

Some Comments on Modelling the Effects of Mutual Recognition of Imputation/Frinking Credits

R.R.Officer

2nd November 2012

- The respective Australian and New Zealand company tax systems are both based on a full Imputation Tax System. Such a system gives rise to imputation or franking credits associated with a franked dividend. Such credits are able to offset other tax liabilities or in Australia's case if there are no tax liabilities (tax exempts) the credits are distributed. In the case of the offsets the credits are really a pre-payment of personal tax liabilities at the company level; in both situations the credits reduce or in the extreme, eliminate company tax. A company tax system that eliminates the 'double taxation' of corporate income i.e. company tax is applied to the taxable income and then personal tax is applied, is an Integrated Company Tax System. Such a system was recommended as the ideal company tax system by the Campbell Enquiry.
- The rationale for changing from a Classical Tax System, where tax is applied to company profits and the dividend distributions are taxed again at personal tax rates, to a Full Imputation system was to remove the double taxation of the Classical Tax System. Under an imputation system credit is given for the tax paid by the company when dividends are distributed. Removal of the double tax has the advantage that it discourages entities being formed simply to avoid the tax, it also removes the tax penalty attached to equity so that a more equitable tax balance is applied to equity and debt of a company leading to more efficient capital structures and it encourages companies to distribute their profits removing 'agency costs' attached to retained earnings. In effect, an Imputation Tax System is a more 'efficient' tax system than the Classical System.
- The two countries' company (Imputation) tax systems look very similar but their effect on the respective economies is likely to be significantly different because of the interaction of the imputation company tax system with other forms of taxation, particularly personal taxation and what is defined as taxable income on which credits are earned. It would be mistake to assume that the efficiencies gained by the introduction or presence of an imputation tax and the reduction but not elimination of the company tax are of the same relative magnitude in each country. The issue goes to the heart of modelling the mutual recognition of franking credits (MRIC) and the assumptions employed in order to obtain numerical estimates of the value of MRIC. In economics and finance "models are to be used but never to be believed".

- The problem is compounded when general equilibrium models of the economies are used (but often not designed) to test the effect of MRIC. Such models employ a large number of assumptions (implicit as well as explicit) whose specific effects are often not well understood. It is for this reason I have chosen to explore the ‘boundary conditions’ for an MRIC and the direction of effects and their implications.

Alternative States:

1. Frictionless and open capital markets and unilateral acceptance of credits.

Both countries are such a small component of world capital markets that with frictionless and open capital markets the cost of capital is determined by the world capital market. The amount of capital employed in the respective countries will be invariant irrespective of the domestic tax policies applied to the tax residents as distinct from foreign investors. A reduction in the double tax for residents could be expected to lead to an increase in investment by residents and an equivalent reduction or ‘crowding out’ of capital by overseas investors and conversely. There are no ‘efficiency gains’ to investment with the introduction of an imputation tax under such an assumption of frictionless and open capital markets.

Let us now suppose that Australia decides to unilaterally recognise, give credit, for the NZ imputation credits – effectively compensating Australian investors in NZ for the company tax that is implicit in the dividends they receive from their NZ investments. Such a move would increase Australian investment in NZ but it would ‘crowd out’ an equivalent amount of existing capital invested, under the assumption the cost of capital is set exogenously to the NZ economy.

There would be no benefit to NZ investments from such a unilateral recognition of imputation credits. However, there would be a cost to the Australian Treasury of the NZ credits recognised. The advantage is to Australian investors who could broaden their portfolios and/or take advantage of investments in another market that previously had the penalty of double taxation. There would be, of course, be ‘wind fall gains’ to existing Australian investors in NZ.

There is not an offsetting benefit to the NZ Treasury except in the circumstance that the Australian capital crowded out local capital, in these circumstances NZ would collect tax without having to pay for any redemption of credits. However, where the Australian capital ‘crowded out’ off-shore investors the NZ Treasury would still collect the same amount of tax as before the unilateral recognition of the credits by Australia.

As it has been pointed out elsewhere when there is a unilateral recognition of credits there is not the benefit that arises with a unilateral removal of tariffs.

2. Frictionless and open capital markets and bi-lateral acceptance of credits.

The results would be similar to those above except it would extend to both countries. There would be no change in the amount invested but the Treasuries of both countries would have to meet the cost of credit redemptions, as an offset the respective Treasuries would receive

benefit to the extent each country ‘crowded out’ the home country capital. The net position would be a function of how much capital moved across the Tasman from the respective countries and the amount of domestic capital replaced in the respective countries. Estimates suggest the NZ Treasury stands to have a net gain and Australia Treasury a loss.

There is an advantage to those investors of both countries who are or will become investors across the Tasman in terms of broadening portfolios and ‘wind-fall gains’.

3. *Closed capital markets, except across the Tasman, and bi-lateral acceptance of credits*

Both countries could be expected to benefit from the increased investment as a result of lowering of the cost of capital and the greater capital flows. As above in 2, both countries investors would benefit and the net position of the respective Treasuries could be expected to be a function of the capital movement would depend on the relative amount of capital moving across the Tasman. It is likely that the Australian treasury could suffer a net loss but this does not imply the country would be worse off because the increased investment could offset that position. To the extent the Australian Treasury suffered a net loss the NZ Treasury would obtain a gain as the ‘first round’ losses/gains are a zero sum game with closed capital markets except for those across the Tasman.

4. *Segmented capital markets and bi-lateral acceptance of credits*

The most realistic scenario is likely to be that where large companies can access international capital markets but the ‘frictional costs’ are prohibitive for small companies under current tax regimes. In these circumstances the major beneficiaries to the MRIC are likely to be small companies whose costs of capital are likely to be lowered in the respective countries by the MRIC. There would be clear benefits in investment outcomes along the lines already discussed. The only detriment is likely to be the net position of the respective Treasuries such that one benefitted (in the ‘first round effects’) relative to the other.

There are benefits in extending the imputation system across the whole of Australasia for the same reasons the respective countries introduced an imputation tax system including extending the benefits of CER to financial markets. So that the net position of the respective Treasuries should not be the ultimate determinant of a decision with respect to the MRIC since it is always open and feasible to have a netting of credits between the Treasuries such that each compensated the other for the payments or credits made of their respective countries credit liabilities.