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International trends in dividend taxation

Implications for Australian Companies and Tax Policy

Report prepared for the ASX

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Overview

Over the last decade, governments around the world have introduced an extensive range of reforms to their dividend taxation regimes to meet the needs of their increasingly open economies.

This report outlines the key challenges governments face when reviewing and reforming their dividend taxation regimes, identifies the key international trends in the way they are seeking to address those problems, and examines the implications of those trends for Australian companies, their shareholders, and Australian tax policy.

In particular, it places the options for dividend taxation reform proposed in the Treasury *Review of International Taxation Arrangements* consultation paper into perspective with those international trends and identifies other related options that need to be explored further by government.

Reductions in tax rates

Perhaps the greatest challenge facing governments is the need to raise revenue in a more efficient manner. In the past, most governments relied heavily on income tax as their main source of revenue. However, there is now widespread international recognition of high and rising costs of taxing income from capital.

This concern for the costs of taxing income from capital is responsible for what is probably the most noticeable, significant and sustained international trend in dividend taxation – the trend towards reducing tax rates on income from capital, particularly the rates of tax imposed on dividend income.

In view of the increasing mobility of capital, most countries, including Australia, have been focussing their attention on reducing company tax rates in order to reduce the cost of capital, increase investment and international competitiveness. As discussed in section 4 of this report, reductions in foreign company tax rates will have benefited Australian multinational companies that have investments in those countries. In addition, reductions in Australia's company tax rate will have benefited all Australian companies by reducing effective tax rates on shareholders' income, reducing the cost of capital, and increasing shareholder value.

However, as discussed in section 5, reducing the rates of tax imposed on the income of foreign investors also increases the effective tax rate imposed on saving. As a result, many countries have accompanied their reductions in company tax rates with reductions in the rates of personal tax imposed on income from capital, particularly dividend income.

Given the high statutory rates of personal tax applying in Australia to most resident shareholders and Australia's relatively low rates of tax on the income of foreign shareholders, consideration needs to be given to reducing personal tax rates in order to reduce the disincentive for Australians to save and invest.

If Australia wants to reduce disincentives to save and invest, improve the quality of investment, increase its ability to attract and retain skilled labour, and enhance its prospects for increased growth and employment, the preferable approach it to implement lower and more uniform rates of personal income tax.

In order to achieve the greatest possible improvement in the efficiency of the income tax system, a reduction in personal tax rates is best achieved by **reducing the top personal rate of income tax** since:

- the deadweight costs of raising tax revenue rise more than proportionately as the rate of tax increases; and
- most saving and investment in Australia is undertaken by individuals subject to that top marginal tax rate.

If further reductions in the top personal tax rate are not possible due to either revenue concerns, or concerns about the perceived equity of the tax system, then consideration should also be given to **implementing a dual income tax regime**. This would subject income from capital to a low flat rate of tax, but would continue to tax all income from labour at current statutory marginal rates of tax.

The main advantages of such an approach are that it would reduce the disincentive to save and invest while lowering the fiscal cost of such a reduction and preserving the perceived equity of the tax system.

These advantages would be offset to some extent, however, by the potential efficiency losses from applying different rates of tax to income from capital and income from labour. This would encourage tax planning and distort individuals' decisions regarding the manner in which to organise their business activities (eg it would provide an incentive for individuals to incorporate and recharacterise their labour income as income from capital).

Alternatively, personal tax rate reductions could be restricted to dividend income by **implementing a split rate tax system**. This would apply a lower rate of personal tax to income from capital when it is distributed. The main advantage of such an approach is that it would potentially reduce the disincentive for individuals to save and invest in shares at lower revenue cost that the options outlined above. Once again, however, those advantages would be offset to some extent by the potential efficiency losses from taxing distributions of income at a rate lower than retained earnings, which could distort companies' finance decisions and dividend policy.

Shift away from dividend imputation

Another significant, but less obvious, trend in international dividend taxation is the shift away from dividend imputation regimes.

Rather than provide shareholders with an imputation credit for the amount of company tax paid, many countries now simply reduce the amount of personal tax paid on that dividend income, regardless of the amount of company tax paid on that income or the source of that income. This is achieved either by providing a notional tax credit equal to some proportion of the value of the dividend, or by exempting part or all of the dividend income from personal tax. For example, the United Kingdom has replaced its partial dividend imputation regime with a regime that provides shareholders with a notional tax credit equal to 1/9th of the value of the dividend.

It is important to note that those reforms are not directed solely at reducing the cost of capital and increasing the overall level of investment in the economy. Rather, they are also directed at reducing:

- the disincentive for residents to save and invest, by reducing the rate of personal tax imposed on their dividend income;
- the distortions in patterns of investment by residents; and

- the compliance and administrative costs associated with dividend imputation regimes.

This international trend away from dividend imputation regimes is discussed in Chapter 2 and Appendix 2.1 of the *Review of International Taxation Arrangements* consultation paper (the 'consultation paper'). However, Chapter 2 has a very narrow focus. It seeks only to reduce the shareholder level bias against Australian shareholders investing offshore through Australian multinational companies **if it can be established that this would reduce the cost of capital**.

