removal of these taxes occurred in the context of the arrangements in Australia for the allocation of GST revenue to the states, and was regarded as improving economic efficiency.

Further comparators, albeit of a different order of magnitude, are the reductions in tariffs phased in by both governments during the 1980s/ 1990s. Between 1980 and 2005, the reduction in customs revenue in New Zealand amounted to about 3 1/2 per cent of total annual tax revenues, equivalent to about NZ$1.8 billion per annum in today's terms. If in Australia the revenue cost of tariff reductions, as a share of total Commonwealth tax revenues, was similar to that in New Zealand, the revenue cost of phasing down tariffs will have been about A$10 billion.

Q3

- Are the revenue cost estimates given reasonable?
- Are the revenue costs of a magnitude that they would need to be covered by specific compensating fiscal measures, or are they in a range that could be covered within the annual budget-setting process, as fiscal circumstances allow?
- How would the efficiency benefits of MRIC rate alongside other tax policy initiatives that have been proposed, or implemented, to raise economic efficiency?

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Appendix 1: Background on current arrangements

Companies in Australia and New Zealand are subject to tax on their income. The current rate of company tax in New Zealand is 28% and, in Australia, 30%.

Income distributed to company shareholders as dividends is also subject to tax as income in the hands of shareholders. These may be natural persons, taxed as individuals, or other entities, eg, a superannuation fund, or a trust. In Australia superannuation funds are taxed at 15%, and in New Zealand Portfolio Investment Entities (PIEs), which include KiwiSaver funds, are taxed at members' prescribed investor rates. These are the same as members' individual marginal income tax rates, up to a maximum of 28%. Trustees' income in both Australia and New Zealand is taxed at the top personal marginal tax rate, 45% and 33% respectively.

Australia and New Zealand both operate a dividend imputation system. This is a mechanism to avoid income earned by companies being subject to double tax, once at the company level, and again, on distribution, in the hands of shareholders. It works by imputing to shareholders the company income from which the dividend has been paid, grossed up for company tax, but with shareholders being able to claim a credit for that tax. This, in effect, makes the company tax a withholding tax, and integrates the taxation of company income with the taxation of dividends. A worked example is provided in the following table.

Worked example of the imputation mechanism (using New Zealand tax rates)

Company income		$100
Less company tax paid (@28% company tax rate)		($28)
Company income net of tax, available for distribution		$72
Shareholder income and tax		
Dividend received by shareholder (assuming 100% distribution)		$72
Add tax imputation credit		$28
Company income imputed to shareholder		$100
Personal tax (assuming 33% marginal tax rate)	$33	
Less imputation credit (the amount of company tax already paid)	($28)	
Additional personal tax payable	$5	
Total tax		
Company tax		$28
Personal tax		$5
Total		$33

The motivation for this integrated approach, which was introduced in Australia in 1987 and in New Zealand in 1989, appears to have been to achieve tax neutrality with respect to business organisational form (incorporated or unincorporated); financial structure (debt or equity); and companies' income distribution policies (earnings retention or distribution). Integration also delivers tax neutrality across different forms of capital income – profits, rents and interest. Achieving neutrality in these respects has been thought worthwhile from the standpoints of avoiding economic inefficiency from distorted investment incentives, and the costs incurred as the result of firms and investors using counteracting (avoidance) devices.

Note that for a shareholder whose marginal tax rate is lower than the company tax rate, the imputation regime results in the shareholder being eligible for a net tax credit. In both Australia and New Zealand such a credit can be used to offset tax payable on the shareholder's other taxable income, eg, wages and salaries. In Australia, if the taxpayer's total tax liability is less than the amount of the imputation credit, a tax refund is payable. In New Zealand in the same situation, imputation credits can only be carried forward.

Imputation and cross-border equity investment

Subject to the trans-Tasman 'triangular' provisions (outlined below), neither country applies the imputation arrangements to dividend income received by their nationals from companies abroad (whether trans-Tasman or in any other country). Nor do other countries recognise the imputation credits attached to the dividends distributed by Australian and New Zealand companies.

