Mutual Recognition of Imputation and Franking Credits
Talking Points

INTRODUCTION

The lack of mutual recognition of imputation and franking credits between Australia and New Zealand means that shareholders are effectively double taxed on their dividend returns from their trans-Tasman investments. This is more than a technical tax issue; it is a barrier to capital raising, it is an impediment to the free flow of capital across the Tasman which distorts investment decisions, and it is a barrier to firms taking their first step to internationalise by expanding across the Tasman.

This is inconsistent with New Zealand and Australia's shared vision for a seamless trans-Tasman business environment – a Single Economic Market (SEM). The SEM initiative builds upon the very open trading environment created by Closer Economic Relations (CER) and related agreements, and aims to address behind-the-border impediments to trans-Tasman business activities.

Introducing mutual recognition could increase post-tax dividend returns on trans-Tasman investment by up to about 40 per cent.

EXTENDING CER TO CAPITAL

- CER has made it much easier and cheaper for trans-Tasman businesses to operate. It has been good for businesses in both countries and helps them to be globally competitive. Bilateral trade has grown rapidly under CER, averaging 6.2 per cent growth per year since 1991.
- It's now time to extend CER – beyond people, goods and services – to capital, to ensure its free flow across the Tasman.
- In a single economic market, it should be no more difficult for capital to flow across the Tasman than it is for capital to flow from the North Island of New Zealand to the South Island, or from one Australian state to another.

BARRIER TO FREE FLOW OF CAPITAL

- In practice, however, there's an outstanding barrier to the free flow of capital across the Tasman – the absence of recognition, by tax authorities, of New Zealand imputation credits in Australia, and of Australian franking credits in New Zealand.
- These tax credits are attached to dividends to show the individual shareholder's proportion of tax that the company has already paid on the dividend, which offsets further taxation of the dividend once it's distributed to shareholders. This prevents the double taxation on dividend returns.
- The problem is that the relief provided by these tax credits is limited to company taxes paid within one country or the other. This means that, while franking credits can be used by Australian shareholders and imputation credits by New Zealand shareholders, Australian franking credits can't be used by New Zealand shareholders (and vice versa), reducing post-tax returns for investors.

MUTUAL RECOGNITION AS PART OF SEM

- Allowing mutual recognition of franking and imputation credits between Australia and New Zealand would allow shareholders resident in one country to use credits for company tax paid in the other country to offset their domestic taxes. That would prevent their dividend return being taxed twice.
- Removing a tax barrier that works against trans-Tasman investment is similar to removing a tariff on trans-Tasman trade. SEM's stated purpose is to remove regulatory barriers to trans-Tasman trade and firms operating in both markets, with the aim of creating a seamless trans-Tasman business environment. This would be to the net benefit of the trans-Tasman economy.
- Introducing mutual recognition of franking and imputation credits would increase post-tax dividend returns by up to 38.9 per cent for Australian investment in New Zealand and up to 42.9 per cent for New Zealand investment in Australia.
- That would expand the number of trans-Tasman investors from which to source capital, as well as increase the efficiency and flexibility of trans-Tasman investment.
- Given the magnitude of the potential benefits, mutual recognition is the logical next step on the SEM agenda.
- The review *Australia's Future Tax System* (the Henry Review) recognised the benefits of mutual recognition, but, even more ambitiously, saw mutual recognition as just one element of a broader examination of the appropriate degree of harmonisation of business income tax arrangements between Australia and New Zealand. New Zealand's submission to the Henry Review expressed the view that mutual recognition would not require the harmonisation of tax rates or bases between Australia and New Zealand.

HOW CAN WE HELP GET MUTUAL RECOGNITION?

- Advancing work on mutual recognition requires agreement between the New Zealand and Australian governments. Probably the biggest barrier to introducing mutual recognition is its fiscal cost. This fiscal cost is due to credits for company tax paid across the Tasman reducing the amount of tax payable domestically by shareholders on their dividend returns. As mutual recognition has high fiscal costs for both governments, mutual recognition is unlikely to succeed without strong support from businesses on both sides of the Tasman. If mutual recognition is to succeed, both governments will need to reach the view, in the spirit of CER and SEM, that a free and open trans-Tasman capital market will inevitably benefit the overall trans-Tasman economy and outweigh the short-term fiscal costs.

- Imputation credit streaming has been suggested by some as an alternative to mutual recognition. However, imputation credit streaming is not a viable policy option as it undermines the core principle of taxing all shareholders evenly on their share of a company's profits. It's important for businesses to understand that this is not a viable alternative to mutual recognition.

WHAT MUTUAL RECOGNITION WOULD MEAN FOR BUSINESSES

Both Australian and New Zealand businesses should be interested in mutual recognition as it has the potential to relieve from double taxation their very extensive trans-Tasman business interests.

Scenario A – Large Australian company with a New Zealand subsidiary and multiple Australian shareholders

Take, for example, a large Australian parent company (with largely Australian shareholders) that has a subsidiary in New Zealand. The New Zealand subsidiary pays New Zealand company tax on its business income. When the New Zealand subsidiary pays a dividend to its Australian parent, the dividend will be exempt from tax. However, when the Australian parent pays a dividend to its shareholders, the dividend will be taxable in Australia for its Australian shareholders.

- Without mutual recognition, the Australian company's shareholders are double taxed on the business income of the New Zealand subsidiary.

- With mutual recognition, the Australian shareholders will be able to use imputation credits gained from the payment of New Zealand tax to offset their Australian tax payable.

Scenario B – New Zealand business expanding into Australia

Smaller companies would also benefit. Take, for example, a small but growing New Zealand-owned business with a simple company structure that has expended into Australia by setting up an Australian subsidiary company. The Australian subsidiary company will pay Australian company tax on its business income. When the Australian subsidiary pays a dividend to its New Zealand parent company, the dividend will be exempt from tax. However, when the New Zealand parent company pays a dividend to its New Zealand shareholders, the dividend will be taxable in New Zealand.

- Without mutual recognition, the New Zealand shareholders are double taxed on the business income of the Australian subsidiary company.

- With mutual recognition, the New Zealand shareholders will be able to use franking credits gained from the payment of Australian tax to offset their New Zealand tax payable.

<u>Case Study – NZ firm</u>

Type of business: Manufacturer and Designer of Mechanical Equipment, Privately Owned, 100% New Zealand Owned

Percentage of sales being made in Australia - approximately 76 %

Turn/over Approximately - 180 million NZD,

Staff numbers - 400 NZ based 210 Australian based 2 Singapore based

Is this an incentive to move your business to Australia?

Yes an increasingly big incentive.

Is this a disincentive to invest in Australia relative to other markets?

Partially, although we cannot ignore the opportunities there even with double taxation. It just makes the consideration of relocating or dealing with the issue more urgent for the shareholders to address.

What is the impact on your shareholders?

The shareholders are effectively double taxed on any investment in Australia meaning fewer earnings get to them for reinvestment in New Zealand or in other profitable ventures.

What would be the benefits to your company of resolving this?

It would mean the shareholders would be further encouraged to invest more heavily into a very convenient and rewarding market, knowing the investment was not going to be double taxed, it would also mean the profits would more actively flow back to New Zealand shareholders in the form of dividends which could only enhance further NZ investment