Eliminating the Double Tax on Dividends - Legal and Practical Issues

An Occasional Paper

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Foreword: The Institute

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Introduction

In his 1985 Statement on Tax and Benefit Reform the Minister of Finance announced his intention to introduce in 1988/89 a new system for taxing companies and their shareholders. Whereas shareholders currently pay personal tax on dividends paid from a measure which has already borne company tax, the so-called imputation system will effectively remit the prior-paid company tax. Shareholders who receive dividends will be granted a credit for the company tax already paid against their personal tax on the dividends grossed up to their pre-company-tax equivalent value.

In their book *How to Integrate Company and Shareholder Taxation: Why Full Imputation is the Best Answer* Matt Benge and Tim Robinson carefully explain the economic and practical rationale for full imputation. This paper, delivered at an Institute of Policy Studies seminar in July 1985, explores in greater detail some of the legal and practical issues involved.

After some contextual remarks, it explains how the present separate taxation of companies and shareholders in practice shows little resemblance to the conventional model used to describe its defects. Secondly, it notes external constraints on the NZ and Australian company tax rate. The third section examines and rejects the arguments put forward by the Australian Campbell Commission of Inquiry for fully integrating company and personal taxation. Finally, the paper explores some of the legal and practical problems which will have to be resolved before introduction of the full imputation system in New Zealand.

1. Approaches to Eliminating the Double Tax on Dividends

Business is generally not carried on by individuals directly (apart from very small scale business), but by some form of legal intermediary such as a company, partnership, trust or even a combination of intermediaries. Invariably in practice special taxation regimes are created for these intermediaries because it is not possible for judges through elaboration of the word "income" to develop workable and appropriate rules to deal with the legal complexities of income generated in business structures; for example, in the United Kingdom the taxation of trusts was initially developed in the courts - and legislation was required to overcome the problems created.

The method that has developed for the taxation of companies and shareholders in Australia and New Zealand is the so-called "classical" system whereby companies are taxed as separate entities on their taxable income at a rate of 46% or 45% respectively and then shareholders are taxed on most dividends received at their applicable tax rates without reference to company tax on the same income (with marginal rates ranging from 0% to 60% in Australia and from 0% to 66% in New Zealand). Despite the use of the term "classical" to describe the system, suggesting considerable antiquity, the main features of the Australian regime only achieved their present shape in 1952 (Parsons, 1967) and the New Zealand regime in more recent times (arguably it retains a vestigial connection between company and shareholder taxation in the $200 exemption for interest and dividends combined - in the 1960's the link was more substantial, Ross, 1967, pp.139-140).

The criticism that the classical system involves the "double" taxation of corporate income has been heard for many years around the world, and while this way of stating the problem is itself open to criticism, there can be no doubt that the system has significant defects.

1.1 Alternatives to the Classical System

Many types of proposals have been made for reform of the existing system. The two major forms that will be considered in this paper can be conveniently referred to as imputation and integration systems under which shareholders are effectively given credit for all or part of the tax paid by the company on *distributed* profits (imputation) or *all* profits (integration). An imputation system was recommended for Australia by the Taxation Review Committee in 1975 (Asprey, Ch.16) and integration by the Committee of Inquiry into the Australian Financial System in 1981 (Campbell, Ch.14). In New Zealand official enquiries into the tax system have so far shied away from recommending such far reaching reform (Ross, 1967, Ch.19), McCaw, 1982, Ch.17 II, compare Simcock, 1982, Bevin, 1985).

Some other solutions can be mentioned briefly. One not uncommon method is to grant relief by way of tax deduction, exemption, credit or rebate for dividend income at the shareholder level in a way which has no close or necessary connection with tax paid by the company (the lack of connection being what distinguishes these methods from imputation systems). The current New Zealand exemption for $200 of interest and dividend income, the similar US exclusion, the 30% rebate on dividend income up to $1000 of dividend income which existed in Australia from 1982 to 1983, and the 20% rebate proposed by the Task Force on Tax Reform (McCaw, 1982, p.183) all fall into this category.

These measures are very imprecise adjustments because they do not attempt to correlate corporate and individual tax rates and do not treat the corporate tax as part of the shareholders' income which is contrary to the logic of treating company tax as paid on behalf of shareholders (it is like not regarding PAYE deductions from employees' salaries as part of their income). Because these measures do not reflect a clear structural relation between company/shareholder taxation, politically they are susceptible to repeal or erosion through failure to index ceilings in times of inflation.

Another type of reform which has received much attention in recent times is "Cash Flow" taxation of companies. This method is the company equivalent of progressive expenditure taxation of individuals and involves taxing the company on net cash flow by giving, for example, immediate full deductions for capital expenses (Meade, 1978, Ch.12, Swan, 1984). As I assume that Australia and New Zealand will continue to operate primarily an income base for the progressive

taxation of individuals albeit that the emphasis on income tax will be lessened in favour of indirect consumption (expenditure) taxes, this method does not seem particularly apt for company taxation though variants have been suggested for combination with the income tax such as a tax deduction for investment in *new* share issues (Bossons, 1985, Krever, 1985) or *all* share issues and purchases (Sieper, 1985b, p.35). A possible problem with the latter two suggestions is that their policy underpinnings will not be apparent to even the intelligent taxpayer and so will be as susceptible to repeal as current ad hoc responses to the problems of the classical system.

It seems that the only possibilities on the current horizon for substantial reform are the imputation and integration systems, and of these, as I hope to show, the former is the only realistic choice.

1.2 Perspective

My title for this paper quite deliberately reflects in the words "Practical and Legal Issues" a concern with the details - the minutiae - of proposed tax reforms, particularly their relation to the existing elements of the tax system because tax reform does not occur in a vacuum.

Economists (who form the main advisers to government on tax reform) often have a different perspective. The economist's approach has been described by a lawyer as "romantic" (Parsons, 1984, p.122); the economist tends to concern himself with broad issues of general principle, and eschews consideration of the intricate details of tax systems. For example, in a well know work, two eminent British economists say,

> "Since most people are - rightly - uninterested in the minutiae of hypothetical tax systems, we shall not take our description of alternatives beyond the point at which we are confident that we, or a competent firm of management consultants, could fill in the remaining details" (Kay and King, 1983, p.2).

In fairness, however, I should say that this attitude is on the wane. Considerable attention is now devoted by economists to transitional issues and the problems created by the way in which the market tends to capitalise the effects of existing tax provisions into

asset values and to produce unintended and uncontrollable windfall gains and losses for asset holders when a change in the system occurs.

My discussion will suggest that it is impossible to contemplate the introduction of large scale changes to the system of company taxation without looking at the details of implementation of those changes from the very outset. The process of tax reform involves the proposal being made in general principle and then investigated in detail to see whether too many sacrifices of that principle have to be made or too many costs incurred in giving concrete application to the principle. There does seem to be a trend in this direction in tax reform in Australia, the introduction of the prescribed payments system and the new retirement taxes being examples of an evolutionary process of tax reform in which broad ideas are gradually given concrete shape. The trend is perhaps even more advanced in New Zealand to judge by the method of introduction of the Fringe Benefits Tax and the planned Goods and Services Tax.

My discussion should not be taken to imply by its concentration on difficulties that worthwhile reform of the company tax system is impossible or not worth the trouble. Sensible reforms can be achieved. However, careful consideration of detailed drafting of tax legislation and practical difficulties is a necessary part *from the outset* of any proposal for change. Here I must admit to a contradiction in my addressing a New Zealand audience along these lines. I do not claim to be expert in New Zealand tax law and so will address many of my remarks to the Australian situation though there will often be a New Zealand analogue.

2. Defects of the Classical System

The defects of the classical system of company taxation are well known. They can be summarised as follows; firstly, total income taxes paid on company income do not correspond to shareholders' marginal rates (with high marginal rate shareholders often undertaxed, and low marginal rate shareholders invariably overtaxed); secondly, bias is created for raising capital by debt rather than equity often giving rise to thin capitalisation rules; thirdly, a bias is created in favour of retention of company profits as opposed to distribution, giving rise to undistributed profits or excess retentions tax. Before plunging into the details of reform proposals, I will elaborate on these defects.

The discussion in the succeeding sections and Appendix 1 is initially based on a very simple model of company and shareholder taxation. It assumes an Australian (or New Zealand) resident company in which all the shareholders are Australian (or New Zealand) resident natural persons. The company is taxed at a flat rate of 46% and a shareholder at whatever is the appropriate marginal rate in view of his other income (Australian tax rates are used for the calculations). The shareholder is assumed not to be taxed on any profit made on the sale of his shares. Similarly the policy arguments are stated in traditional form at the outset; a more realistic and complex view of the current system is developed in the concluding part of the discussion.

2.1 Equity

Because of the two layers of tax on corporate profits (at the company and shareholder levels), the criticism is often made that the present system involves "double taxation" of company profits. Implicit in this criticism is the view that there is inevitable overtaxation of such profits.

Though the answer has been made often enough in the Australian context (e.g. by the Asprey Committee, 1975, pp.225-227, Campbell Committee, 1981, pp.210-211), it is as well to repeat here than in many cases there is presently either proper taxation of undertaxation of profits as is demonstrated in Appendix 1. In the case of Stock Exchange listed companies which on average pay out by way of dividend about 45% of after tax profits (Swan, 1982a, p.9, Officer, 1982a, p.147), a shareholder whose marginal rate of tax of 60% will pay almost exactly the same taxes in total ($60.58) on $100 of taxable income passing through a company as he would pay of he derived $100 of taxable income directly ($60).

In the case of private companies which usually will pay by way of dividend 20% of after tax profits (because such companies are allowed under the Australian provisions relating to undistributed profits tax to retain a maximum of 80% of those profits provided they are not income from property), a shareholder whose marginal rate of tax is 60% will pay considerably less taxes in total ($52.50) on $100 of taxable income passing through a company than he would pay if he derived $100 of taxable income directly ($60). It is precisely for this reason that Australia has long sought in its tax law to force private companies to pay dividends equal to a specified percentage of after tax profits (the percentage has varied over the years and is currently 100% for private company dividends, 90% for other income from property and 20% for other income). Otherwise private companies would provide a simple tax shelter for high income earners and would allow them to reduce their marginal rate from 60% to 46% by ensuring that income was generated in a private company which paid no dividends.

In the case of low income taxpayers (with marginal rates of 30%, 25% or 10%), the present system always produces overtaxation. In the case of the 30% taxpayer, calculations of the kind in Appendix 1 show that he pays in total on $100 of company income $53.29 tax in the listed company situation with 45% payout of profits), and $49.20 tax in the private company situation compared to $30 tax for $100 of income derived directly. This may be one reason why low income taxpayers (apart from the retired) rarely invest in listed companies (Campbell Report, 1981, pp.213-214, 550-563, Davies, 1982, pp.259-442).

The problem with the separate system as these examples show is not that there is inevitable overtaxation of company profits but rather that the total tax burden on company profits is at variance (being either higher or lower) with the tax burden where the same

amount of taxable income is derived directly. Hence the commonsense principle of horizontal equity (that persons with similar amounts of income, whether derived directly or through companies, should pay similar amounts of tax) is offended.

Moreover, because the tax burdens of high income earners tend to be reduced and the tax burdens of low income earners are inevitably increased when income is derived through a company the principle of vertical equity is contravened. This principle in generalised terms requires that persons with different levels of income should pay appropriately different amounts of tax. It finds expression in the Australian income tax system in the progressive rate scale and this rate scale is departed from in the case where income is derived through a company.

The remarks above contain two related assumptions which should not be made explicity: firstly, that the shareholder personally enjoys the full monetary benefit of his proportionate share of company taxable income (if $100 of company taxable income is attributable to a particular shareholder, it has been assumed that the shareholder enjoys $100 benefit, subject only to company income tax and individual income tax on dividends paid by the company); and secondly that the company income tax is effectively borne by the shareholder. Both these assumptions require elaboration, and are taken up under the next two headings.

2.2 The definition of income

The most famous theoretical definition of income is that of Simons (1938, p.50), "The *sine qua non* of income is *gain*, as our courts have recognized in their more lucid moments - and gain *to* someone during a specified interval." Income in this sense is measured by the individual's consumption and net accretion to wealth over the period. To the extent that companies pay dividends out of their profits, the shareholder will clearly enjoy the benefit of the company's taxable income but companies will in practice retain a significant proportion of their profits which will thus not be directly available to shareholders. There are a number of ways in which a shareholder can currently realize the benefit of taxable income retained by the company apart from receipt of dividends, the simplest being sale of the shares, which may or may not in itself give rise to tax consequences.

The important point for present purposes is this: there is no certainty that taxable income retained by a company will reflect itself exactly in share prices, or for that matter in any other way that will give shareholders a readily available equivalent. In the case of an individual shareholder, the most accurate reflection of income in the Simons' sense for the company context is to add together dividends received by the individual during the year from the company and any gain that has accrued in the value of the shares during that period. That this is the ideal was recognised by the Canadian Royal Commission but was rejected as impractical because it involved the proposal of taxing capital gains on an accruals basis (Carter, 1966, Vol.4, p.425). The 1969 Benson White Paper which responded to the Commission's proposals adopted in a modified form this ideal solution but the Canadian government instead implemented an imputation system for the taxation of corporate income and a capital gains tax on a realisation basis.

2.3 Incidence of the company tax

The examples and equity arguments set out above all assume that the company level of tax is in fact borne by the shareholder. All taxes must ultimately fall on natural persons and the intention is that the company tax will fall on the shareholders. However, it is hotly disputed amongst economists, both as a matter of theory and empirical proof, what the ultimate incidence of the tax is. Apart from the shareholder, the possible groups on whom the tax could fall are consumers in the form of higher prices and employees in the form of lower wages than would otherwise prevail.

If the effective incidence of the company tax is not on the shareholder, then it will operate as a selective sales tax if the incidence is on consumers (which was the Ross Committee's finding for New Zealand, 1967, p.144) or as a selective payroll tax if the incidence is on employees. In either of these forms the tax does not appear very desirable on policy grounds. One solution to the problem of the possible incidence of the tax on consumers or employees is to abolish the company tax altogether; another solution is to retain the tax in its current form on the basis that it is well established so that the economic system has adjusted for the untoward effects of the tax and that it successfully raises significant amounts of revenue.