The consultation paper notes that returning to a classical tax system would reduce this bias but rejects that option on the grounds that it would re-introduce all of the problems the imputation regime was implemented to address. This is confirmed by the results of the analysis in section 4 and 5 of this report, which indicate that returning to a classical tax system, while retaining personal tax rates at their current levels, would adversely affect Australian companies and their shareholders.

In addition, the consultation paper notes that this bias could be reduced by implementing a UK style notional tax credit regime. However, this approach is rejected in view of its potential revenue cost, potentially adverse impact on low marginal tax rate individuals, and transitional concerns.

The consultation proposes a number of 'alternative' options that would involve less significant change for taxpayers:

- Option A, which would involve the application of a UK style notional tax credit to dividends that are paid out of foreign source income from listed countries (ie unfranked dividends).
- Option B, which would allow foreign source income to be streamed to foreign shareholders (without reducing the imputation credits that can be provided to Australian shareholders, or the amount of exempt dividends that can be paid to foreign shareholders out of the foreign dividend account).
- Option C, which would provide franking credits for foreign dividend withholding taxes.

Section 4 of this report confirms that, if it is assumed that the marginal investor is a foreign shareholder, then the implementation of a UK style notional tax credit regime, option A, or option C are unlikely to reduce the cost of capital of Australian companies. However, it also shows that those options have the potential to reduce the effective tax rates imposed on the income of Australian shareholders and increase shareholder value.

Those results do not mean that such options for reform should be abandoned since they would not reduce the cost of capital and would only provide 'windfall' gains for Australian shareholders. Rather, those results suggest that such options provide a range of alternative approaches for the government to reduce the current tax disincentive for Australians to save and invest by reducing rates of personal tax on dividend income.

Indeed, the results suggest that implementation of a UK style notional tax credit regime is worthy of much more detailed analysis, since it would:

- reduce the disincentive for Australians to save and invest if the notional credit rate was set at a rate sufficiently high to reduce the effective marginal rates of tax on shareholder's income below their current levels;
- reduce the current disincentive for Australian shareholders to invest offshore through Australian multinational companies by providing those shareholders with a notional credit for the amount of foreign company tax imposed on their foreign source income; and
- reduce administrative and compliance costs by simplifying the imputation regime.

In addition, the analysis in section 5 also suggests that such a reform could reduce the cost of capital in those cases where capital market imperfections constrain the access of Australian companies to international capital markets (eg due to the existence of asymmetric information between Australian companies and foreign shareholders).

If the government is reluctant to consider replacing the dividend imputation regime with a UK style notional tax credit regime, then it should consider **implementing option A** instead. In effect, this would restrict the personal tax rate reductions to dividend income from listed countries. Such a reform would:

- enable the current dividend imputation regime to be retained for those companies that have no foreign source income;
- reduce the effective marginal tax rate imposed on that foreign source income, thereby reducing the disincentive for Australian investors to invest offshore through Australian multinational companies;
- reduce the cost of capital for those Australian companies with restricted access to international capital markets; and
- involve a lower revenue cost than replacing the current dividend imputation regime with a UK style notion credit regime.

If fiscal constraints also preclude the implementation of option A, then consideration should be given to **implementing option C**. Such an approach has the potential to:

- reduce the effective marginal tax rate imposed on that foreign source income, thereby reducing the disincentive for Australian investors to invest offshore through Australian multinational companies;
- reduce the cost of capital for those Australian companies with restricted access to international capital markets;
- encourage the repatriation of profits back to Australia;
- involve a lower revenue cost than option A, since no credit would be provided for the underlying company tax paid.

Consideration also needs to be given to **pursuing a more strategic approach to negotiating Australia's double tax treaties**. In addition to considering whether the recently negotiated protocol to the Australia-United States tax treaty provides an appropriate basis for future treaty negotiations (option 3.5 of the Treasury consultation paper), the Government should be seeking to develop, and maintain, a much more detailed information on:

- the nature and extent of Australian investments in the treaty country and treaty country investments in Australia; and
- the sensitivity of those investments to changes in the taxes governed by the treaty.

Clarifying the source of dividend income

Irrespective of the government's decisions relating to options A and C, Australia would benefit from implementing option B to allow conduit income to flow through Australian multinational companies without adverse tax consequences for either Australian or foreign shareholders.

In particular, the results of the analysis in this report suggest that **implementing option B** would:

- reduce the effective tax rates imposed on the dividend income of Australian shareholders in Australian multinational companies with significant foreign investments and foreign shareholders, thereby reducing the current bias against investing offshore through Australian multinational companies;
- potentially reduce the cost of capital for those companies by reducing the effective tax rate imposed on the dividend income of foreign shareholders in Australian multinational companies;
- reduce the incentive for Australian companies to shift their operations offshore;
- reduce the need for Australian companies to set up complex dual listed company structures to stream foreign source income to foreign shareholders and Australian source income to Australian shareholders; and
- reduce the disincentive for foreign multinational companies to set up their regional headquarters in Australia.

Simplifying the measurement of foreign source income

Expanding the list of broadly exempted countries to include additional countries that are currently unlisted would potentially benefit those Australian companies and their shareholders that derive income from such countries.