This is often referred to in terms of imputation credits not being able to 'cross the border'. It results in trans-Tasman company income being taxed twice (box 1).

Box 1 **The cross-border double tax**

Assume an investor requires a minimum 6% post-tax rate of return to invest.

With a 33% personal tax rate, and the application of the imputation credit regime, the investor would require the company to generate a pre-tax return of 9% to deliver the required post-tax return (9.0 x 0.67 = 6.0).

For a foreign investment, however, the minimum pre-tax return required is higher. Again assuming a 33% personal tax rate, a foreign company tax rate of 30%, and no imputation credits, the pre-tax rate of return required is 12.8% (12.8 x 0.7 x 0.67 = 6.0).

Thus, an investor will have an investment bias toward domestic investments. In this example, foreign investments of comparable risk need to yield nearly 4 percentage points more than domestic investments to be attractive.

Non-resident withholding tax

A third layer of tax can also arise where non-resident withholding tax (NRWT) is payable by the source company on dividends paid to non-residents.

NRWT reflects the application of the 'source principle': a foreign resident is considered to have sourced income in the country where it has been earned, and that country has a claim to taxing it, at least to some extent. (The tax is payable as a withholding tax because the source country has no legal jurisdiction over, and hence cannot tax, foreign residents.) In principle, dividends paid by companies in New Zealand and Australia to their non-resident shareholders are subject to a withholding tax in essentially the same way as is any other income paid to non-residents (in addition to the company tax paid by the company).

However, New Zealand and Australia have taken measures that largely mitigate, or remove, this additional (what would be a third) layer of tax on corporate earnings (as have many other countries). Under the New Zealand-Australia double tax agreement, (DTA) dividends paid by subsidiary companies to a parent, in most situations, are exempt from NRWT. Additionally, Australia unilaterally exempts from withholding tax dividends that are fully franked and New Zealand achieves the same through the foreign investor tax credit (FITC) mechanism. In effect, therefore, withholding tax has been removed for trans-Tasman dividend payments.

The triangular arrangement — partial relief of trans-Tasman double taxation

In 2003 the Australian and New Zealand governments agreed to a reform that provides partial relief from trans-Tasman double taxation, but which is much more limited than mutual recognition. It provides that if an Australian parent company with shareholders in New Zealand also has a subsidiary that earns income and pays tax in New Zealand, then the Australian parent is able to attach New Zealand imputation credits when it pays dividends. And similarly for a New Zealand parent that has a subsidiary and shareholders in Australia.

But as the resulting imputation credits have to be allocated to all their shareholders (in both countries) on a pro rata basis (ie, 'streaming' is not allowed), and each country's credits can be used only to offset a domestic tax liability, a large proportion of such credits typically has no value. For this reason, few companies make use of the triangular arrangement, instead preferring to distribute dividends un-imputed and to retain available credits in their imputation accounts. It is only

where a company is incorporated in one country but with most of its shareholders and most of its earnings in the other that the triangular arrangement provides meaningful relief from double taxation.

A worked example of the triangular arrangement follows.

Consider a company that is an Australian tax resident with two shareholders, one Australian holding 60 per cent and the other a New Zealand shareholder, holding 40 per cent of the shares. Assume also that the company earns $3,000 of income in Australia and $1,000 of income in New Zealand (in the same unit of currency), and that the company tax rates are respectively 30% (Australia) and 28% (New Zealand). Thus $900 of company tax is paid on the Australian income and $280 of company tax is paid on the New Zealand income, leaving $2,820 available for distribution as dividends ($1,128 to the New Zealand shareholder and $1,692 to the Australian shareholder). These details are summarised as follows:

Shareholdings	
Australian	60%
New Zealand	40%
Company income, of which	$4,000
In Australia	$3,000
In New Zealand	$1,000
Company tax paid	$1,180
In Australia (30% rate)	$900
In New Zealand (28% rate)	$280
Dividends (assuming full distribution of post-tax income)	
Australian shareholder (on 45% marginal tax rate)	$1,692
New Zealand shareholder (on 33% marginal tax rate)	$1,128
	$ 2,820

The extent of the difference the triangular arrangement makes to the tax-paid return to the New Zealand shareholders, compared with no mutual recognition, and full mutual recognition, is shown in the table below.