It has also been argued that reform of the tax should proceed whatever its effective incidence on the basis that the beneficial

effects claimed for reform will still follow (Asprey, 1975, pp.238-239), presumably on the basis that reform of the tax will correct the effective incidence to ensure that it is on shareholders; that is, when the correlation of company and shareholder taxes is made explicit by reform, the intended incidence will follow.

Another approach to the incidence problem is to modify reform proposals to allow for the possibility that the full incidence is not on shareholders. Although the Asprey Committee proposed partial imputation instead of full imputation, this was not for the purpose of making this adjustment (1975, p.238). This approach may also be used as an argument for the variations on the Campbell proposal considered below. It assumes that at least part of the tax effectively falls on shareholders, which does not seem to be an unreasonable proposition.

2.4 Gearing

The arguments as to the effect of the classical system on gearing turn on the fact that interest payments on company borrowings are generally tax deductible to the company whereas dividend payments are not so deductible (see Appendix 1 - both interest and dividends are assumed to be taxable to their recipients in this analysis). This is considered to bias company financial decisions in favour of borrowings over share issues and so to contravene the principle of economic efficiency which, in one of its manifestations, requires the tax system to be neutral in its effect on economic decisions. The result is that companies become more highly geared than would be the case in the absence of the current tax system and so expose themselves to increased risks of bankruptcy because interest expense represents a legal liability for which the company can be sued whereas a company cannot legally be forced to pay a dividend.

It is true that gearing ratios have tended to increase in recent times. Thus for manufacturing companies, the ratio of debt to equity has increased from 0.77 in 1973 to 0.95 in 1981 (Reserve Bank of Australia, Companies Supplement); the ratio is total liabilities less shareholders funds as a proportion of shareholder funds. However, there is a variety of possible explanations for this phenomenon including the high rates of inflation which together with a failure to index the income tax base (including deductions) significantly increases the value of interest deductions. Inflation in effect has been used to pay off company debts; in addition, at least in the early and middle stages of the recent high levels of inflation, interest

rates did not adjust fully for inflation rates and so made borrowing even more advantageous.

2.5 Distribution policies

The examples in Appendix 1 demonstrate that all shareholders in a company will achieve the best tax result if the company retains all its after tax profits. Thus it is said that there is a bias to retention of company profits which is another departure from neutrality produced by the classical system. In elaboration of this criticism it was put to the Campbell Committee (1981, pp.212-213) that this bias has restricted the growth of the market for new share issues and of the secondary market, denies new and developing businesses access to the funds locked into existing companies, and causes less productive use of funds because retained profits are not put to the test of the market. Whilst the committee did not fully accept these arguments, it did regard the current system as producing some undesirable bias against distribution.

On the other hand, it was recognized that the effect on distribution policies tended to counteract the bias towards borrowings over share capital, because high marginal rate shareholders achieve better tax results by investment in shares in companies with high retention rates. Thus from Appendix 1, it is apparent that a 60% marginal rate taxpayer suffers less taxes in total if a company distributes none or only 20% of its after tax profits ($46 and $52.50) respectively for $100 of company income) where he invests in share capital, as compared to investment by way of loan (where tax on $100 of interest received from the company is $60).

The recognition that the current system can produce counterveiling biasses is important. As will appear in the next section, there are many more examples of this tendency than if often recognized.

2.6 The Real Corporate Tax World

The discussion in the preceding sections and Appendix 1 has been based on a very simple model of company and shareholder taxation. Similarly the policy arguments were stated in tradtional form.

Economic analysis of the policy issues surrounding the classical system has become more complex. For example, it has been argued that the assumption that a sale of share is tax free ignores an implicit tax which the market imposes by discounting the sale price of share for the tax which undistributed profits will eventually bear when they are distributed (Sieper, 1984, pp.5-10, Officer, 1985, of. Krever, 1985, whose scepticism I share). I do not intend to elaborate this kind of analysis but instead to sketch a more realistic picture of the classical system as it operates in Australia and New Zealand today. The most general and important point is that the real world is very different to that of the model.

2.6.1 Individual Shareholders

In the case of individual resident shareholders some cash dividends or distributions of property may escape taxation in the hands of the shareholders. In New Zealand this will commonly occur when a distribution is made out of a capital profit realised by the company under the *Income Tax Act* 1976, which I shall refer to as NZITA, s.4(5), though this has recently become more difficult to achieve. In Australia distributions of capital profits in the form of cash or other property other than bonus shares are taxable to shareholders under the provisions of *Income Tax Assessment Act* 1936, which I shall refer to as ITAA, s.6 (definition of "dividend") and s.44 (*Slater Holdings*, 1984). The benefit of capital profits made by a company can only be realised in Australia by means of a sale of shares and, to the extent that this involves area benefit to shareholders, a bonus issue out of capital profits pursuant to ITAA s.44(2). There may be, however, other means available in Australia by which cash distributions can be made to shareholders out of capital or revenue profits in a manner which will not attract taxation (Parsons, 1976, pp.402-442).

The treatment of distributions out of capital profits and bonus issues in Australia and New Zealand provide an interesting contrast. Australia has adopted means to ensure that the non-taxation of capital profits is confined at the company level and does not pass through to shareholders in distributions other than bonus issues, on the theory that all dividends whatever their source represent income of the shareholder. The exception for bonus issues out of capital profits cannot be explained on the basis that bonus issues do not produce any real gain to shareholders because bonus issues out of revenue profits are taxable in Australia. In New Zealand the benefit of non taxation of capital gains at the company level is passed through to

shareholders and bonus issues are generally not taxable whether they are paid out of capital or revenue profits. The New Zealand position appears more consistent, but gives rise to greater scope for manipulation as recent experience apparently shows.

Both countries have anti-avoidance provisions to prevent bonus issues being followed by reductions of capital as a non taxable return of capital to the shareholder although there is a limited but long standing drafting defect in Australia in ITAA s.47(3) in the context of a liquidation where the bonus issue was paid out of capital profits from the sale (as opposed to the revaluation) of capital assets.

In contrast to escaping tax on dividends, individual resident shareholders may be taxed on the sale of their shares in a number of situations in addition to the tax on dividends. In Australia and New Zealand this may be because the shareholder is a share trader, the transaction is regarded as an isolated business deal, or the shareholder purchased the shares with the intention of reselling them at a profit or engaging in a profit making undertaking or scheme (ITAA s.25A, NZITA s.65(2)(e); in Australia sale within a year of purchase will attract tax (ITAA s.26AAA).

In Australia the shareholder will also be taxed on a sale where the purchaser is a dividend stripper, the amount of the assessable income being determined by the extent to which a dividend equal to the sale price paid to the selling shareholder would have been taxable. This occurs pursuant to ITAA s.177F, which is part of Part IVA, the general anti-avoidance provisions which replaced ITAA s.260 as from 27 May 1981. This section reverses the notorious decision in *Slutzkin* (1977) which held that ITAA s.260 did not apply to the selling shareholder and was relied upon in the bottom of the harbour scandal for the view that the vendors would not be caught even where the sale price was based on the pre-tax profits of the company (a so-called "wet" Slutzkin) rather than the post-tax profits of the company (a so-called "dry" Slutzkin). New Zealand has a similar provision in NITA s.99(5).

By way of a sidelight, both Australia and New Zealand have dealt with the *Investment and Merchant Finance* decision (1971) which held that the dividend stripper who purchased the shares was entitled not only to escape taxation on the dividend stripped out of the company, but also to deduct the loss thrown up on the consequent sale of the shares. The method of dealing with this problem however is different; in Australia it is done by taxing the dividend pursuant to

ITAA ss.46A and 46B, whereas in New Zealand not only does this occur, but also an adjustment is made to the loss of the share dealer (NZITA s.198).

If the shareholder is not taxed on any dividend then the tax result will be more favourable than that which appears in Appendix 1. However, if the shareholder is taxed on a disposition of the shares the outcome will be less favourable than that in Appendix 1. In these cases the equity arguments about the classical system in 2.1 above take on a different complexion and make the system look worse or better depending on which situation applies.

2.6.2 Share Investment by Companies

Just as different tax regimes can apply to different individual shareholders, so too, and much more significantly, different regimes apply to different kinds of entities. An ordinary company which invests in shares will not be taxable on dividends received by virtue of the tax rebate under ITAA s.46 in Australia and the tax exemption under NZITA s.63 in New Zealand. And, absent the circumstances mentioned above in relation to sales of shares by individuals which give rise to tax consequences, such companies will not be taxed on the profits made on a sale of shares.

The rebate or exemption applied to prevent dividends being taxed when received by a company is justified of course by the need to prevent cascade taxation of company profits as they are passed through a series of companies by way of dividend. The assumption underlying the rebate or exemption is that the profits will pass down a chain of companies until they at last reach an individual's hands where they will be subject in the ordinary case to tax. However, in complex modern industrial economies it is probably the case that dividends paid by one company to another are more likely than not to be retained at one point in the chain of companies and not to be passed out to individuals. If this is so then the rebate or exemption creates a further distortion in the classical system of taxing companies and it has been argued in the US by Andrews (American Law Institute, 1982 pp.487-513) that the current treatment of inter-corporate dividends should be confined to direct investment by one company in another, that is, to the holding company subsidiary relationship, and denied to corporate portfolio investment. It will be seen from the discussion below that the current treatment of inter-corporate dividends creates significant biases and tax avoidance activities in the tax system.

The regime outlined above for ordinary companies investing in shares would mean that in the absence of special provisions, all individuals would be better off if they conducted their investment activities through a private investment company. In Australia this problem is met by the threat of a 50% undistributed profits tax if a private company receiving dividends does not distribute either 100% of them in the case of dividends received from another private company or 90% of them in the case of dividends received from a public company (ITAA ss.104, 105B(b) and the provisions of s.46 which deal with the more general problem of ensuring that profits in the private company context generally cannot be stored up in a chain of companies but must reach an individual in a relatively short period of time). In New Zealand the matter is approached through the excess retention tax, NZITA Part V.

2.6.3 Banks and Non-Life Insurance Companies

Two very significant groups of investors in company shares, namely banks and non-life insurance companies, are subject to yet another tax regime in respect of those investments which constitute part of their reserves to meet unexpected claims in the form of natural disasters in the case of insurance companies and runs in the case of banks. These two groups will not be taxed on dividends received because of the rebate or exclusion but are taxed on profits made on sale of the shares pursuant to the banking and insurance cases (e.g. *Auckland Savings Bank*, 1971 *Chamber of Manufacturers Insurance*, 1984). This is the exact opposite of the usual treatment of individual shareholders, and indeed it is highly unlikely that any individual would be subject to the same tax treatment.

The difference in tax treatment produces opposite effects on company distribution policies. Individuals rationally will prefer companies who retain all their profits and do not pay any dividends whereas banks and non-life insurance companies will prefer to invest in companies which pay out all profits in the form of dividends to the maximum extent possible.

It is sometimes said that economic rationality would produce the consequence that no companies paid dividends, but this view concentrates on the position of individuals and overlooks the different treatment of other very important groups of taxpayers. The difference should on economic principles produce "clientele" effects (Swan, 1982a, pp.9-10) whereby individuals' investments will be directed into low payout companies and banks and non-life insurance

companies' investments into high payout companies. It is not clear, however, that this outcome in fact occurs and to the extent that individuals and banks and non-life insurance companies invest in the same companies (which will be very common in the relatively thin markets in listed securities in Australia and New Zealand) the classical system will be producing countervailing biases with respect to distribution policies of companies and not the one way bias in favour of retention suggested in 2.5 above.

2.6.4 Tax Exempt Bodies (Especially Superannuation Funds)

A significant proportion of investment in shares nowadays is carried out by tax exempt bodies, the most significant example far and away being the tax exempt superannuation fund (pursuant to ITAA ss.23(ja), (jaa), 23F, 23FB and NZITA s.61(21)). Under the classical system these investors, although theoretically tax exempt, do not receive any relief in respect of tax paid by companies in which they invest. They may produce a bias for tax exempt bodies to invest in companies by way of loans rather than share capital, thus reinforcing the bias towards loan capital under the classical system. So far as they invest in shares, the preference will be for companies which pay as little corporate tax as possible, that is, companies whose profits consist largely of capital gains or which are able to utilise tax preferences to eliminate taxation even though in a commercial sense they are making a profit. Again these clientele effects do not seem to be highly developed in the current Australian market with superannuation funds having substantial investment in all kinds of companies.

It is true that tax is ultimately borne by members of the superannuation fund when distributions are made to them upon or after retirement but their interest in the fund will have been growing at a pre-tax rate of return rather than at a post-tax rate of return and will over a period of time be substantially greater than if the individual had invested directly in company shares. The exemption of superannuation funds is one part of a tax regime whereby savings in the form of superannuation are exempted from tax until they are spent. In other words superannuation receives personal expenditure tax treatment rather than personal income tax treatment (the critical difference between the two being the exemption of savings from tax under the expenditure tax, Vann, 1984, pp.1-10). When policies are pursued in the income tax system which give preferential treatment to some forms of savings, it is inevitable that biases will occur whatever the system of company and shareholder taxation.

2.6.5 Other Entities

There are a variety of other entities which have substantial investments in shares and which are subject to special tax regimes. Examples are life insurance companies, non-exempt superannuation funds and unit trusts. I do not intend to pursue the details of the taxation of these entities. However, detailed consideration would further emphasise the point that the operation of and the biases produced by the classical system of company taxation are much more complex in the real world than they are in the context of the simple model presented above.