The results of the analysis in this report suggest that although such a reform is unlikely to reduce the cost of capital for Australian companies, it would benefit Australia by significantly reducing the compliance costs incurred by those companies that have significant investments in unlisted countries.

Rather than introduce further piecemeal reforms to the current CFC and FIF regimes, however, it would be preferable to undertake a comprehensive review of those regimes. An important function of that review would be to clarify the policy objectives of those regimes and explore alternative options for reducing the compliance costs while ensuring that Australian shareholders are not able to defer tax by accumulating profits offshore in low tax jurisdictions.

Executive Summary

Pressures for Change

Over the last two decades, widespread deregulation of international trade and foreign investment, coupled with rapid advances in communications and transportation technologies, has resulted in the 'globalisation' of world markets and the emergence of an increasing number of multinational companies.

Many Australian companies, for example, have expanded their activities offshore and now earn significant amounts of foreign source income and are attracting increasing numbers of foreign shareholders.

Those developments have placed pressure on governments around the world to review and reform their dividend taxation regimes, since those regimes were originally designed to meet the needs of closed, rather than increasingly open, domestic economies.

In response to those pressures for change, governments have introduced extensive reforms to their dividend taxation regimes aimed at reducing the extent to which their income tax systems deter saving and investment, increase the domestic cost of capital, and reduce international competitiveness.

Objectives of this Report

This report:

- outlines the common problems, or 'key challenges', those dividend taxation reforms are intended to address;
- identifies the key trends in the manner in which governments are seeking to address those problems; and
- analyses the implications of those key trends for Australian companies, their shareholders, and Australian taxation policy.

Key Challenges in Dividend Taxation

Section 2 of the report outlines the fundamental tax policy objectives governments are seeking to achieve when reviewing and reforming their dividend taxation regimes, and the common problems, or 'key challenges' governments encounter when seeking to improve the extent to which their tax regimes achieve those objectives.

Tax policy objectives

When reviewing and reforming their income tax regimes, and the rules governing the taxation of shareholders' income, governments are seeking to improve the ability of those regimes to achieve three fundamental, but potentially conflicting, tax policy objectives:

- **Efficiency**. Ideally, the income tax regime should be 'efficient'. That is, it should be capable of raising revenue in a manner the does not impose any net cost on the nation as a whole. In practice, however, all income tax regimes deter saving and investment, distort patterns of investment as well as decisions regarding the best way to organise and finance business activities, and impose significant compliance costs on taxpayers and administrative costs on governments. These unintended effects of income taxation impose a 'deadweight cost' on the nation as a whole by reducing the overall efficiency with which the economy operates. In general, the magnitude of those deadweight costs is greater the higher the rate of income tax, the greater the differences in tax rates imposed on the incomes from alternative investments, and the more sensitive investment decisions are to levels and differences in tax rates. In view of the increasing mobility of physical and financial capital, the deadweight costs of taxing income from capital are likely to be rising over time in view of the increasing sensitivity of investment decisions to tax. In principle, the greatest improvements in efficiency can be made by reducing the rates of tax imposed on those investments that are the most sensitive to tax. This explains why the governments of many small capital importing nations such as Australia have reduced the rates of tax imposed on the income of foreign investors, particularly the income derived from portfolio debt and equity investments that are sensitive to tax.
- **Equity**. Ideally, the income tax regime should also be equitable. That is, it should be capable of raising revenue in a manner that is consistent with the government's equity objectives. In practice, however, attempts to improve the equity of the tax system can reduce its overall efficiency. For example, in the past, many governments sought to improve the perceived equity of their income tax regimes by subjecting income from capital to a schedule of increasing statutory rates of personal tax. However, in recognition of the high and rising deadweight costs of taxing income from capital, many governments now apply a lower flat rate of tax to income from capital, and only subject income from labour to increasing rates of personal tax.
- **Sustainability**. Ideally, the income tax regime should also be a sustainable source of revenue in the longer term. In practice, however, the increasing mobility of both financial and physical capital, as well as skilled labour, is raising questions about the sustainability of the income tax regime as an efficient source of revenue in the future. This is the reason why governments have been choosing to raise a greater proportion of their revenue from more efficient and sustainable sources of revenue such as consumption taxation.

When seeking to improve the ability of their income tax regimes to achieve those three fundamental tax policy objectives, however, all governments face a number of 'key challenges', or common problems, with the taxation of shareholders' income.

Problems with the accurate measurement of shareholders' income

The problems associated with the accurate measurement of shareholders' income significantly constrain the government's ability to improve the efficiency, equity and sustainability of the income tax regime.

In principle, the design of an efficient and equitable income tax system requires accurate measurement of the domestic source income of resident shareholders, the foreign source income of resident shareholders, and the domestic source income of foreign shareholders.