The triangular arrangement – worked example

	New Zealand 33% tax rate shareholder		
	Mutual recognition		
	Nil[3] $	Triangular $	Full $
Dividend	1128	1128	1128
Company tax:			
NZ shareholder 40%	472	472	472
Aust shareholder 60%			
Imputation credit	0	112 [40% of $280]	472 [40% of $1180]
Shareholder tax	372 [33% of $1128]	409 [33% of ($1128 +$112)]	528 [33% of ($1128+$472)]
	0		
Less imputation credit			472
Net shareholder tax		112	
	372		
			56
		297	
Total tax	844	769	528
Company	472	472	472
Personal	372	297	56
Effective rate	53%	48%	33%

Appendix 2: Estimates of revenue costs

This appendix provides some New Zealand Inland Revenue Department estimates of the fiscal cost to New Zealand and Australia, respectively, should MRIC proceed (Tables 1 and 2). (These are static estimates that do not take account of 'second-round' effects on firms' investment decisions. The latter effects, including on the fiscal costs, will be taken into account in the small purpose-built model to be considered at the workshop.)

The estimates shown are based on:

- Official data on:
  - the stock of equity investment of each country in the other.
  - dividends paid on portfolio investment, and earnings on FDI.
- Assumptions as to:
  - the proportion of FDI earnings distributed to ultimate shareholders who can claim imputation credits (note that the relevant distributions are those to ultimate shareholders, not intra-group distributions from a subsidiary in one country to a parent in the other).
  - the domestic tax rates applicable to the underlying shareholders in their country of residence.

Direct data on the proportions of FDI earnings that currently are distributed to ultimate shareholders are not available. Nor is information readily available on the proportion of those shareholders who are Australasian resident taxpayers (who could claim MRIC credits) and those who are third-country shareholders (who still could not). Hence the need to make assumptions on these parameters (which in the tables that follow are subsumed into a single proportion). Given uncertainties about these parameters and their criticality for the results, a range of estimates is shown.[4]

In addition to the 'base' results, an indication is given of the possible revenue effects of changes in distribution policies that could be induced by MRIC. There are two elements to this.

First, the estimates show by how much the fiscal 'cost' of recognising trans-Tasman imputation credits results could change if MRIC was to cause FDI

[4] Note that these uncertainties do not arise with portfolio investment, for which official statistical data are available on dividends actually paid and received (hence no need to make assumptions about distribution ratios).

companies[5] to alter their future dividend distribution policies. The results, however, are comparatively insensitive to this factor. [6] The reason is that the fiscal cost of recognising a credit for company tax paid in the other country is offset by additional personal tax collected on the underlying dividend. For existing dividends, the additional personal tax is only on the "gross-up" applied to the dividend. For new dividends, additional personal tax is collected on the entire dividend, which gives a larger offset. In effect, for new dividends the fiscal impact comes from the difference between the shareholder's personal rate and the offshore company rate, which can be either positive or negative. Shareholders with a higher rate than the offshore company rate will have additional tax to pay on any new dividends and will hence reduce the overall fiscal cost to their country of residence. Those on a lower personal tax rate than the offshore company rate will increase the fiscal cost.

Second, if Australian companies were to alter their distribution policies, that would result in different levels of retentions, and therefore changes in the value of the firm and hence capital gains tax proceeds. Note that the estimates shown assume that the capital gains tax (CGT) applies on an accruals basis (in effect that retentions are taxed at the CGT rate), whereas in fact capital gains tax is payable only upon realisation of the gain. Thus the CGT-inclusive estimates are a maximum estimate. Correspondingly, the CGT-exclusive estimates can be regarded as a minimum estimate.