2.6.6 The Effect of Tax Expenditures

It is only in recent years that Australia and New Zealand have begun to investigate in detail the nature, extent and revenue consequences of tax expenditures (or tax preferences) in their income tax systems (a tax expenditure may be defined as a departure by way of concession from a normative concept of what the income tax should be; the definition can be construed narrowly so as to include only explicit legislative concessions to various activities or taxpayers, or more broadly to include defects in the income tax base such as the lack of a capital gains tax). It is clear in both countries that tax expenditures have reached significant levels and have tended to grow in recent times (House of Representatives Standing Committee on Expenditure, 1982, Australia, Budget Statement 1984/85, No. 4, pp.309-319, McCaw, 1982, pp.61-68, Douglas, 1984 Budget Part II, pp.20-30).

The corporate sector is a very significant beneficiary of these concessions with the result that many companies have been able to reduce their taxable income to zero or put themselves in a tax loss position even though from a commercial point of view they are making profits. Moreover it has proved possible, particularly by the device of leasing, to spread these losses across corporate taxpayers even though both Australia and New Zealand have elaborate provisions designed to prevent the transfer of losses (ITAA ss.80-80F, NZITA ss.188-189).

The effect of these tax losses (which has been heightened by the real losses incurred during the recent recession) has been to alter many companies' method of raising finance. A company with significant tax losses gains no immediate benefits from a tax deduction for interest payments on borrowings or rental payments under leases so

that from the company's point of view debt and lease finance become much the same in tax terms as money raised by share issues. Even though the company paying interest or rent does not get an effective deduction, the receipt of the interest or rent is still taxed in full to the lender or lessee.

From all parties' point of view, finance transactions would be more effective for tax purposes if the "borrower" gave up its deduction for finance charges while the "lender" was not taxed on its returns from the transaction. Where the "lender" is a company this result can be achieved by the use of the redeemable preference share. Although generally speaking companies cannot according to the maintenance of capital rules purchase shares from shareholders, a special exception is made in the case of the redeemable preference share under the Australian *Companies Code* s.120 and the NZ *Companies Act* 1955 s.66. By issuing redeemable preference shares for a set period to the "lender", the borrower", which is required to pay a fixed preference dividend on the shares, gives up the deduction which it otherwise would have had for interest, but the "lender", because it is receiving a dividend, is effectively not taxed pursuant to the rebate or exclusion which applies where one company receives a dividend from another.

There are a number of pitfalls that need to be avoided in structuring the transaction. The "lender" must protect itself against the possibilities that company law will not permit the "borrower" to pay the necessary dividend purposes, or that the "borrower" is not able to redeem the shares when obliged to do so because of the maintenance of capital rules which apply to share redemptions. Various devices including large share premiums and nimble dividends are utilised to overcome these problems, but the most significant protection which the "lender" requires is a put option from a company of substance which is related to the "borrower" under which the related company agrees to buy the preference shares from the "lender" if the "borrower" is in any difficulty in meeting its obligations. The put option will be secured by appropriate means. Another problem for the "borrower" is the carry forward of losses under the loss carry forward provisions when the share capital structure of a company changes, but again these problems can generally be overcome, especially now in Australia where losses have become transferable as between one hundred percent related companies under ITAA s.80G (this has been possible for a number of years in New Zealand under NZITA s.191).

2.6.7 Leveraged Share Investments

Another area where the bias in favour of debt over equity is reversed is in relation to leveraged share investments. If a company borrows for investment in shares the interest deduction on the borrowing will effectively be denied with respect to dividends received on those shares. In Australia this arises through the operation of the rebate provisions whereby under ITAA ss.46 and 50 the amount of dividends subject to tax rebate is reduced by the interest paid on the loans; in New Zealand the result follows because dividends are exempt income and interest on borrowings to purchase assets which produce exempt income is not deductible under NZITA ss.102, 104 and 105(1)(k).

To the extent that the share investment is a direct investment in a subsidiary, it is possible in Australia to overcome this problem by ensuring that dividends are only received after the loan has been discharged. It is possible to get the deduction because dividends in Australia are assessable income and interest payments to purchase an asset which will produce income in future years will in ordinary circumstances be deductible (*Total Holdings*, 1979). The same result would not seem to follow in New Zealand because dividends are exempt income. In both Australia and New Zealand, however, where the company making the investment has other income producing activities it should be able to so manipulate its borrowings that interest payments are thrown against other receipts of an income nature and not against dividends. This process is assisted by ITAA s.50 and NZITA s.102.

In the case of individuals investing in shares, by way of contrast, it is highly advantageous to borrow. Interest payments will be deductible against dividend income and provided borrowings are carefully managed it should be possible either to offset dividend income entirely with interest deductions, or even to throw up a tax loss position (so-called "negative gearing": the recently announced restriction on negative gearing in Australia is limited to investment in land). By this means it will be possible for the individual to avoid tax on dividends and to take a tax free capital gain so far as profits are retained in the company (Swan 1982a, pp.10-11).

It is clear once again that the operation of the classical system is more complex than the simple model used at the outset would suggest and moreover that the bias for debt over equity which the classical system is alleged to have produced by no means holds in many important situations.

3. The Corporate Tax Rate

One of the most important factors in designing any corporate tax system is the relationship between the corporate tax rate and the maximum individual marginal tax rate. If the latter rate is substantially higher than the former rate, then there is scope for tax avoidance in the form of using the company as a tax shelter (assuming that it is possible, as is often presently the case, to extract the benefit of the retentions at a later time in a tax-free form by a sale of the shares, and that the sale price, as mentioned in 2.6, has not capitalised the potential tax liability on retention if and when they are ever distributed). The discussion of the defects of the classical system above has assumed this kind of differential in tax rates. If, however, the two rates are approximately the same, this problem disappears and simplification of even the classical system can be achieved by abolition of provisions designed to force a minimum level of distributions such as undistributed profits tax in Australia and excess retentions tax in New Zealand.

It has not been considered possible to increase the corporate tax rate to the level of the recently prevailing maximum individual rates because Australia would be rendered unattractive for foreign investment if corporate tax rates were out of line with the rates in comparable countries (Asprey, 1975, p.231). This means that 50% is regarded as about the upper ceiling for the corporate tax rate.

The reason for this effective limit is not simply that high rates do not appear attractive in the international competition for foreign investment but because of the ceilings in foreign tax credit systems of major capital exporting countries. Under these ceilings the investor (typically a corporate) can not claim credit for foreign taxes in excess of the tax charged on the income from the investment by the country of residence of the investor. Although total taxes paid are a function of both the tax base and the tax rate, the income tax base has in the past been sufficiently similar in Western countries to mean that if the corporate tax rate in the country of

source of the income exceeds the tax rate in the country of residence of the investor, it is likely that unusable excess tax credits will be generated ("overspill"). The result is that investment is diverted into countries that do not produce excess credits. This reasoning does not apply in full force to the US which applies an "overall", rather that a "per country" ceiling to foreign tax credits so that high rates in one overseas country can be averaged with lower rates in another country, but proposals have been recently made for the US to return to a "per country" limit (Reagan, 1985, pp.385-396).

Now that both in Australia and New Zealand it has been seriously proposed that maximum marginal tax rates for individuals be decreased to about 50%, the alignment of the corporate and individual rates becomes a possibility even given current international restraints.

A related problem that is relevant is the attitude taken by government that reform of the corporate tax structure should be nearly revenue neutral. It is generally feared that substantial losses would result if an imputation or integration system were introduced with the corporate tax rate remaining at current levels. (Asprey, 1985, pp.232-234, Campbell, 1981, pp.216-218, McCaw, 1982, pp.181-183, though Swan, 1982a, pp.22-26, and Officer, 1982a argue to the contrary). In addition to the problem of maintaining total revenues intact, the share of company income taxes as a percentage of total tax receipts has been falling significantly in recent years and a further decline is unacceptable. Hence a rise in the corporate rate is a likely concomitant of change to the classical system which dovetails conveniently with the fall in the individual rate currently being pursued as revenue neutrality can be achieved with a corporate rate of about 50% (the Draft White Paper, 1985, Ch.17 calculated that a full imputation system would imply a tax rate of 52%, and the Australian Prime Minister indicated in closing the Tax Summit that consideration would be given to a full imputation system with a tax rate of 48%).

Unfortunately for this rosy scenario, events overseas may affect the acceptability of a 50% corporate rate. The United Kingdom in its 1984 budget announced a dramatic restructuring of its corporate tax rates. The rate is to be reduced over a period from 52% to 35% as a number of tax preferences primarily utilised by corporates are phased out to keep the change revenue neutral. In the United States, President Reagan has accepted a Treasury proposal to broaden the tax base and lower corporate tax rates from 46% to 33% (at the same time actually increasing the corporate share to tax revenue, Reagan, 1985, pp.118-119). Finally in Canada the new government in its first budget

has released a discussion paper with a similar proposal which will reduce the standard combined federal and provincial rate from 46% to 39% (Wilson, 1985).

There is no reason why Australia and New Zealand cannot similarly broaden the tax base to buy down the corporate rate. Indeed there is clear interest in base broadening (evident particularly in the Draft White Paper, 1985). However, tax rate reductions for corporations would defeat the object of aligning company and individual maximum marginal rates as 50% seems to be about as low as the maximum individual tax rate is going to go. The problem is that, just as a 60% corporate rate is regarded as unacceptable in today's international environment, so 50% may be too high if income tax base broadening occurs in Australia and New Zealand, and there is a general downward movement of rates combined with elimination of tax preferences internationally.

At first sight there may be some comfort in the fact that President Reagan's proposals are currently facing very concerted opposition (comfort in more regards than one as will be seen below); however, in this area the proposals for tax reform in the US may cut two ways - the corporate tax proposals in fact will collect more revenue than at present which may create less chance for overspill of foreign tax credits whereas the reintroduction of a per country limitation has the opposite effect.

The shrinking of corporate tax revenues around the world in recent years generally has increased chances of overspill. Moreover, although current proposals to reform the corporate tax base and to cut corporate tax rates are generally revenue neutral, they do entail significant redistribution of tax burdens among corporations and this may increase the prospect of overspill if the distribution of tax burdens among corporations in Australia and New Zealand remains the same.

Nevertheless the only viable alternative may be for Australia and New Zealand to adopt the 50% rate in a context of no adjustment to the corporate tax base, but it will then be necessary to forgo considerable simplification of the problems of an imputation system as explained below. In what follows I will generally assume that it will be possible to equate the corporate and maximum individual tax rates though there will be some discussion of the consequences of the maximum individual rate significantly exceeding the corporate rate.

4. The Campbell Proposals for Corporate Tax Integration (1)

In a nutshell integration involves attributing all corporate income whether distributed or undistributed to shareholders and taxing that income at the appropriate marginal rate for the shareholder. The Campbell proposals involve the retention of a tax at the corporate level, but this tax is only by way of withholding (similar to the PAYE deduction from wages and salaries) which is regarded as part of the shareholder's income and then credited as tax paid by the shareholder.

This system was regarded by the committee as overcoming the defects of the classical system outlined above (although the committee's analysis was based very much on the simple mode of the classical system rather than the real world corporate tax). The committee (as many others before them) found the equity arguments to be one compelling reason for a change to the classical system. Of their proposed integration system, they said (1981, p.215).

> "(ii) It would ensure a more equitable tax system: As the returns from corporate share ownership would bear the same tax as the returns from investing in other ways and from personal effort, greater horizontal equity would be achieved.

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(1) This part is based on a paper presented to a conference held jointly by the Australian Tax Research Foundation and the Bureau of Industry Economics on 13 February 1985; it will be published by the Foundation in the near future. In discussing the Campbell proposals it is necessary to have regard also to the Commissioned Studies, especially the contributions of Swan (1982a, 1982b, 1982c,) and Officer (1982a, 1982b).

As all corporate source income would be taxed at progressive rates applicable to the individual shareholders, there would be greater vertical equity between shareholders...

(v) It would eliminate the present tax disincentive to the ownership of equities, as a form of investment, for many potential shareholders in the lower and middle income ranges... these groups would be relatively the larger gainers from such a scheme as the normal progressive tax schedule would apply to all income from all sources."

The committee was also certainly aware that the argument in relation to the effect of the classical system on gearing ratios was by no means clear cut, but they nevertheless listed as one of the benefits of the integration proposal: "It would remove the present tax bias in some corporate decision making toward debt rather than equity finance." (1981, p.215). Their attitude to the argument on distribution policies has been set out above (2.5).

Although general integration has not been implemented in any tax system in the world to date, it has quite a respectable pedigree in the sense that it has been recommended in three different countries by official enquiries concerned in whole or in part with the tax system; in Canada by the Carter Royal Commission (1966, Vol. 4, Ch.19); in the US by the Treasury (US, 1977a) and in Australia of course by the Campbell Committee. The Australian history goes back much further to a minority report of the 1921 Royal Commission of Taxation (1921, pp.132-134), though the majority rejected the proposal on the grounds that it was not a proper measure of income (an argument considered above) and that it would produce undesirably large distributions of company profits to put shareholders in funds to pay the tax.

4.1 Variations

The Campbell Committee considered a number of variations on its proposals and rejected a number of them while recommending others as interim measures in a gradual shift to integration.

Swan suggested in his study for the Committee (1982a, pp.12-13) that the withholding rate at the company level should be 60%, that is, the same as the maximum marginal rate for individuals. This approach

prevents the use of tax avoidance schemes by high marginal rate individual shareholders based on the interposing of a number of other companies between the shareholders and the company in order to delay indefinitely the collection of tax from the shareholders and is a common feature of integration proposals (see e.g. Carter Commission, 1966, Vol.4 pp.6-7). The Campbell Committee rejected this suggestion because, apart from international considerations, it would create cash flow problems for low marginal rate shareholders by reason of the delay between the collection of the withholding tax at a high rate at the company level and the refund of tax over-withheld to the shareholders.

Similarly, the Committee rejected the idea that the company withholding rate should be the standard rate of tax for individuals (currently 30%) on the basis that high marginal rate shareholders would then have substantial individual tax payments to make but may lack the funds to do so if the company were retaining a high proportion of this income. This method of withholding was a feature of the British system for many years and has a number of administrative advantages.