In practice, however, this is difficult due to:

- **Problems measuring the amount of income earned by each shareholder**. There are practical problems associated with:
  - **measuring shareholder income as it accrues**. Although some forms of income, such as cash dividends, are easy to measure, other forms of shareholder income such as accrued gains in the value of shares, are much more difficult to measure. For example, changes in the market value of shares in private companies are particularly difficult to measure. Even the market price of shares in publicly listed companies may not provide a reliable guide to the actual value of those shares unless the total stock of shares is changing hands frequently. As a result, rather than measure income as it accrues, governments are forced to defer the assessment of tax on that income until it is received by the shareholder in the form of dividend income, or realised by the shareholder on the sale of shares in the company; and
  - **attributing that accrued income to each shareholder**. Even if shareholder income could be measured as it accrues, further problems arise when trying to attribute that accrued income to individual shareholders. This is a relatively easy task for small, closely held, companies that only have one class of shares that do not change ownership. This is the reason why some countries treat such companies in the same manner as partnerships for tax purposes. However, it is a much more difficult task for large, widely held, publicly listed, companies with multiple classes of shares that are traded on the share market. Once again, these problems mean that an assessment of the amount of income derived by each shareholder can only be made once the company's income has been distributed to shareholders or when individuals sell their shares;
- **Problems determining the source of shareholders' income**. Most countries determine the source of dividend income being the country in which the company is resident for tax purposes. This simple rule for determining the source of dividend income used to work reasonably well when companies only undertook investments in their home countries, and only had resident shareholders. Over the last few years, however, the accuracy of that simple rule has been eroded significantly by the emergence of an increasing number of multinational companies that have offshore investments and foreign shareholders. Application of this simple rule to those multinational companies can result in significant errors in the measurement of the source of dividend income. For example, it can result in the foreign source income of foreign shareholders that flows through resident company (ie conduit income) being deemed to be domestic source income and subjected to domestic tax.

Problems collecting tax on shareholders' income

These practical problems with the measurement of shareholders' income also create problems for governments when they are:

- **Collecting tax on the domestic source income of resident shareholders**. As noted above, governments must wait until shareholders either receive income from a company, or sell their shares in the company, before they can assess the amount of tax payable on that income. As a result, in the absence of a company tax regime, shareholders would have significant scope to avoid tax on their income by accumulating it in companies. This is the reason why governments retain a company tax regime, even though this creates further problems in the form of potential double taxation of shareholder income. The company tax regime provides a mechanism for levying an interim withholding tax on the income that shareholders accrue from the retained earnings of the company. This not only reduces the scope for shareholders to avoid tax by accumulating income in the company, but its also reduces the scope for shareholders to evade tax on their dividend income by failing to declare that income, and helps reduce the administrative costs associated with the collection of tax on dividend income, since there are far fewer companies paying dividends than shareholders receiving dividends;

- **Collecting tax on the foreign source income of resident shareholders**. Governments face even greater problems collecting tax on this income since they do not have the power to require foreign companies to levy a withholding tax on that income. Rather, in the absence of any special rules, governments would have to wait until that income is distributed back to resident shareholders in the form of dividend income, or residents sell their shares in the foreign company. Since this would provide resident shareholders with significant scope to avoid tax by accumulating it offshore in low tax jurisdictions, many governments have introduced special rules to measure and tax that foreign source income as it accrues (eg 'controlled foreign company' and 'foreign investment fund' regimes). In view of the complexity of those regimes, however, many governments are now seeking to simplify those regimes in order to reduce compliance and administrative costs; and
- **Collecting tax on the domestic source income of foreign shareholders**. Tax is difficult to collect on this income in view of the difficulties associated with trying to require foreign shareholders to submit tax returns. As a result, governments typically use the company tax regime and dividend withholding taxes to levy final withholding taxes on that income. The company tax regime is used to levy a final withholding tax on the income foreign shareholders accrue from the retained earnings of the company and the dividend withholding tax regime imposes a final withholding tax on the dividend income foreign shareholders receive from the company. The application of these final withholding taxes is intended to reduce the scope for foreign shareholders to defer, avoid, or evade domestic tax on that income.

Problems determining the appropriate rates of tax to apply to shareholders' income

Perhaps the greatest problem governments face when reviewing and reforming their dividend taxation regimes is determining the appropriate rates of tax to apply to the:

- **Domestic source income of resident shareholders**. When determining the rates of tax to apply to the domestic source income of resident shareholders, governments must first determine how much revenue they need to raise, and then determine how to raise that revenue in the most efficient manner. In the past, most governments used to rely on the income tax regime as a convenient source of revenue and were continually raising their rates of company and personal income tax to fund their increasing expenditure needs, with little regard for the deadweight costs of raising that revenue. By the early 1980s, however, most governments had recognised that their income tax regimes were no longer an efficient and sustainable source of revenue. As a result, since then governments have been seeking to improve the efficiency of their income tax regimes by broadening the tax base to include a wider range of income and implementing lower and more uniform rates of income tax. Many governments have gone even further by introducing dual income tax regimes, or split rate systems, that impose a low flat rate of tax on certain forms of income from capital, including dividend income, while continuing to tax labour income at increasing rates of personal income tax. Although this has the potential to reduce the extent to which the income tax system deters saving and investment, in so doing, it also creates additional problems. In particular, it has the potential to reduce the efficiency of the tax system by distorting patterns of investment. In addition, it can undermine the ability of the income tax regime to provide a sustainable source of revenue by providing taxpayers with opportunities to reduce their income tax liabilities by recharacterising labour income as income from capital.