The data on the stock of trans-Tasman equity investment and on the two-way flow of dividends is taken from Statistics New Zealand (SNZ) and the Australian Bureau of Statistics (ABS). However, these data differ. Generally the data from the [investment] destination country's statistical agency shows larger amounts of investment from, and dividend flows to, the other (compared with the corresponding data from the source country's statistical agency). Given these differences, estimates of the fiscal costs are shown on the basis of each set of source data.

Finally, as noted, the estimates are static/. In particular, no allowance is made for:

- The extent to which MRIC would result in induced reallocations of investment across the Tasman, or from third countries.

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[5] The introduction of MRIC should not result in any change in distribution policies in respect of portfolio investment, given that portfolio investment shareholders are not normally in a position to influence dividend policy.

[6] This assumes that already accumulated retained earnings would be quarantined, such that MRIC would apply only in respect of future income.

- How mutual recognition may cause a change in financing structures, with more equity, and less debt investment. However, there may not be much unwinding of existing financing structures, since replacing deductible interest with imputed dividends is broadly neutral. But to the extent that there is change, there would be a shift in the country where tax is payable (tax on interest is payable in the country of the lender, whereas profits are taxed where they are earned).

Table 1: Fiscal costs of mutual recognition for New Zealand
(Based on five year average of total New Zealand equity investment in Australia from 2007-2011, and the Australian 30 per cent company tax rate. All figures are in $NZ million)

	SNZ data	ABS data
<u>Assuming all shareholders on top tax rate of 33c:</u>		
Assumed utilisation of MRIC credits based on existing dividend distributions for FDI (plus 100% utilisation of portfolio investment MRIC credits)		
75% utilisation	135	185
50% utilisation	115	160
25% utilisation	100	135
If MRIC is assumed to increase the FDI dividend distribution rate by 25 % pts,		
the above cost estimates adjust by:	*-9*	*-14*
<u>Assuming a representative distribution of shareholder tax rates</u>		
75% utilisation	150	210
50% utilisation	130	180
25% utilisation	110	150
If MRIC is assumed to increase the FDI dividend distribution rate by 25 % pts,		
the above cost estimates adjust by:	*-1*	*-2*
<u>Assuming all shareholders on capped Portfolio Investment Entity rate of 28c:</u>		
75% utilisation	160	220
50% utilisation	140	190
25% utilisation	120	155
If MRIC is assumed to increase the FDI dividend distribution rate by 25 % pts,		
the above cost estimates adjust by:	*+ 2*	*+ 3*

Table 2: Fiscal costs of mutual recognition for Australia
(Based on five year average of total Australian investment in New Zealand from 2007-2011, and the New Zealand 28 per cent company tax rate. All figures are in $NZ million)

Assuming all shareholders on top tax rate of 45c:	ABS data	SNZ data
Assumed utilisation of MRIC credits based on existing dividend distributions for FDI (plus 100% utilisation of portfolio investment MRIC credits)		
75% utilisation	555	745
50% utilisation	370	510
25% utilisation	190	275
If MRIC increased the FDI dividend distribution rate by 25 % pts, the above cost estimates adjust by	*-99*	*-128*
Or allowing for CGT:	*+69*	*+90*
Assuming a distribution of shareholder tax rates		
75% utilisation	615	830
50% utilisation	415	570
25% utilisation	215	305
If MRIC increased the dividend distribution rate by 25 % pts, the above cost estimates adjust by	*-25*	*-35*
Or allowing for CGT:	*+93*	*+118*
Assuming all shareholders are super funds on a rate of 15%:		
75% utilisation	750	1015
50% utilisation	510	695
25% utilisation	260	375
If MRIC increased the dividend distribution rate by 25 % pts, the above cost estimates adjust by	*+135*	*+175*
Or allowing for CGT:	*+210*	*+272*