The Committee chose 46% as the appropriate withholding rate partly as a compromise to meet the problems of a lower or higher rate (representing the middle marginal rate for individuals) and partly because it is the current corporate rate and so would involve no disruption to current company cash flows. The problem of dealing with the different marginal rates of shareholders point up an important difference between withholding under the PAYE system for wage and salary earners and withholding under the Campbell proposals.

The PAYE system is designed to produce an amount of tax withheld which is closely related to the ultimate tax liability of the wage or salary earner and requires an estimate of total wages or salary for the year together with information concerning the personal position of the taxpayer (e.g. is the taxpayer entitled to the spouse rebate?). It is feasible in the case of full time single job employees to make the appropriate calculations. On the other hand, a flat rate withholding tax which is the only practical method in the company-shareholder situation can never be closely related to the personal situation of individuals taxed under a progressive rate scale.

As an interim measure, the Campbell Committee recommended that integration should only operate in the first instance for marginal rates of tax above 46%. That is, shareholders on or below that rate

would not need to engage in the calculation of including their proportionate part of corporate income in their assessable income and then taking a tax credit for tax withheld at the company level; their shareholdings would give rise to no tax consequences at the individual level (dividends would be ignored for their tax purposes) and the 46% company tax would be their rate of tax on their share of company income.

As only a relatively small group of taxpayers would be affected by this measure, it would be simpler to implement than full integration at the shareholder level; however, at the company level it would still be necessary to make a calculation of income to be attributed to every shareholder since the company would have no means of knowing the various marginal rates of its shareholders. The effect of this measure on different shareholders is set out in Appendix 1 from which it will be seen that some improvements over the classical system will result - equity will be improved as high marginal rate shareholders will be taxed at the correct rate, while low rate shareholders will experience a reduction in total taxes in every case except where the company pays no dividends; the bias in favour of retention will be eliminated as all shareholders experience the same level of taxes, whatever the proportion of income distributed; and the bias for debt over equity will be reduced.

The next step in moving towards full integration would, under the Campbell proposals, be to reduce from 46% to the standard rate (now 30%) the minimum total tax on company income allocated in individuals. Although further improvements as regards both equity and the bias towards debt would occur, all individual shareholders would now find it necessary to make the calculations required by the integration system as all except 46% rate shareholders would either have additional tax liabilities or be entitled to refunds (although shareholders with marginal rates below 30% would only receive a refund sufficient to bring their tax on company income down to 30%). In terms of simplicity there is no difference between this interim measure and full integration (unlike the preceding interim measure), so that it can only be justified on grounds of reducing revenue losses to the government.

Besides variations based on tax rate, there are a number of other permutations possible within the Campbell framework such as the treatment of tax exempt shareholders, of international issues and tax preferences. However, these issues are common to integration and imputation systems and will be taken up in the context of imputation.

The discussion of the Campbell proposals will concentrate on problems that are unique to integration and these relate to the critical difference between the two systems, that is, the treatment of retentions.

4.2 Critique

Before turning to the proposal in detail a general comment can be made on the basic thrust of the integration proposal. The proposal is one aspect of implementing the comprehensive definition of income associated with Simons (1983), that income is the gain to an individual over a specified period and is measured by the individual's consumption and net accretion to wealth over the period. In the case of an individual shareholder, the most accurate reflection of income in this sense in the company context is as already noted to add together dividends received by the individual during the year from the company and any gain that has accrued in the value of the shares during that period.

The Campbell proposal departs from the ideal in that it attributes all corporate income to individual shareholders whether or not the shareholder has enjoyed the benefit of that income by way of dividends and accrued capital gain. There is an assumption built into the Campbell proposals that retained corporate income will be reflected in share prices. Whilst in the long term the evidence apparently supports this relationship (David, 1968, pp.242-246 cited in Salter, 1985), the short term volatility of the stock market will mean that at any given time the relationship between share price and retained earnings may be quite remote. It strikes me as an inherent weakness of the Campbell proposals that they were not combined with a capital gains tax so that shareholders could achieve some kind of loss off-sets when retained earnings on which they had been taxed were not fully reflected in share prices (compare Head, 1982, pp.160-165).

Another weakness of a general kind in the Campbell proposals as to integration is that they seem inconsistent with the reasoning of a number of other tax proposals in the same part of the Report. Firstly the Committee recommended that certain companies be allowed to elect to be taxed as a partnership, but there were to be a number of quite restrictive conditions on the companies which could so elect in order to discourage misuse of the election (Campbell, 1981, p.224). The integration proposals and the proposals for certain corporations to be taxed as partnerships are very similar, the major differences being

that there would be no withholding of tax at the corporate level in the partnership election proposal and that corporate losses could not be distributed to shareholders in the integration proposal. It is odd that the committee should be aware of the restrictions necessary for practical reasons in the partnership proposal, but seem unaware of exactly corresponding problems in the integration area.

Secondly, the Committee proposed that the current tax exempt status of superannuation funds should be removed so that their income would be taxed on a current basis and not only on distribution. The Committee nevertheless considered that it was impossible administratively (although desirable theoretically) to tax members on their aliquot share of the funds' income at the members' respective marginal rates, because of the difficulty of determining before money was actually distributed to members their precise entitlements to income. The system which the committee regarded as theoretically desirable in this context is equivalent to integration in the corporate context but is rejected for reasons which it will be seen below apply as much to companies as to superannuation funds.

Viewed from the legal and practical perspective, the integration proposal seems to be tailor made for tax avoidance activities. This is because it involves the allocation of income for income tax purposes to taxpayers who do not receive any money necessarily in the hand. Income splitting is thereby encouraged as it is possible for wealthier family members to divest income to less wealthy family members without having to give up effective control of the underlying property in question. Moreover, paper tax avoidance schemes are made possible by this kind of tax structure - a recent example in Australia was the allocation of trust income to tax exempt beneficiaries under conditions which postponed for many years the payment over of the income and accordingly give a very low present value to the income stream (the benefit of the funds being directed to the "real beneficiaries" in the meantime).

4.3 Reception

For many Australian economists the Campbell Report seems to have settled the feasibility of the integration proposals - at least this is so in the domestic context, it being conceded that problems remain in the international area (Officer, 1982c, pp.347-348, Head, 1984, p.158) - though their overseas colleagues do not seem to agree (McClure, 1979, Ch.5, 1983, Prest, 1982, Cnossen, 1984, p.263). I shall attempt to show briefly that even in the domestic context

integration is administratively impossible, or at least that so many compromises have to be made in implementation that the end product departs from the idea to such an extent as to be unsuccessful in achieving the aims of the ideal. This conclusion has recently been accepted in Australia by the Draft White Paper (1985, Ch.17).

4.4 Timing of the Allocation Process

For a company whose tax year ends on 30 June and coincides with its accounting year for financial reporting purposes (the most common case in Australia - tax years of companies in New Zealand being much more various though the same results ensue), an allocation to shareholders of corporate taxable income would be made under the Campbell proposal on the day when the share register closed for final dividend purposes or (if no dividend is to be paid) when notices for the annual general meeting are sent out. Normally this would occur on a day (called the day of record) in the period September to November following 30 June, at which stage the company may well not have submitted its tax return for the year ending the previous 30 June and certainly will not have received an assessment in respect of that period (and only one or two instalments of tax for that period would have been paid).

The shareholder on the members' register as at the day of record would have allocated to him his share of the corporate income for the *whole* year ending on 30 June and (assuming the shareholder is an individual with a tax year ending on 30 June, almost invariable in Australia, though again similar results follow for the New Zealand tax year ending on 31 March) would include the amount allocated in his income for the year ending on following 30 June. No apportionment of the income would occur where the shareholder held the share for only part of the year of income (and indeed if the shareholder acquired the share after 30 June but before the day of record, the allocation would still be made).

If there were an adjustment to the company's taxable income either in the assessment subsequently issued or in any amended assessment or following an appeal, no retrospective re-opening of the allocation would occur but instead adjustments would be made to the allocation in the year when the company's taxable income for the earlier year was finalised. For example, if the company reported income of $1m. for the year ending 30 June 1984 and allocated that income on 30 September 1984 but the Revenue in its assessment issued

in say February 1985 adjusted taxable income upwards to $1.1m. the additional $0.1m. would be added for allocation purposes to the company's taxable income for the year ending 30 June 1985 and would be allocated to shareholders on the 1985 day of record, say 30 September 1985, to appear in the shareholder's 1985-1986 tax return.

This process obviously could never achieve perfect allocation in the sense that a shareholder would have allocated to him the precise amount of corporate income as corresponds in particular to his period of membership of the company, but it is claimed that any unfairness would be overcome by the stock market which would adjust share prices appropriately to take account of prospective tax liabilities and benefits arising out of the corporation's activities. In the same way it is suggested that share price adjustments will prevent trading across the day of record by high and low marginal rate taxpayers to produce the most advantageous tax result. The analogy is invoked of the price adjustments which occur when a share cum div goes ex div.

There is a growing body of evidence that market price adjustments very quickly occur for any new information that becomes available about a corporation and affects its activities. This phenomenon is explained by the economists in the efficient market theory which in its most relevant form for present purposes states that by or at the time information which affects a company's performance is made public, the information will be incorporated into share prices so that investors utilising such information subsequent to its release cannot earn extraordinary returns. (See for example Lorie and Hamilton, 1973, Chs.4 and 5, Harding, 1979, Officer, 1980, for non-technical explanations of the theory.)

Whilst not questioning the general validity of the efficient market theory, it seems to me that more is required than mere assertion to demonstrate the operation of the theory in this context to eliminate the inequities that are apparently entailed in the concept of the day of record and the lack of retrospective adjustment to past allocations. Overseas economists have been less sanguine about the ability of the market to make the appropriate adjustments in this area (McClure, 1979, p.163).

The Campbell proposals would require very detailed disclosure in a company's financial statements of the directors' prognosis of the Revenue's assessment of taxable income that is being allocated. The directors will hardly want to signal to the Revenue that they are aware of a number of doubtful claims in the company's income tax

return (especially as the financial statements will be published prior to assessment) but this seems an inevitable outcome of the Campbell proposals. Alternatively if full disclosure does not occur, the market will not, on the version of the efficient market theory stated above, be able to make the appropriate price adjustments for the tax position of the company.

American experience in comparable areas is not encouraging. Under US tax law a corporation can use the LIFO or FIFO method for calculating the opening and closing values of inventory. Clearly in inflationary conditions corporate taxable income will be less if the LIFO method is adopted but in fact 95% of US corporations adopt the FIFO method because of the so-called LIFO conformity requirement (*Internal Revenue Code* s.472). This provision requires that if a corporation uses LIFO for tax purposes, then it must use it for financial reporting purposes and when used for financial reporting purposes, it apparently is feared to have an adverse effect on share prices and the ability of firms to raise capital because of the lower rate of profits that the method produces (US Treasury, 1984, Vol.1, pp.109-110, Vol.2, pp.189-192 - the provision is slated for abolition, Reagan, 1985, pp.174-177). This suggests to me that, however specific were the financial reporting requirements with respect to income tax, there would always be a strong incentive for firms to play down adverse tax possibilities and play up beneficial tax possibilities in their financial statements, so that the market would not be fully informed concerning a company's tax position.

The proponents of the efficient market theory suggest that changes between FIFO and LIFO do not fool the market (Copeland and Weston, 1983, pp.319-327), but they fail to explain why so few firms adopt LIFO in times of inflation when it will produce advantageous tax consequences.

A more fundamental problem with the operation of the efficient market theory smoothing out possible inequities arising from the allocation of a whole year's corporate income to shareholders on the register on the day of record is that it has no proven operation for the majority of companies whose securities are not traded on stock exchanges and for which there is not a ready market (for the theory has been developed in the context of listed securities). Most of these companies will be private companies for income tax purposes and proprietary companies for company law purposes.

A proprietary company is required by *Companies Code* s.34 to contain in its memorandum or articles of association a provision restricting the right to transfer its shares; there is no similar requirement for private companies in New Zealand under *Companies Act* 1955 Part VIII, though such provisions as a matter of practice will be common. A common form of this restriction is that the articles will confer a right or pre-emption on other shareholders or the directors, that is, the selling shareholder will be obliged to offer his shares first to other shareholders or the directors and will only be able to sell the shares to outsiders if the other shareholders or directors do not wish to buy them. Unless there is a provision for purchase at a valuation, obviously many sales will occur for prices below the value of the shares (if there were no such restriction on their transfer).

This problem is a very real one as is demonstrated by the many cases where a shareholder has died and the directors are apparently exercising their powers under the article restricting transfer in a harsh manner to ensure a transfer of the deceased shareholder's shares at an under value. The problem was addressed by the Cohen Committee in 1945 (paras, 58-60) and was still causing problems in 1983 when the oppression remedy in *Companies Code* s.320 was amended to give additional protection to the estate of deceased shareholders (see *Companies Code* s.320(4A)(a)). Moreover, it is possible to have an article in this context which sets an artificial price for transfer of shares, e.g. transfer at par value (see *Phillips v. Manufacturers' Securities Ltd*, 1917, a decision whose authority is recognised by standard texts on company law).

It will be apparent that in the case of most companies in Australia shares may be transferred at a price which has no relationship whatever to the profits retained by the company. It follows that allocations under the Campbell proposals will operate extremely inequitably in this context. Indeed articles of the kind mentioned will be one part of the tax avoidance process with private companies. There will be a number of low marginal rate shareholders in the company who will have allocations made to them but will be denied the benefit of corporate retentions. Instead retentions will be diverted to high marginal rate shareholders who are the "real" beneficiaries of the corporate income which has been retained in the company.

There will not even be a need to create these new schemes; for those tax practitioners whose memories go back far enough, precedents

from the 1940's will be revived. Those were the days when the levy of undistributed profits tax in Australia was related to the marginal rate of shareholders and the tax was avoided by having a number of low marginal rate shareholders in the company (for a scheme of this kind which got into company law difficulties see *Ngurli v. McCann*, 1954). It is interesting to note that levying undistributed profits tax by reference to shareholders' marginal rates was dropped in favour of a flat rate tax not only because of this type of avoidance activity, but also because the method was found to be an administrative nightmare. This does not argue well for implementation of the Campbell proposals.