- **Foreign source income of resident shareholders**. Most governments seek to tax the worldwide income of their resident shareholders at the same tax rates as are applied to their domestic source income in order to ensure that the tax system does not unintentionally distort choices between alternative domestic and offshore investments. In view of the practical problems associated with the accurate measurement of that foreign source income, however, this is not always possible. Most governments have introduced special rules to measure the income that resident shareholders accrue from their foreign investments. However, the complexity of those rules has meant that they have had to be confined to those investments where the scope for avoidance of domestic tax is greatest. In other words, governments face the problem of having to make complex trade-offs between the potential efficiency gains from improving the measurement of the foreign source income of resident shareholders, against the potential losses in efficiency arising from the high compliance and administrative costs associated with those rules.

- **Domestic source income of foreign shareholders**. The determination of the appropriate rate of tax to impose on the domestic source dividend income of foreign shareholders is particularly problematic for the governments of small, open, capital importing countries like Australia. In view of the increasing mobility of capital, those governments now recognise that the imposition of domestic tax on the income of foreign investors can deter foreign investment, raise the domestic cost of capital, and reduce international competitiveness. The extent to which this will occur depends on two main factors - the extent to which domestic taxes alter the total tax rate applying to the foreign investor's domestic source income, and the sensitivity of foreign investment to any changes in that total tax. Where foreign investors are able to claim the full amount of domestic tax paid against their home country tax liabilities, reducing the amount of domestic tax levied on that income will not reduce the total tax rate applying to the domestic source income of foreign investors. Rather, all it will do is reduce national welfare by transferring revenue to the foreign revenue authority. By contrast, where foreign investors are not able to credit the full amount of tax against their home country tax liabilities, reductions in the rate of domestic tax do have the potential to reduce the total tax rate imposed on the foreign investor's domestic source income. The sensitivity of foreign investment to such changes in that total tax rate also varies considerably across investments. Foreign portfolio debt and equity investment is generally highly sensitive to changes in tax rates due to the availability of alternative investments in other countries. By contrast, foreign direct investment tends to be less sensitive to changes in tax rates since alternative investments are not as readily available. This is the reason why many governments have sought to eliminate or at least significantly reduce, the rates of domestic tax imposed on foreign portfolio investments, whereas they continue to apply higher rates of tax on the income from foreign direct investment.

Problems reducing the double taxation of shareholders' income

In addition to determining the appropriate rates of tax to apply to shareholders' income, governments also face the problem of reducing the:

- **Double taxation of the domestic source income of resident shareholders**. Although governments have retained their company tax regimes to reduce the scope for shareholders to avoid or evade tax on their income, this means that shareholders' income is potentially subject to double domestic taxation – once when it is earned by the company, and again when it is distributed to shareholders. As a result, many governments have sought to integrate their company and personal income tax regimes to reduce the scope for such double domestic taxation. In principle, shareholders should be provided with relief from the double taxation of all of their income. Due to the problems associated with the measurement of income as it accrues, and the attribution of that accrued income to individual shareholders, however, it is not possible to fully integrate the company and personal income tax regimes. Rather, it is only possible to provide double taxation relief for dividend income. This is the reason why no country has fully integrated its company and personal income tax regimes. Rather, most countries have developed partial integration regimes that only provide relief from double taxation for the domestic source dividend income of resident shareholders. It is important to note, however, that such partial integration regimes potentially impose significant compliance costs on taxpayers and administrative costs on governments. As a result, some countries, such as the United States, still continue to operate classical tax regimes, and many other countries have replaced their dividend imputation regimes with either modified imputation regimes or modified classical tax regimes that provide relief at the shareholder level regardless of the amount of company tax paid, or the source of that dividend income.

- **Double taxation of the foreign source income of resident shareholders**. The foreign source income of resident shareholders is also potentially subject to multiple layers of foreign and domestic taxation. For example, consider the case of income earned by a foreign company that is then distributed to a domestic company, before being distributed to a resident shareholder. Such income can be subject to **double foreign taxation** – once when it is earned by a foreign company and again when it is distributed to shareholders, **double international taxation** – foreign taxation and domestic taxation, and **double domestic taxation** – once when it is earned by a domestic company, and again when it is distributed to the resident shareholder. Until recently, most countries used a combination of dividend imputation and foreign tax credit regimes to relieve that double taxation. In particular, most governments used dividend imputation regimes to provide resident shareholders with relief from double domestic taxation of their foreign source income. In addition, shareholders receiving foreign source income direct from foreign companies were provided with foreign tax credits to relieve the double international taxation of their income. However, the dividend imputation regimes operating in most countries, including Australia, did not provide resident shareholders with relief from the double international taxation of the foreign source income they earn through domestic companies, or relief for the full amount of foreign company tax paid on their foreign source income. As a result, there was a bias against investment offshore through resident multinational companies as well as an overall bias against investment offshore. In order to reduce that bias, many countries have abandoned their dividend imputation regimes in favour of modified imputation regimes and modified classical tax regimes that provide double tax relief to shareholders regardless of the source of dividend income. It is important to recognise, however, that in seeking to improve world welfare through the provision of foreign tax credits a government might reduce national welfare by distorting the pattern of investment by domestic shareholders. That is, governments face a complex trade-off between their national welfare objectives on the one hand, and their world welfare maximisation objectives on the other.