4.5 Classes of Company Shares

This is an area where I suggest the economists in Australia have simply failed to understand the problem (although it is well understood by their overseas colleagues (McClure, 1979, p.157)).

Take firstly the preference share. "Preference share" is a term used to refer to shares which have a priority to dividend (usually for a fixed amount expressed as a percentage of the par value of the share) and to a return of capital on winding up of the company. The "normal" preference share will be cumulative as to dividends, that is, if a dividend is missed in any particular year the preference shareholders will be entitled to have that dividend made good before the ordinary shareholders receive a dividend; non-participating, that is, after the rights to the preference dividend have been satisfied no further dividend will be paid on the preference shares; will not participate in surplus profits on a winding up after the par value of the shares has been satisfied by payment; will sometimes be protected against a reduction of capital by the so-called "Spens" formula by which if a movement in interest rates makes it burdensome for the company to pay the preference dividend, the preference shareholders can not be eliminated from the company at par value on a reduction of capital and the reduction can only occur at a premium; and finally will be non-voting unless preference dividends are in arrears. It is to be emphasised, however, that there is no need for preference shares to follow this pattern as there is virtually no limit to the rights that can be attached to various classes of shares, though there are limits under *Companies Code* s.125 to changing the rights attached to a class of shares. Preference shares are commonly contrasted to ordinary shares.

Under company law a dividend can only be paid out of profits (*Companies Code* s.565) and there are elaborate rules for determining what this limitation means. Profits for company law purposes will almost never be the same as taxable income, but for the moment the two concepts will be assumed to be the same. The Campbell Report did not explicitly deal with the method of allocation in a company where there are preference shares. Two methods suggest themselves: firstly an allocation could be made to preference shareholders of the amount of preference dividend to the extent there was taxable income to support the allocation; or secondly preference shareholders would only be taxed on dividends in fact received. Whichever method is used, problems will occur.

Under both methods, it would be possible (and in fact would probably have occurred often in recent times if the Campbell proposals were in operation) for ordinary shareholders to have profits allocated to them for tax purposes even though those profits were ultimately distributed to preference shareholders. Suppose a company has preference shares which carry a dividend each year of $1m, the company in year 1 makes $3m of taxable income of which $1m is distributed to preference shareholders, say $1m is distributed to ordinary shareholders and $1m is retained. In year 2 due to a downturn in the economy the company makes zero profits; however, to keep face with preference shareholders a distribution is made in year 2 out of the $1m. retained profits from year 1 to the preference shareholders (if a preference dividend is missed in any year there will be adverse commercial consequences for the company). The distribution made to the preference shareholders in year 2 would have already been allocated to the ordinary shareholders in year 1 and taxed to them, even though in the result the ordinary shareholders have not received the benefit of those profits. This example assumes, as in fact is the case under the legal rules, that a preference dividend can be paid in a year when a company makes a loss or does not make any profit so long as there are undistributed profits from previous years.

If the first suggested allocation method were used, that same sort of problem could arise but in reverse. Suppose a preference dividend were missed in a year when a company has taxable income; this could happen for a number of reasons one of which is the difference between taxable income and profits - the company may have taxable income but may not have any profit which can legally be distributed. Under the first method the taxable income would be allocated to the preference shareholders in priority to the ordinary shareholders on

the assumption that a distribution will be made in subsequent years to catch up the missed dividend. If the company goes into liquidation, it is by no means certain that the preference shareholders will receive the missed dividend before any payments are made in the liquidation to ordinary shareholders. The rights of preference shareholders to missed dividends in a winding-up is a murky issue which has exercised the attention of the courts on a number of occasions, the most recent example being last year (*Pell v. Marshall*, 1984). The outcome may be that the preference shareholders in this situation have been taxed on income which in fact is ultimately distributed to ordinary shareholders.

Many variations on these examples can be constructed to produce misallocation of income where there are preference and ordinary shares. It is difficult to conceive of the efficient market theory adjusting for the problem and serious inequities could arise. Nevertheless Swan and Officer in their paper for the Campbell Committee simply state that they cannot see any problem with preference shares (Swan, 1982a, p.16, 1982, p.94, Officer, 1982b, p.156). Swan also adds the riposte that preference shares constitute only a small proportion - 1 or 2% - of shares traded on stock exchanges (Swan, 1982a, p.16). It is true that there has been a tendency to simplication of capital structures of publicly listed companies so that preference shares have become less and less important for listed securities, but the problem is one that is not confined to preference shares.

In recent times the deferred dividend share has made its appearance on Australian capital markets. The advantage of this share is for companies wishing to raise capital for large scale investments which will not be income-producing for a number of years. The deferred dividend share allows a company to raise capital for the project and to defer servicing that capital until the project is producing profits. It is difficult to see any sensible allocation process for this kind of share. Whatever process is adopted would be artificial and the efficient market theory would have to be called upon once more to make good the deficiency. I doubt whether it is wise to place so much reliance on this theory.

Nor does the problem end there. Options over unissued shares and convertible notes are also problems. These securities have value not only because of the right that they confer to share in future profits of a company upon exercise of the option or the conversion right, but also because they give a right to share in retained profits generated

between the date of issue of the security and the date of conversion into a share (retained profits arising before the date of issue of the option or convertible note will no doubt have to be purchased in the sense that the exercise price for the option and the price and interest rate on the convertible note will take account of retained profits as at the date of issue).

Even if one swallows hard and accepts that the efficient market theory can overcome all the possible misallocations that can occur where there are different classes of securities on issue by a company, again the Campbell proposals simply do not take account of the fact that most companies are private companies, and whilst listed companies have a fairly standard set of conditions attaching to different types of securities, securities of private companies are much more variable. Take for example the not uncommon dividend article under which directors may declare any amount of dividend they like on any particular share or class of shares without declaring dividends on any other shares or class (for decisions involving companies with an article of this kind see Case C63, Case K1, Case L11). I suggest that it is simply impossible to devise any proper method of allocation of retained profits when such an article is present.

It is instructive to look at the US experience with Subchapter S which provides an election for certain corporations to be taxed as partnerships. One limitation on the availability of this election is that it can be only utilised by companies with shares whose rights are identical (a slight relaxation occurred in 1982 when shares with different voting rights were permitted, see *Internal Revenue Code* s.1361(b)(1)(D), (c)(4)). The reason for this limitation is that the allocation process simply could not be made to work where the company had different classes of shares. The Asprey Committee endorsed this limitation in its proposal for some companies to be taxed as partnerships (1975, p.240) and so, ironically enough, did the Campbell Committee (1981, p.224).

It may be possible to change the rules of company law to ensure that the allocation method had some chance of working, but restrictions on the ability to create different classes of shares would be so severe as to be completely unacceptable to the commercial community. It has been suggested that some kind of tax refund system could be devised to deal with the problem of different classes of shares (Krever, 1985), but no details are provided and it is difficult to see how records could be kept over the years to ensure that refunds

and additional levies of tax are attributed to the correct shareholders.

4.6 Different Categories of Shareholders

4.6.1 Trusts

In Australia the income of a trust to which a beneficiary is presently entitled is taxed to the beneficiary at his marginal rate (though sometimes the tax is paid by the trustee), while generally speaking income to which no beneficiary is presently entitled is taxed at 60%, the tax being levied on the trustee and no further tax being paid upon distribution to the beneficiary in a later year when the beneficiary does become presently entitled. In New Zealand the regime for the taxation of trusts is different, but nonetheless a distinction is drawn between income to which a beneficiary is entitled in possession and other income, and so similar problems to those noted below can arise.

Trust law does not regard retained income of companies whose shares constitute trust property as income of the trust and any increase in the value of the shares arising from retained income is regarded as belonging to the capital beneficiary of the trust. Accordingly trust law would provide no ready means of allocating retained corporate income as income of the trust and tax law would have to provide special rules in the trust situation.

It would not be possible to provide automatic allocation in accordance with the income rights of beneficiaries as under a discretionary trust beneficiaries have no income rights until income is actually distributed by the trustee and such distributions may be out of past year income rather than current year trust law income. Nor would it be possible to have a rule that allocations of corporate income to beneficiaries were to be made in accordance with distributions by the trustee as no distributions may occur, either because the trustee elects to make no distribution, or because there is no trust law income to distribute, e.g., if the company in which the trust holds shares earns taxable income but does not pay a dividend. In any event such a rule would operate unfairly.

Two rules suggest themselves. Firstly, the trustee could be given the right to allocate the income as he saw fit. Secondly, the

retained income could be taxed to the trustee under ITAA s.99A at the maximum marginal rate.

If the first method were adopted, large scale tax avoidance activities would result. The trust would have a charity as one potential beneficiary and the trustee would allocate all of the retained corporate income to that beneficiary. If the second method were adopted, corporate profits would end up being taxed at 60% regardless of the marginal rate of the ultimate beneficiary of the corporate profits which would undermine the whole raison d'etre of the Campbell proposals. Australia could no doubt adopt the system which exists in some overseas countries whereby undistributed trust income is initially taxed at the maximum marginal rate but then adjustments are made to the beneficiary's marginal rate when distributions actually occur. However, once again, the Campbell proposals would be entailing significant alterations to other areas of law besides the corporate tax area.

Where a trust has successive interest, for example, a life tenant and remainderman, the allocation process would prove impossible to operate in a fair manner. Retained corporate income can not be allocated to the life tenant as the life tenant does not enjoy the benefit of that income. Nor can it be allocated to the remainderman as it is not possible in many cases to tell who the remainderman will be until the life tenant actually dies. Taxation to the trustee would be the only feasible solution, but this is unsatisfactory for reasons already explained.

4.6.2 Companies

The discussion under this heading is based on the assumption that the company rate of tax is below the maximum individual rate. It demonstrates the problems that such a differential can create under the Campbell proposals. Even if the rates were the same, there would still be a necessity for rules as to inter company shareholdings though the problems would not be as great.

The Campbell proposals would permit deferral of tax in the case of 60% marginal rate shareholders by the interposing of a series of companies between the shareholder and the company whose allocation is in question. The Campbell Committee (1981, p.231) suggested, without elaboration, that some kind of additional tax at the corporate level could be levied to bring the effective tax on corporate income where deferral was a possibility up to the maximum marginal rate of 60%.

This kind of problem existed for many years with the undistributed profits tax, and gave rise to companies being formed in "chains" and "snakes" as a means of avoidance of undistributed profits tax until the dividend rebate provisions in ITAA s.46 were modified to ensure that deferral of tax was substantially eliminated.

The additional tax could be levied in a number of alternative ways. One possibility would be for a company making an allocation of income to pay the additional tax whenever an allocation was made to another company. Alternatively the tax could be levied on the company to which an allocation of corporate income was made. In the second alternative it would be necessary for the company paying the tax to maintain two separate accounts with respect to allocations of corporation income, one account recording allocations on which compensating tax had already been paid because the income had already been through an allocation to a company and the levy of additional tax. The second account would record allocations which had not been subject to additional tax and on which additional tax would be payable by the corporation receiving the allocation. Whichever alternative was used a complex accounting mechanism would be necessary. It would be possible to institute such an account mechanism, for similar kinds of mechanisms are already operated in imputation systems in overseas countries (an idea of the complexity involved can be gained from Salter, 1985, Ch.3).

The question would be to determine when the additional tax should be levied. On one view deferral would only be a problem in the private company area, because this is where manipulation of the deferral advantage would occur. On this view the tax would only be necessary where an allocation was made to a private company and could probably be implemented in a simplified form by partial denial of the corporate dividend rebate on the model of ITAA s.46(2)-(4) (the provisions which overcame "chains" and "snakes"). On the other hand if the problem were seen as one of deferral per se rather than manipulation of the advantage of deferral, then the additional tax would be required whenever allocations passed through companies and would necessarily require very complex accounting mechanisms. It is ironic that one of the advantages seen by the Campbell Committee for the integration proposal was that it would eliminate the bias in favour of retentions and hence eliminate the need for undistributed profits tax. Yet similar problems which give rise to the need for this tax would prompt the additional tax described above which almost certainly would be much more complex than the current undistributed

profits tax because of the special accounting mechanisms that it would require.

The effect of a universal additional tax, however, would be to tax in a penal way some corporate income and *never* to give relief for that penalty in some cases. Where an individual ultimately receives income passing through companies there would be credit not only for the ordinary tax withheld at the corporate level but also for the additional tax withheld so that relief from the penalty would occur at that stage. The problem would arise where there were cross holdings of shares between two companies, a not uncommon situation with listed companies in the takeover atmosphere which has pervaded the last ten years. It would be possible to operate the allocation process suggested by the Campbell Committee in this situation, unlike other integration proposals under which the day of record would be the last day of the year of income and which would require complex equations to effect an allocation, equations so complex that they would be unworkable in the real world in the case of a series of cross holdings (McClure, 1979, p.156), but the allocation process in this context would not be particularly accurate.

Suppose in the 1983-1984 income year company A has taxable income of $1m. and is 25% owned by company B which has $2m. of taxable income and which is 20% owned by company A; suppose also that their day of record is 30 September. On 30 September 1984 company A would allocate to company B $0.25m. of corporate income and this would be included in B's assessable income for the year ending 30 June 1985; conversely company B would allocate to company A on 30 September 1984 $0.4m. of corporate income and this would be included in the taxable income of company A for the year ending 30 June 1985. If the companies' income apart from these allocations remains constant then company A for the income year ending 30 June 1985 would have taxable income of $1.4m. of which $0.35m. would be allocated to company B on 30 September 1985; while company B would have taxable income of $2.25m for the year ending 30 June 1985 of which $0.45m would be allocated to company A on 30 September 1985. The circular effect of these allocations will be apparent and a little thought will indicate that the allocations are not precisely accurate.