- **Double taxation of the domestic source income of foreign shareholders**. Most countries collect tax on the domestic source income of foreign shareholders through the imposition of company tax and dividend withholding tax. Once again, this creates scope for the double domestic taxation of that income – once at the company level when it is earned, and again at the shareholder level when dividends are distributed to foreign shareholders.

Key Trends in Dividend Taxation

Section 3 of the report identifies the key trends in the manner in which governments are seeking to address the problems identified in section 2.

Reductions in tax rates

The most significant and sustained international trend is the ongoing reduction in rates of tax imposed on income from capital, particularly dividend income. This is intended to reduce the extent to which the income tax system deters saving and investment, increases the cost of capital, distorts patterns of investment, and reduces international competitiveness.

This has involved:

- **A shift away from income taxes to alternative tax bases**. In recognition of the high and rising costs of raising revenue through income taxation, most governments have introduced indirect consumption tax regimes (ie VAT or GST regimes) in order to broaden their tax base and reduce their reliance on income tax as a source of revenue. Consideration has also been given in the United States, the United Kingdom and New Zealand to the replacement of the income tax regime with either a direct consumption tax, or a cash flow tax. To date, however, most countries continue to raise a significant proportion of their revenue by taxing income.
- **Broadening of the income tax base**. In addition to broadening the tax base through the introduction of indirect consumption tax regimes, most governments have also sought to broaden their income tax bases to include a wider range of income from capital, such as capital gains, and have phased out special investment and accelerated depreciation allowances. Those reforms are intended to impose a more uniform rate of tax on the income from alternative investments in order to reduce the extent to which the tax system distorts patterns of investment.
- **Reductions in the company tax rate**. Perhaps the most noticeable development is the ongoing international trend to reduce statutory or 'headline' rates of company tax. In view of the increasing international mobility of capital and increasing international competition for foreign investment, countries have been seeking to reduce their company tax rates in order to reduce their domestic cost of capital and increase international competitiveness. Indeed, this trend has been so significant and widespread that it has raised concerns about the viability of income taxation as a sustainable source of tax revenue and the OECD has been seeking to reduce the scope for such 'harmful tax competition' between nations.
- **Reductions in dividend withholding tax**. In addition to reducing their rates of company tax, many countries have also reduced the rates of withholding tax they apply to the domestic source income of foreign shareholders. Some countries exempt that dividend income from tax. For example, Australia exempts fully franked dividend income from dividend withholding tax, thereby eliminating the potential double domestic taxation of that income. Other countries, such as New Zealand, limit relief to cases where the foreign shareholder is unlikely to be able to claim a credit for the amount of domestic tax imposed on that income, thereby reducing the revenue cost of providing such relief.

- **Reductions in rates of personal tax on income from capital, particularly dividend income.** Less noticeable, but just as significant, is the international trend towards reducing the personal tax rates applying to income from capital, particularly dividend income. This has been achieved in many Scandinavian countries through the implementation of a 'dual income tax' regime that applies a lower flat rate of tax on income from capital, but continues to tax income from labour at increasing statutory marginal rates of personal tax. Rather than implement a dual income tax regime, some countries have sought instead to reduce the rate of tax applying to the dividend income of shareholders through the introduction of split rate regimes. Under those split rate regimes, retained earnings are taxed at the company rate, but income distributed to shareholders in the form of dividends is taxed at a lower flat rate of tax. This approach of applying a lower rate of personal tax to dividend income is also used by many countries as a low cost means of partially integrating their company and personal income tax regimes. That is, it serves to reduce the amount of double domestic taxation of dividend income without the need for a complex dividend imputation regime that imposes significant compliance costs on taxpayers and administrative costs on the government.

Shift away from dividend imputation regimes

Another significant international trend in dividend taxation is the recent shift away from dividend imputation regimes.

- **No country fully integrates its company and personal tax regimes**. In view of the practical problems associated with the measurement of shareholders' income as it accrues, and the attribution of that accrued income to individual shareholders, no country has fully integrated its company and personal income tax regimes.
- **Most countries partially integrate their company and personal income tax regimes**. Since full integration is not feasible, most countries have sought to partially integrate those regimes by providing shareholders with relief from the double taxation of their dividend income. The extent of that dividend relief and the manner in which it is provided varies significantly across countries. Some countries:
  - operate classical tax systems that provide no explicit relief from double domestic taxation (eg the United States);
  - provide relief at the shareholder level through either full imputation regimes which provide relief for the full extent of tax paid at the company level (eg Australia), or partial imputation regimes which only provide relief for part of that company tax;
  - provide relief at the company level through partial dividend deduction regimes.
- **Recent trend away from dividend imputation**. Over the last few years, however, there has been a noticeable trend away from dividend imputation towards the provision of relief at the shareholder level regardless of the amount of company tax paid or the source of the dividend income. This has been achieved through the implementation of either modified dividend imputation regimes, which provide shareholders with a credit equal to some proportion of the value of the dividend paid, or the implementation of modified classical tax regimes, which apply a lower rate of personal tax to dividend income. Those reforms are directed at reducing the disincentive for residents to save and invest, reducing the bias against investing offshore which arises because dividend imputation regimes do not provide credits for foreign tax, and reducing the administrative and compliance costs associated with operating a dividend imputation regime.

- **Proposed options for the reform of Australia's imputation regime – options A, B and C**. The Australian Treasury has noted this potential bias in its recent *Review of International Taxation Arrangements* consultation paper and has identified a number of potential options for reform. The consultation paper notes that this potential bias could be eliminated by returning to a classical tax system. However, it rejects this option on the grounds that it would re-introduce all of the problems that the dividend imputation regime was implemented to address, including the double taxation of dividend income, distortions in portfolio choice and financing decisions. In addition, the consultation paper also notes the international trend away from dividend imputation regimes towards the provision of relief at the shareholder level regardless of the source of income or the amount of company tax paid on that income. However, the consultation paper rejects that approach and raises three alternative options for reform:
  - the provision of shareholder relief for unfranked dividends paid out of foreign source income (Option A). In effect, this option involves the implementation of a modified imputation regime for foreign source income;
  - allowing dividend streaming of foreign source income to foreign shareholders (Option B). It is important to recognise that this option is not really an alternative to option A and C. Rather, it is a mechanism for ensuring that the foreign source income that flows through Australian multinational companies to foreign shareholders does not have adverse implications for the amount of imputation credits that can be paid to Australian shareholders; and
  - providing franking credits for foreign dividend withholding taxes (Option C).

Clarifying the source of dividend income

Both Australia and New Zealand have been at the forefront of the provision of relief from domestic tax for conduit income flowing from foreign investments through resident multinational companies to foreign shareholders.

New Zealand has implemented a comprehensive conduit holding company tax regime that reduces the amount of New Zealand tax imposed on such conduit income to 15 per cent. This is intended to provide some relief from New Zealand tax while at the same time limiting the scope for using the conduit regime to avoid domestic tax by streaming domestic source income to foreign investors.

Australia also currently provides some conduit relief through its foreign dividend account rules and the Australian Treasury's *Review of International Taxation Arrangements* consultation paper raises a number of options for further reform of those rules to address problems with those rules and expand the provision of conduit relief. This includes option B which would enable Australian multinationals to stream dividend income paid out of foreign source income to foreign shareholders without reducing the amount of franking credits available to Australian shareholders for the company tax paid on their Australian source income.

Simplifying the measurement of residents' foreign dividend income

Many countries, including Australian, have introduced regimes aimed at assessing and collecting tax on the foreign source income that resident shareholders earn from their foreign investments as it accrues, rather than when it is paid. Those rules are intended to reduce the scope for shareholders to avoid tax on their foreign source income by accumulating their income in foreign companies.

In order to reduce the compliance costs associated with those regimes, most countries restrict the application of these rules to those cases where the scope for such avoidance is greatest (eg ‘passive’ income form portfolio investments located in low tax jurisdictions).

In view of the complexity of those rules, however, most countries have been exploring alternative approaches to further reducing compliance costs. Of these, the Netherlands use of a ‘presumed’ income approach is the most interesting. In effect, this involves assuming that investors make a risk free rate of return on their investments and levying tax on that income. Such a ‘risk free rate of return’ is also being considered in New Zealand.

Implications for Australian Companies and their Shareholders

Section 4 of the report examines the implications of these key international trends in dividend taxation for Australian companies and their shareholders under the simplifying assumption that those changes have no impact on their real investment decisions and the assumption that the marginal investor is a foreign shareholder.

Key trends analysed

The analysis focuses on the implications of those international trends that are likely to have the most significant implications for Australian companies and their shareholders. These include:

- **reductions in rates of tax**, particularly rates of company tax both overseas and in Australia;
- the **shift away from dividend imputation regimes**, including the impact of returning to a classical tax regime, implementing a UK style modified dividend imputation regime, and implementing the options for reform proposed by the Australian Treasury (options A and C);
- the **clarification of the source of dividend income** by allowing Australian multinationals to stream dividends paid out of foreign source income to foreign shareholders (option B); and
- the **simplification of the measurement of foreign source income** through the extension of the list of countries exempted from the controlled foreign company regime (option 3.3).

Approach adopted

Section 4 uses Ernst & Young’s *Tax Impact Model* to analyse the impact of those key changes in dividend taxation on three representative types of Australian companies:

- an **Australian corporate group**, comprising an Australian parent company that has a subsidiary in Australia. This corporate group is intended to be illustrative of the vast bulk of Australian companies that have no foreign investments and only a few foreign shareholders;
- an **emerging Australian multinational**, comprising an Australian parent that has a subsidiary in Australia and has established a subsidiary in a listed country, as well as a subsidiary in an unlisted country. This corporate group is intended to be illustrative of those Australian companies that are just starting to invest offshore and attract more foreign shareholders; and
- a **mature Australian multinational**, comprising an Australian parent, that has an Australian subsidiary, as well as significant investments in a foreign subsidiary in a listed country and some

investment in a subsidiary in an unlisted country. This corporate group is intended to be illustrative of those Australian companies that already have significant offshore investments and substantial numbers of foreign shareholders.

Specifically, the *Tax Impact Model* is used to determine the impact of these key trends in dividend taxation have on:

- the **effective tax rates** imposed on the incomes of these Australian companies and their shareholders;
- the **cost of capital** of those companies; and
- **shareholder value**.