If additional tax were to be levied, then the circularity of the allocations would mean that a part of corporate income would be in oscillation between the two corporations so long as they maintained their cross shareholders. Moreover the levy of the additional tax as between the corporations would be quite arbitrary depending on when

each corporation purchased its shares in the other. If both purchases occurred in the same period between two days of record then each corporation would be subjected to additional tax on the full amount of the first allocation. If however company A obtained its holding in a year prior to company B, then the additional tax would fall more heavily on one company (A if the first method referred to above were used and B if the second method were used). In this latter situation, the total additional tax would be less because the first allocation by A to B would include some income which had already borne additional tax, whereas if the purchases occur in the same year the first allocations will both attract additional tax.

4.7 Losses

The Campbell Committee considered that it was not feasible to allocate corporate losses to shareholders and proposed instead that these would be carried forward within the company as at present to reduce taxable income and therefore allocation in future years. This raises again the problem of misallocation where shareholdings change, though no doubt the efficient market theory will be called upon in reply. However, the Campbell Committee did advocate the sharing of losses within a company group (1981, p.227). We know from overseas experience that this is possible (though a glance at US experience will once again dispel any notion that group tax accounting is a simple matter) and Australia has recently introduced transfer of losses where there is 100% ownership, thus confirming what had been the Revenue's practice for a number of years of ignoring ITAA s.80DA where profits were pumped into a loss-making 100% subsidiary (see s.80G).

If integration is combined with the transfer of losses in cases of less than 100% ownership then unfairness will exist between the minority shareholders in the loss-making company who are denied the immediate benefit of the loss and the shareholders in the holding company of the loss-making subsidiary who receive the benefit of the loss immediately (assuming the holding company has other income sufficient to absorb the loss). It is suggested that it is impossible for the efficient market theory to eliminate this unfairness because different treatment is occurring in respect of exactly the same class of share in the loss-making subsidiary.

The Campbell Committee did not give any detailed attention to provisions designed to prevent trafficking in loss companies and one

assumes therefore that the current controls would remain with the integration proposals. This will mean with respect to losses that integration will not occur when any event of the kind specified in ITAA s.80ff occurs and the losses will then disappear entirely for tax purposes. A closer step to integration with respect to losses would be made if the proposals of the America Law Institute (1982, pp.199-290) were adopted. Under these proposals transfer of more than 50% of the shares in a company would not operate to disallow losses. Instead (stating the proposal in simplified form) the losses could only be offset each year against a percentage of corporate income which corresponded to the percentage of shares remaining in the same ownership; thus if 40% of shareholding remained constant, losses could be carried forward and offset against 40% of corporate income. The practical difficulties of this kind of regime are being investigated in detail in the US (Senate Finance Committee, 1983, House Committee on Ways and Means, 1983, *Tax Reform Act* of 1984, s.48) and it is suggested that the proposal should be given study in the Australian and New Zealand context.

5. Imputation

Imputation is one of three systems whereby credit for all or part of income tax paid by a company can be passed through to shareholders with respect to dividends paid by the company (to repeat, the essential difference between integration and imputation is that imputation gives credit only for tax paid by the company on its taxable income so far as that income is distributed, whereas integration gives credit for all tax paid by the company on all its taxable income whether distributed or not). The method by which imputation works is to gross-up the dividend paid to a shareholder by the amount of company tax for which relief is to be given, include the grossed-up amount in the shareholder's taxable income and then give the shareholder a tax rebate or credit for the amount of corporate tax by which the dividend has been grossed up.

For example if the corporate tax rate is 50% and a shareholder receives a dividend of $50, the shareholder would gross-up the dividend by $50, include $100 in assessable income, and receive credit against his tax liability of $50. This example assumes that full imputation is in place; partial imputation would involve a gross-up and credit of an amount between zero and $50 depending upon the degree of imputation sought.

The other two methods are the dividend deduction and split rate systems. Under the dividend deduction method, the company receives a tax deduction for dividends paid and therefore pays no tax on distributed profits. Analytically this is the equivalent of full imputation. The split rate method involves imposing a lower rate of corporate tax on distributed profits. Analytically this is the equivalent of full imputation. The split rate method involves imposing a lower rate of corporate tax on distributed profits than on undistributed profits. Analytically this is equivalent to partial imputation. Examples will be found in Appendix 1 dealing with full imputation, partial imputation and dividend deduction systems.

There are already in existence several imputation systems in major western countries (notably Canada, France, Germany, Italy and the United Kingdom). This is probably sufficient to overcome any doubts as to the administrative feasibility of the system. The reason why imputation is feasible and integration arguably is not is that imputation operates only with respect to *distributions*. The problems identified above in integration proposals all relate to the difficulties of attributing *retentions* to shareholders in a fair and effective way.

A number of studies of the various alternatives available in the implementation of imputation in a workable way have already been done in an Australian context (McClure, 1983, Cnossen, 1984, Salter, 1985 and see the large study of McClure, 1979). In addition, the Asprey Committee provided a blueprint for an imputation system in Australia (1985, Ch.16) and the matter was recently taken up again in the Draft White Paper (1985, Ch.17). In view of this wealth of material, I will not cover all the issues involved but instead will concentrate on matters that have not been fully explored to date or which have particular relevance to the Australian and New Zealand setting. Before turning to this discussion I will indicate how an imputation system will affect and seek to solve the problems identified with the classical system in 2 above.

If the company tax rate and maximum individual tax rate are the same and if there is full imputation, the imputation system will operate very much like integration in that companies will be under considerable pressure to pay out all their profits by way of dividends so that individual shareholders on less than that maximum marginal rate can get the benefit of the tax credit. To the extent that imputation in this case is like integration the benefits of integration with respect to horizontal and vertical equity and the choice of debt or share capital for company finance will be achieved. However, unlike integration this system would not be neutral with respect of distribution policies of companies, the pressure being for distribution.

That need not be a worry in that the arguments regarding distributions policies suggest that if there is to be a bias, a bias in favour of distribution is much better than a bias against distribution as is currently found in the classical system. Moreover, the rapid development in Australia of dividend reinvestment plans in recent years would almost certainly mean that the increased dividend payouts would lead to increased reinvestment by shareholders so that

the outcome for individual companies may not be much different from the present situation. These comments relate to the criticism of the classical system which follow from the very simple model used in Part 2.1-2.5 of the paper. Just as the discussion in 2.6 shows that the real corporate tax world is much more complex than the simple model of the classical system suggests, so too the effects of this form of imputation system in the real world would be considerably more complex than the comments above suggest.

If the imputation system adopted follows the lines of the Asprey Committee (1975, Ch.16) in that the corporate rate would be below the maximum individual rate and there would only be partial imputation, the improvements over the classical system would not be as clear cut, though it could be expected that there would be greater equity and less bias against share capital as opposed to debt capital and against distribution as opposed to retention. It would still be necessary to have in place a regime like the current undistributed profits tax to ensure a sufficient level of distributions from private companies, although the presence of a capital gains tax in the system may make a difference for reasons taken up in the next section.

5.1 Imputation and Capital Gains Taxation

Companies offer a unique vehicle for the generation of capital gains. For virtually all other assets it is not possible for the asset owner to control the level of capital gains as this will be a matter determined by market forces (although it will be possible by exploitation of defects in the existing income tax law especially as regards deduction to turn income in effect into capital gains, Sieper, 1985a, 1985b). In the case of a shareholder who is not liable to tax under the current system on profits made on the sale of shares, the choice is open whether to take dividends which are taxable or to retain profits in the company and to realise the benefit of the retentions by a sale of the shares. Particular individuals will only have such control in the case of small private companies where the relationship between the level of retentions and the amount of capital gain is very close, but even in the case of the large public company the collective weight of shareholder opinion is likely to produce the same effect (the comments in 2.6 above show, however, that not all shareholders will have the same view point). Because of this feature of company shares they are, along with land, the major object of capital gains taxes.

The argument for introduction of a capital gains tax is a more general matter which I will not explore here. The official view in Australia has often been in favour of the introduction of such taxes (Asprey, 1985, Ch.23, Draft White Paper, 1985, Ch.7) and in New Zealand to the contrary (Ross, 1967, Ch.72, McCaw, 1982, Ch.10 compare McKay 1982; interestingly, capital gains taxation is discussed in the New Zealand context as part of wealth taxation, rather than as a reform of the income tax base which is the economists' view of the matter).

Although the Campbell Committee did not recommend a capital gains tax, the integration system can be fully coordinated with a capital gains tax levied on realisation of assets if it can be made to work in other respects (and indeed a capital gains tax is a natural concomitant of integration). This is done by increasing the costs of shares for capital gains purposes by allocations of corporate income to shareholders and reducing the costs by dividends received, or to put it another way, by increase cost to the extent of retentions (McClure, 1979, p.148).

Such a reconciliation cannot be achieved in the case of an imputation system in the presence of a capital gains tax. To the extent that retentions of company profits are reflected in share prices and give rise to capital gains, the levy of a capital gains tax amounts in effect to the reintroduction of the classical system in respect of retentions. The retentions bear the corporate level of tax which is unrelieved at the shareholder level because imputation credits relate only to distributions and then the capital gains tax operates on profits arising from those retentions without reference to the company tax already paid. The simple device of exempting capital gains made on shares from a capital gains tax is not viable because capital gains do not arise only from retentions. The other element involved is goodwill which can produce gains (or for that matter losses) beyond the effect of retentions. Goodwill here refers to the market's favourable or unfavourable reaction to the prospects of a particular company and also to the prospects of the economy in general.

The ideal solution to this problem would be to levy a capital gains tax on an accruals basis but it is generally agreed that such a tax is not feasible. Another possible solution is to divide any capital gain into two elements, that arising from retained earnings and that arising from goodwill. The element arising from retained earnings would be treated in the same way as dividends under the

imputation system with gross-up and credit for company taxes paid in respect of those gains while the goodwill element would be subject to the full levy of capital gains tax without adjustment. This solution is unlikely to be feasible for the same reasons that the Campbell integration proposals are not feasible - because it requires methods of allocating retained earnings to shareholders, although the problems are not quite as great and perhaps rough and ready formulae could be devised to make a division of the capital gains.

There is, however, an even easier solution to the problem if the form of imputation adopted is equation of company and maximum individual tax rates together with full imputation. As already pointed out this system would be likely to increase the level of distributions by companies significantly. If distributions reach 100% of taxable income and taxable income is more or less equivalent to financial profits, then the problem arising from retained earnings in the capital gains area disappears because the retained earnings have disappeared. This is one reason why I would favour an imputation system along these lines. It is a kind of home made integration which has the benefits but not the defects of that system.

Even if a capital gains tax is not introduced in tandem with an imputation system, the suggested system still has its advantages because it discourages the use of retentions to generate capital gains since retentions will already have been taxed at the maximum marginal rate. However, the absence of a capital gains tax would mean that capital gains at the company level would go untaxed which would raise the question of whether the current New Zealand treatment of company capital gains should be continued or should be modified either along the lines suggested by John Prebble or along the current Australian lines. This capital gains issue is an example of a more general problem that needs to be confronted in the design of an imputation system, the treatment of tax preferences which cause company taxable income to be less than company profits for financial reporting purposes (which determine what level of dividends can be paid).

5.2 Tax Preferences

If there is no requirement that company level tax must actually have been paid on profits from which dividends are distributed and if all dividends qualify for gross-up and credit, there is a real prospect, where the level of tax concessions available to companies is significant as it currently is in Australia and New Zealand, that

shareholders will receive more credits in total than tax paid by the company (so-called superimputation). Theoretically there are numerous ways to deal with this problem (McClure, 1979, Ch.4) but for administrative reasons the choice is much more limited.

One method is to ignore the problem and allow superimputation to occur; this is the Canadian solution generally, although a different approach is taken for one significant tax preference, the small business tax rate which is lower than the ordinary corporate rate. It was also recommmended by the Asprey Committee (1975, p.233) as a short term measure though the level of tax preferences in the Australian tax system was then less significant. Another approach is to divide dividends into two categories, those which receive the gross-up and credit and those which do not, depending on whether the profits giving rise to the distribution have borne tax at the company level or not. This has the effect of passing the treatment of the profits at company level through to the shareholders and is analogous to the current New Zealand treatment of dividends paid out of capital profits. It needs to be considered, however, whether it is administratively feasible to devise and enforce accounting systems on companies which would be necessary to draw the distinction. Consider for example determining the amount of tax preference involved in accelerated depreciation where income is understated in early years but overstated in later years; although total tax paid may be the same, the preference will still have a value depending on the degree of acceleration and interest rates from time to time. By contrast, the existing situation concerning dividends out of capital gains in New Zealand requires little extra effort as existing financial accounting standards incorporate the required record keeping procedures. No doubt some simplifying assumptions are possible to assist in the accounting difficulties as recent US proposals show (Reagan, 1985) but these suggestions are in the context of the substantial elimination of tax preferences.

In addition there would be an incentive under this proposal for companies to pay dividends out of taxed profits because these would give rise to credits in shareholders' hands and would never lead to the payment of additional tax by the shareholder in respect of the dividend if the company tax rate and maximum marginal individual rate are the same (the fact that certain company profits could be distributed without any tax at any level would be irrelevant to shareholders who would be concerned with getting the best tax result they can for any distribution received and the best tax result is a credit). If this is so, then the record keeping required would mainly

have a negative purpose of preventing distributions of tax preference corporate income. If there is no general capital gains tax many shareholders could realise the benefit of the tax preferences simple by selling their shares (on the simplistic assumption that share prices will accurately reflect retentions). Unfortunately this benefit would spread very discriminatorily among shareholders because those shareholders who are taxed on sale of their shares would effectively be denied the tax preferences. As shown above in the discussion of the real corporate tax world, there is a significant group of shareholders in this category.

The third method of dealing with the problem is that adopted in most countries with an imputation system whereby special taxes are applied to ensure that corporate tax has been paid in respect of all profits distributed even though those profits may not have given rise to tax if retained at the corporate level because of tax preferences. Thus in the UK, advance corporation tax is levied on all profits distributed by way of dividend at the time dividends are paid; this tax is then creditable against the corporation's liability for corporation tax and if dividends have been paid out of profits which are not liable to corporation tax because of tax preferences, the advance corporation tax may exceed corporation tax liability but no refund of the excess will be made to the corporation. The effect of this system is that dividends are assumed to be made in the first instance out of profits which have borne tax and then out of profits which have not borne tax. To the extent that dividends come out of profits which have not borne corporation tax through tax preferences, the tax preference is in effect cancelled by the levy of advance corporation tax. In the jargon used in this area, tax preferences are stacked last and washed out on the payment of dividends.

Under such a system a company will be well advised not to pay dividends in excess of its after tax taxable income so that the benefit of tax preference is preserved. The difficulty is that although the shareholder will thereby not immediately be denied the benefit of the tax preference, in the long run the profits will be taxed if a capital gains tax is in place when the shares are sold. Although governments may be disposed to take this route because of the revenue savings involved, it makes little sense to confer a tax preference on one activity or class of taxpayer, but then to cancel it out if the taxpayer happens to be a company. Where no general capital gains tax is in place, the tax preferences are preserved for some shareholders, but cancelled for others as explained above which is hardly a satisfactory outcome.

The problem would be greatly ameliorated if the level of tax preferences in the income tax system were greatly reduced. It is always easy to suggest doing away with tax preferences but in practice governments have found it very difficult to do so. However, in this area there are very strong policy reasons why it should be done (even apart from the general reasons for eliminating tax expenditures), and in addition the move is politically more saleable and for revenue reasons very desirable.

The higher the level of distribution, the less of a problem is the combination of a capital gains tax with an imputation system as pointed out above. The combination of significant tax preferences and a regime like the advance corporation tax will have the effect of lowering the level of distributions. This difficulty can only be addressed by a closer approximation of economic income and taxable income. More significantly there are important international considerations for avoiding an advance corporation tax (see below) while the revenue costs of superimputation and the administrative difficulties of dividing dividends into different classes make the alternatives to a compensating tax unattractive, subject to the qualification that superimputation would not, or at least would be less likely to occur, if tax preferences were by and large eliminated.

The political selling point for the elimination of tax preferences is that if this move occurs in the context of the introduction of a full imputation system, the government will be able to argue that it is giving business an enormous benefit and that business should be willing to bear some associated costs (though after the Tax Summit in Australia one may doubt the effectiveness of this line of argument). The revenue consequences are that the elimination of tax preferences will generate substantial additional revenue from the company sector which, combined with a modest rise in the company tax rate, should be sufficient to offset the revenue losses to which full imputation will give rise.

Although the elimination of tax preferences will greatly enhance the effectiveness of a full imputation system in rationalising company and shareholder taxation, I am not sanguine that a great deal can be achieved in this area. Even if progress is made another problem may be created as increased company tax will give rise to the problem of overspill under foreign tax credit systems (see 3 above). Still, in the short term it is probably best to accept the risk of superimputation and not deal specifically with the problem of tax preferences.

There is one similar area, however, where simple acceptance of the problem probably will not be enough, namely foreign source income generated by companies. This leads up into the most significant area of all for the implementation of an imputation system - the treat of international flows of income.

5.2 International Issues

5.3.1 Outbound Investment

Where a company invests abroad and generates foreign source income, that income almost invariably will be taxed in the country of its source. New Zealand taxes its residents (including resident companies) on their world wide income and then gives credit against New Zealand tax liability for taxes paid in the country of source up to the limit of New Zealand tax referable to that income, NZITA Part VIII. In the result there will usually be little or no tax collected by New Zealand on the foreign operations of its companies. By way of contrast, although Australia formally levies tax on its residents' world wide income, the effect of ITAA s.23(q) is that income derived by Australian residents from sources outside Australia which is taxed in the country of source is exempt from Australian tax (except dividends received by individuals to which a tax credit regime applies, ITAA s.45, and except interest and royalties covered by tax treaties to which a tax credit regime also applies). The result is that currently in the Australian case no Australian tax will generally be collected on foreign source income, although a tax credit system is currently under consideration (Draft White Paper, 1985, Ch.20).

It is unlikely that either Australia or New Zealand will find it acceptable to give imputation credits for taxes paid to foreign countries and accordingly a special compensatory tax may be necessary to ensure that local tax is collected on dividends paid out of foreign source profits. This will give rise to similar, though not as drastic, problems as an advance corporation tax in the international area (see below). Alternatively and more desirably from the international point of view, it should be possible to require accounting mechanisms which will identify dividends paid out of foreign source income and to provide that such dividends do not attract the imputation gross-up and credit procedure.

The effect of any such mechanism would obviously be to discourage investment by Australian or New Zealand residents in overseas

countries, which may not be regarded as a desirable policy in the context of a rapidly developing Asia and the view that Australian and New Zealand investors should be active in the development of the region. The view has its greatest application to direct investment by Australian and New Zealand companies rather than by individuals and so there may be reason for treating companies and individuals differently. This kind of reasoning appealed to the Asprey Committee (1975, p.238) though its suggested solution does not have relevance to a full imputation system where the corporate and maximum individual marginal tax rates are the same.

I have glossed over some important distinctions in this discussion such as the possible different treatment of portfolio as compared to direct investment and of dividends received by individuals as compared to companies generally. The former issue is touched upon briefly in the next section while the latter is not addressed in the paper. It will depend upon the precise nature of the imputation system adopted how inter-company dividends are treated.

5.3.2 Inbound Investment

It is commonly provided in imputation systems overseas that the grossing-up and tax credit procedures are applicable only to resident shareholders of resident companies. With respect to other shareholders or other companies, the system operates in effect as a classical system with a tax at the corporate level and a separate tax on net dividends with no grossing-up in the hands of shareholders (there is gross up and credit in respect of dividend withholding taxes, but this is conceptually distinct from imputation which grosses up and credits company taxes). In the case of non-resident shareholders, that tax on dividends is the usual kind of withholding tax (the UK is an exception here - it abolished withholding tax when introducing its imputation system). The Asprey Committee suggested (1975, pp.236-237), as for that matter did the Campbell Committee in relation to its integration proposal (1981, pp.232-233), that Australia follow this route in introducing an imputation system.

It is not simple parochialism and a desire to protect the revenue which justifies these proposals. It is very difficult to collect tax directly from non-resident shareholders in view of the rule found in many legal systems, including our own, that the courts refuse to enforce revenue laws of another country, although this rule in the future will no doubt be much eroded by the tax treaty network (OECD, 1981). Moreover, in the case of individual non-resident

shareholders, only their Australian (or New Zealand) source income is included in assessable income with the result that, under the progressive rate scale, their tax rate will often be less than may be appropriate given their world wide income (even allowing for the fact that they are denied the benefit of the zero bracket in Australia).

In the case of Australia and New Zealand, it is as well to be frank and to admit that revenue considerations also loom large in the need for this kind of tax regime. The level of foreign investment is such that the extension of imputation credits to foreign investors would dramatically reduce tax collections from the corporate sector. It is for this reason that the dividend deduction and split rate systems cannot seriously be contemplated for Australia or New Zealand as no or reduced taxes are collected from the company under these systems and tax cannot effectively be collected directly from foreign shareholders unless discriminatory withholding taxes are levied. Moreover, because of the pressure that will be exerted by countries with major investments in Australia and New Zealand for extension of imputation credits to their residents, it is necessary to consider what are the appropriate fall back positions which will most successfully protect the tax revenues.

It has been cogently argued by McClure (1979, p.202) when considering this kind of problem in general (and not specifically in the context of countries which rely heavily on foreign investment), that imputation credits should be extended to foreign resident portfolios investors but not to foreign direct investors. This is on the theory that direct investment is most appropriately dealt with by an indirect tax credit of the country of residence of the direct investor, under which company tax paid by a subsidiary is credited against tax liability on dividends received from the subsidiary (the US and the UK provide this kind of credit on a unilateral basis). This method of dealing with the problem has received some recognition in tax treaties in recent times and may not be too costly in terms of revenue for Australia or New Zealand since most foreign investment is direct investment at the moment. However, the situation is changing rapidly as the internationalisation of securities markets proceeds apace and portfolio investment across national boundaries becomes common place.

If a full imputation system were introduced with the corporate and maximum marginal individual tax rates the same, it would make sense for Australia and New Zealand to abolish dividend withholding tax and branch profits tax since foreign investment which did not

attract an imputation credit would be taxed at the maximum marginal rate by the corporate tax alone. It might be argued that these taxes should still be retained as resident individuals generally will be paying similar amounts of tax in the context of current New Zealand and Australian proposals even though marginal tax rates are cut, because part of the income tax burden is replaced by indirect taxes and the policy reasons for this switch do not have any real relevance to foreign investors in order to encourage their investment (as occurs in New Zealand), branch profits tax and dividend withholding tax may still have a place in relation to income subject to the concessional tax rate. Considerations in relation to tax treaty bargaining lead to a similar conclusion; branch profits tax and dividend withholding tax could be levied generally, but foregone in the context of a treaty negotiation provided that imputation credits were not demanded for foreign investors (or at least for all foreign investors).

5.3.3 Tax Treaties and Non-Discrimination

Whilst the denial of imputation credits to non-resident shareholders is conceptually simple and has some policy justification, the difficulty with this position in international affairs is the treaty negotiating position of the USA which is most insistent that imputation credits should be granted to its residents. One possible solution to the problem would be for countries with an imputation system to apply a higher rate of withholding tax than countries with a classical system. Germany attempted this approach in the 1970's but was sternly rebuffed by the US which insists upon mirror image withholding rates in all tax treaties (McClure, 1979, p.89, 1984, pp.250-251, though this attitude may be changing, Reagan, 1985, pp.127-129). The alternative of operating in effect a classical system at the international level while operating an imputation system in favour of residents is that the US insists that such a regime contravenes the non-discrimination article common in modern treaties based on the OECD model (OECD 1977, pp.41-42, 162-174). Both Australia and New Zealand have ceded non-discrimination clauses in treaties recently negotiated with the US (Article 23 in each case; a similar article is also included in the treaty recently concluded between the UK and New Zealand). It should be noted that neither of these articles is as extensive in prohibiting discrimination as the OECD model.

A question arises as to whether the US position is justified. The Asprey Committee commented that the discrimination with which these clauses deal is discrimination against another country's

nationals which has never been contemplated; if imputation is to be denied to some shareholders it would be on the basis of their residence whatever their nationality (1975, pp.236-237). The Campbell Committee took the same view (1981, pp.232, relying on Kaplan, 1978). The matter is not dealt with specifically in the OECD model or commentary, but in regard to that part of the non-discrimination article providing that a permanent establishment which an enterprise of a contracting state has in the other contracting state shall not be less favourably treated for taxation purposes in that other state than the tax levied on enterprises of that other state carrying on the same activities, the following comments are made,

> "As regards that imputation system ... it seems doubtful, at least on a literal interpretation of the provisions ... whether it should be extended to non-resident companies in respect of dividends paid out of profits made by their permanent establishments. In fact, it has identical effects to those of the split rate system but these effects are not immediate as they occur only at the time of the shareholders personal taxation. From a purely economic and financial standpoint, however, it is conceivable that such profits should be treated as though they were profits of a distinct company in State A where the permanent establishment of a company which is a resident of State B is situated and, to the extent that they are distributed, carry the ... 'tax credit'. But to take the matter further, to avoid all discrimination it is necessary that this advantage should already have been accorded to shareholders who are residents of State B of companies which are residents of State A. From the practical standpoint, the two States concerned should, of course, agree upon the conditions ands procedures for allowing the ... 'tax credit' to shareholders who are themselves residents of either State, of the companies concerned that are residents of State B.
>
> Contracting states which are faced with the problems described above may settle them in bilateral negotiations in the light of their peculiar circumstances". (OECD, 1977, P.171).

The implication of the commentary is that the non-discrimination article does not require the extension of imputation credits to non-resident shareholders. If the non-discrimination article is infringed by the failure to extend credits, then the courts will give effect to

the treaty provision and require credits to be extended unless there is some provision in the tax legislation which makes it quite clear that the treaty cannot override the legislation (*Sun Life Assurance Co. of Canada*, 1984, pp.514-516, 519; in both Australia and New Zealand, treaties generally override local legislation, Australian *Income Tax (International Agreements) Act*, 1953, s.4, NZITA, s.294).

Whilst it seems that the US position in regard to non-discrimination is not justified, the position taken has certainly had an effect in treaty negotiation. The UK, France and Germany have in recent treaties granted imputation credits to certain US shareholders (the most extensive grant being by the UK to include direct investment as well as portfolio investment).

Canada recently negotiated a treaty with the US which does not contain provision for imputation credits for US shareholders (the UK also negotiated such a treaty but was forced to re-negotiate in this area, Kaplan, 1978). Canada was able to deny imputation credits because its system differs markedly from European systems in that credits are granted to shareholders irrespective of whether corporate tax has been paid on the income distributed. That is, there is no general equivalent of the advance corporation tax in Canada, apart from an equalisation tax in the small business area. This means that the relation between the corporate and shareholder taxes is more tenuous as shareholders are able to gain credits even where corporate tax has not been paid. The US accepted this distinction, though Canada did cede a withholding tax rate on dividends of 10%, which is lower than the 15% rate that applies to all its other treaties (Asprey, 1975, p.237. Peterson, 1975, Burge and Brown, 1979, Krever, 1985). It is for this reason that the suggestion has been made previously that Australia and New Zealand would be very wise to avoid any general equivalent of the advance corporation tax in any imputation system that was adopted, though it may be possible to operate an equalisation tax in the area of foreign source income of resident companies.

The difficulties of negotiating with the US can be demonstrated by the recent US Australia treaty. Although a member of the OECD, Australia's negotiating position is in many respects much closer to that of third world countries embodied in the UN model for developing countries (1980). This stance is demonstrated by Australia's wide definition of permanent establishment and its higher than OECD recommended withholding rates on dividends and royalties. The US has

a developing model tax treaty which is moving closer and closer to the OECD model (US Treasury, 1977b, 1981). The treaty negotiating process is a matter of give and take, and as Australia always insists on taking its higher withholding rates it has to give in other areas: in the new US treaty, this involved the insertion of Article 16 Limitation on Benefits designed to prevent treaty shopping, an issue taken up below, and Article 23 Non-Discrimination. The latter article is unique in Australia's treaties and was inserted, in a much watered down form, only with the greatest reluctance on negotiations (see *Income Tax (International Agreements) Act* 1953 Schedule 2). US negotiators with whom I have spoken were particularly struck by Australia's obstinacy in regard to the non-discrimination article.

If Australia and New Zealand were to adopt an imputation system, then extreme pressure would be brought to bear by the US, relying in particular on the non-discrimination clause, to extend imputation credits to US shareholders. It is unlikely that the US would be satisfied with limitation of the credit to US individual shareholders as foreign investment by the US in Australia is virtually all in the form of corporate investment. A model for such a limitation is found in the protocol to the Australia-UK agreement and Article 8 of the New Zealand-UK treaty, but special circumstances attach to these - they are a unilateral concession by the UK and are at the cost of a levy of 15% withholding tax (the UK usually not levying any withholding tax); in addition investment by Australian and New Zealand resident individuals in the UK companies is, for historical reasons, likely to be quite significant. An the UK even grants the credit, though it may not be strictly justified by the terms of the treaties, in some cases where the investment takes place through a trust for the benefit of individuals resident in Australia and New Zealand.

Although the UK concession is at the moment a bonus, it will become a positive nuisance in the context of the introduction of imputation systems in Australia and New Zealand. The UK will be quite justified in asking for reciprocal treatment for its residents, and once the example is set of granting credits pursuant to tax treaties, I doubt whether in the long term Australia or New Zealand would be successful in resisting US pressure for imputation credits though there may be some chance of limiting credits to either individual investors as under the UK treaties or portfolio investments, either of which will restrict revenue losses. As an ironic side note the US is now proposing a branch profits tax (Reagan, 1985, pp.405-408) even though it has in the past opposed such taxes on non-discrimination grounds.

Unfortunately, the revenue loss associated with such a development would be even greater than apparent at first sight, for the US would very likely become a tax haven with respect to investment in Australia and New Zealand, that is, investors from third countries would channel their investment through corporations incorporated in the US and seek to obtain the benefit of the imputation credits. The reasons why this activity may be workable are the US insistence on the place of incorporation as the only test for residence of US companies so that a corporation incorporated in the US but managed and controlled from a third country will be regarded as a US resident for the purposes of the Australia-US or New Zealand-US treaties, coupled with the provisions of *Internal Revenue Code* s.861(a)(2)(A), the so-called 80/20 rule (which is due for repeal under current US proposals, Reagan, 1985, pp.397-405). The UK is beginning to discover that the US can act as a tax haven as a result of its extension of imputation credits to US corporations. Articles 16 of the respective treaties would possibly prevent the more blatant examples of this kind of manipulation, but it would be hard to invoke Article 16 in the common case where an investor from a third country already has substantial investments in the US and then directs investment into Australia or New Zealand via the US

The position would become even worse if the US itself were to adopt an imputation system or its equivalent as has been recently recommended by the US Treasury (1984, Vol.1, pp.118-119, Vol.2 pp.134-144) and taken up in a watered down form by the Administration (Reagan, 1985, pp.120-129). This is because the US system if introduced would almost certainly be a dividend deduction system rather than a tax credit system, that is, a corporation would receive a partial tax deduction for dividends paid so that dividends bore less tax at the corporate level, the deduction being available whether the dividends were paid to US residents or non residents of treaty countries. The system would be structured to be the same as an imputation system which extends tax credits to foreign shareholders resident in treaty countries. If the US were prepared to take this approach, then undoubtedly it would demand that all other treaty countries with imputation systems automatically extend credits to all US shareholders. The US, of course, would stand to benefit in any case where its investment in a foreign country exceeded the foreign country's investment in the US, which will be virtually all cases.

There is an ominous note in the recent US tax reform proposals which warrants quotation in full (Reagan, 1985, pp.128-129).

"The United States benefits significantly from its bilateral income tax treaties and take seriously its obligations under those treaties. It is therefore reluctant unilaterally to violate the treaties. Accordingly, subject to the limitation expressed below, the proposed compensatory withholding tax initially would not be imposed generally with respect to dividends paid to shareholders resident in treaty countries, and the benefits of dividend relief thus would be extended unilaterally to such shareholders...

The United States would expect that countries that have not previously done so would extend the benefits of their dividend relief rules to United States residents. Treaty negotiations would thus be undertaken with that view. Unwillingness of treaty partners to negotiate meaningfully on this issue should cause a reversal in the decision unilaterally to extend benefits to foreign shareholders in treaty countries. The Administration would therefore propose to retain the authority, through certification by the Secretary of the Treasury, to impose a compensatory withholding tax on the residents of those treaty partners with which it is not possible to resolve issues concerning.. the granting of reciprocal benefits under the foreign imputation system."

What is particularly alarming is that the US is only proposing to introduce a 10% dividend deduction (equal to 10% imputation), yet apparently expects full imputation credits for its residents from treaty partners even where they have much more significant levels of imputation. This would particularly affect Australia and New Zealand which are contemplating 100% imputation.

5.3.4 Closer Economic Relations

Although adjustments to income tax laws are not dealt with generally in the trade agreement for closer economic relations (Australia New Zealand, 1983) an do not feature largely in the current Australian re-examination of closer economic relations (Senate Standing Committee on Industry and Trade, 1984), it would be a pity not to attempt to coordinate the corporate tax systems of both countries in a context where they are seriously developing imputation proposals as part of similar kinds of overhaul of the income tax system generally. The importance of taxes in the development of

closer economic ties is well demonstrated by the European Community where a considerable degree of harmonisation of corporate tax systems has been achieved. The simplest measure would be for Australia and New Zealand to extend imputation credits to each others residents whether investment be portfolio or direct.

However, apart from revenue loss problems that would arise from unequal investment flows across the Tasman, it would be difficult to extend imputation credits in this way whilst denying similar extension to US residents. Accordingly another mechanism must be found and it is tentatively suggested that the Treasury reimbursement method should be used. That is, Australia would grant imputation credits to its residents who held shares in Australian or New Zealand resident companies, while New Zealand would grant credits to its residents who own shares in New Zealand or Australian companies. In effect each government would be providing imputation credits in respect of corporate taxes collected by the other government and each year an appropriate adjustment would be made between the Treasuries of each country so that the cost of granting credits in respect of dividends for which company tax had not been collected would be passed on the agreed extent to the other Treasury.

A similar result could be achieved if the imputation system did not contain any equalisation tax for foreign source income of domestic companies because this would amount to the extension of imputation credits to outbound investment generally (see 5.3.1 above).

If consideration is being given to coordinating the laws of the two countries in respect of the imputation system, it might also be opportune to consider some of the tax avoidance practices that currently exist in relation to investment flows between the two countries. To take two examples of which I am aware, withholding tax can be effectively avoided on funds lent into New Zealand from Australia at the moment through the use of a Cook Islands base company in which the Australian "lender" invests by way of redeemable preference shares with the Cook Island company on lending the funds into New Zealand. Similarly Eurodollar loans which avoid withholding taxes can be made into New Zealand by a complex arrangement of loans and leases involving US 80/20 corporations, and US branches of Australian and New Zealand companies at various steps in the transaction.

6. Conclusion

The classical system of taxing companies and shareholders separately has serious flaws though the precise effects of the system in the complex and varying tax arrangements in the current system are difficult to define and tend to produce countervailing biases for different shareholders. Under the comprehensive definition of income as gain, the ideal method for taxing income derived through a company is to tax shareholders on dividends received and accrued capital gains each year grossed up for tax paid at the company level if a company level tax is retained, which is essential in Australia and New Zealand if foreign investment is to be effectively taxed. It has been assumed in my discussion that an accruals capital gains tax is not feasible and so the ideal system is ruled out of contention.

The second best method from the theoretical point of view is integration combined with a capital gains tax on a realisation basis which makes appropriate adjustments to the cost basis of share based on profits retained in the company. The proposals of the Campbell Committee do not completely reflect this method but could be combined with a capital gains tax. However, the problems of finding suitable methods to attribute profit retentions to shareholders in a fair and workable manner are insurmountable because of the impossibility of identifying the ultimate recipients of profits until they are distributed. The imputation system meets this difficulty but in turn creates problems of dealing with retentions under a capital gains tax, while the lack of capital gains taxation in combination with imputation produced discrimination among different groups of taxpayers.

The third best method of dealing with income derived through companies is fortunately capable of implementation. This is an imputation system - most desirably with the company tax rate and the maximum individual tax rate the same, tax preferences eliminated and a capital gains tax in effect. The continued existence of preferences and the absence of a capital gains tax are not fatal to this method

though its relative simplicity and effectiveness will be reduced in such circumstances. No general equivalent of the advance corporation tax should be adopted in the Australian or New Zealand context but a special compensating tax on foreign source income may be considered appropriate. Tax credits should generally be denied to foreign resident shareholders except pursuant to tax treaties where the maximum concession should be the extension of credits to either individuals or portfolio investors only.

Problems will still remain. If tax preferences are eliminated and the company tax rate is raised to 50%, there is likely to be overspill of foreign tax credits under the tax systems of many investing countries. The major difficulty will be the US position in treaty negotiations and if major tax reform goes ahead in the US, the likelihood of being able to deny imputation credits will be drastically reduced. Ironically the successful reform of the Australian and New Zealand company tax systems will be greatly enhanced by the failure of tax reform in the United States of America.

Otherwise we may be left in the world of fourth best, the continuation of classical system - dictated by the ugly assembly of legal and practical constraints which so often combine with the political forces of the day to defeat basic tax reform. I believe that we should aspire to third best.

Appendix 1

Classical System

The examples are based on a company income of $100, company tax at 46% or $46 and after tax company income of $54.

Payout of after tax profit	100% $54		50% $27		20% $10.8		0% $0	
Marginal rate of tax of individual shareholder	30%	60%	30%	60%	30%	60%	30%	60%
Company tax	46	46	46	46	46	46	46	46
Shareholder tax	16.2	32.4	8.1	16.2	3.2	6.5	0	0
Total taxes	62.2	78.4	54.1	62.2	49.2	52.5	46	46

Full Imputation

The examples are based on a company income of $100, company tax at 46% or $46 and after tax company income of $54.

Payout of after tax profit	100% $54		50% $27		20% $10.8		0% $0	
Marginal rate of tax of individual shareholder	30%	60%	30%	60%	30%	60%	30%	60%
Company tax	46	46	46	46	46	46	46	46
Net dividend	54	54	27	27	10.8	10.8	0	0
Company tax on dividend	46	46	23	23	9.2	9.2	0	0
Dividend and company tax (gross up)	100	100	50	50	20	20	0	0
Shareholder tax on grossed up dividend	30	60	15	30	6	12	0	0
Shareholder tax credit	46	46	23	23	9.2	9.2	0	0
Net tax on shareholder	(16)	14	(8)	7	(3.2)	2.8	0	0
Total taxes	30	60	38	53	42.8	48.8	46	46

Full dividend deduction system

The examples are based on a company income of $100, and company tax on retentions at 46%.

Payout of after tax profit	100%		50%		20%		0%	
Marginal rate of tax of individual shareholder	30%	60%	30%	60%	30%	60%	30%	60%
Company income	100	100	100	100	100	100	100	100
Dividend deduction	100	100	50	50	20	20	0	0
Net company income	0	0	50	50	80	80	100	100
Company level tax	0	0	23	23	36.8	36.8	46	46
Shareholder tax	30	60	15	30	6	12	0	0
Total taxes	30	60	38	53	42.8	48.8	46	46

Partial (50%) Imputation

The examples are based on a company income of $100, company tax at 46% or $46 and after tax company income of $54.

Payout of after tax profit	100% $54		50% $27		20% $10.8		0% $0	
Marginal rate of tax of individual shareholder	30%	60%	30%	60%	30%	60%	30%	60%
Company Tax	46	46	46	46	46	46	46	46
Net dividend	54	54	27	27	10.8	10.8	0	0
Company tax on dividend	46	46	23	23	9.2	9.2	0	0
Dividend and half company tax (gross up)	77	77	38.5	38.5	15.4	15.4	0	0
Shareholder tax on grossed up dividend	23.1	46.2	11.5	23.1	4.6	9.2	0	0
Shareholder tax credit	23	23	11.5	11.5	4.6	4.6	0	0
Net tax on shareholder	0.2	23.2	0	11.6	0	4.6	0	0
Total taxes	46.2	69.2	46	57.6	46	50.6	46	46

Full Integration

The examples are based on a company income of $100, company tax at 46% or $46 and after tax company income of $54.

Payout of after tax profit	100% $54		50% $27		20% $10.8		0% $0	
Marginal rate of tax of individual shareholder	30%	60%	30%	60%	30%	60%	30%	60%
Company tax	46	46	46	46	46	46	46	46
Income attributed to shareholder	100	100	100	100	100	100	100	100
Shareholder tax	30	60	30	60	30	60	30	60
Credit for company tax	46	46	46	46	46	46	46	46
Total taxes	30	60	30	60	30	60	30	60

Integration applied to 46% (and above) tax rate shareholders

The examples are based on a company income of $100, company tax at 46% or $46 and after tax company income of $54.

Payout of after tax profit	100%		50%		20%		0%	
Marginal rate of tax of individual shareholder	30%	60%	30%	60%	30%	60%	30%	60%
Company tax	46	46	46	46	46	46	46	46
Income at-attributed to shareholder	0	100	0	100	0	100	0	100
Shareholder tax	0	60	0	60	0	60	0	60
Credit for company tax	0	46	0	46	0	46	0	46
Total taxes	46	60	46	60	46	60	46	60

Interest Payments by company

The examples are based on a company income of $100 (before interest deduction) and interest payment of $100.

Marginal rate of tax of individual shareholder	30%	60%
Company tax	0	0
Income of holder of company debt	100	100
Tax on debt holder	30	60

Appendix 2 - References and Cases

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