Key results

The nature and extent of the impact that any change in dividend taxation has on an Australian company and its shareholders will depend on a number of factors including:

- the identity of the marginal shareholder (eg whether the marginal shareholder is a foreign shareholder or an Australian shareholder);
- the extent of foreign investment by the company and the proportion of its shares owned by foreign investors;
- the location of that foreign investment;
- the location of those foreign shareholders; and
- the company's dividend distribution policy.

This means that changes in dividend taxation, either in Australia or overseas, have significantly different effects on Australian companies depending on their stage of development.

For the large numbers of **Australian corporate groups** that have no foreign investments and only a small number of foreign shareholders, international changes in dividend taxation have little direct impact. Of far greater importance to companies at this early stage of development is the manner in which the Australian government responds to those international trends in dividend taxation. For those companies:

- **reductions in the Australian company tax rate** will reduce the effective tax rates imposed on shareholders, reduce the cost of capital to some extent, and increase shareholder value, regardless of whether the marginal investor is an Australian or a foreign shareholder and regardless of the source of finance;
- any **shift away from the current dividend imputation regime** would have a significant impact. In particular:
  - a **return to a classical tax regime** would significantly increase the effective tax rates imposed on shareholders and decrease shareholder value;
  - replacing the current imputation regime with a **UK style notional tax credit regime** would reduce effective tax rates on Australian shareholders and increase shareholder value, and the magnitude of those effects will be greater the greater the rate of notional tax credit. It also has the potential to reduce the cost of capital. However, the magnitude of that reduction decreases with increases in the

rate of notional tax credit since increasing the rate of notional tax credit reduces the tax advantage of debt over equity;

- **options A or C** would have no affect since those companies are assumed not to have any foreign source income.

- **clarification of the source of dividend income** through the implementation of option B, or **simplification of the measurement of foreign source income**, would not affect their operations since those companies are assumed not to have any foreign source income.

However, international changes in dividend taxation will have a direct impact on those **emerging Australian multinationals** that are starting to invest offshore and are attracting an increasing number of foreign shareholders. For such companies:

- **reductions in tax rates**, both overseas and in Australia, will affect those companies. In particular:
  - **reductions in foreign company tax rates** will benefit those emerging Australian multinationals that have investments in those countries by reducing the effective tax rates imposed on shareholders and increasing shareholder value, but are unlikely to reduce the cost of capital for those companies;
  - **eliminating foreign dividend withholding tax** imposed on foreign source income from listed countries such as the United States and the United Kingdom would also benefit those emerging Australian multinationals that have investments in those countries by reducing effective tax rates imposed on shareholders and increasing shareholder value. However, it is unlikely to reduce the cost of capital for those companies unless they earn significant amounts of foreign source income that is subject to high rates of foreign dividend withholding tax;
  - **reductions in the rate of Australian company tax** would confer significant benefits on emerging Australian multinationals by reducing the effective tax rates imposed on their shareholders, reducing the cost of capital, and increasing shareholder value;
- any **shift away from dividend imputation** would also have significant implications for emerging Australian multinationals in view of their high proportions of Australian shareholders. In particular:
  - **a return to a classical tax regime** would significantly increase the effective tax rates imposed on shareholders and decrease shareholder value;
  - replacing the current imputation regime with a **UK style notional tax credit regime** would reduce the effective tax rates imposed on Australian shareholders and increase shareholder value and the magnitude of these effects would be greater the rate of notional tax credit. It also has the potential to reduce the cost of capital. However, once again, the magnitude of that reduction decreases with increases in the rate of notional tax credit since increasing the rate of notional tax credit reduces the tax advantage of debt over equity;
  - **option A** would benefit those emerging Australian multinationals that earn foreign source income from listed countries. It would reduce the effective tax rates imposed on Australian shareholders and increase shareholder value. The magnitude of that benefit would be greater the higher the notional rate of tax credit, the higher the amount of foreign source income earned from listed countries, and the greater the dividend payout ratio; and
  - **option C** would benefit those emerging Australian multinationals with investments in countries that levy withholding tax on dividends paid to Australia. It would reduce effective tax rates on Australian shareholders and increase shareholder value. The magnitude of that benefit would be greater the greater the rate of foreign dividend withholding tax, the greater the amount of foreign source income subject to that tax, and the greater the dividend payout ratio;

- **clarification of the source of dividend income** via the introduction of option B has the potential to benefit emerging Australian multinationals by reducing the effective tax rates imposed on the income of foreign shareholders and increasing shareholder value. However, the magnitude of that benefit is likely to be small given the small volume of conduit income. The effective tax rates imposed on Australian shareholders are unlikely to fall if companies are following the practice of deferring payments of dividends from the foreign dividend account until they have exhausted their imputation credits;
- **simplification of the measurement of foreign source income** through an extension of the list of countries exempted from the CFC provisions would potentially benefit those emerging Australian multinational companies with investments in unlisted countries that are added to the exemption list. The magnitude of that benefit would be greater the lower the tax rate prevailing in the unlisted country, the greater the amount of foreign source income earned from the unlisted country and the greater the amount of time that income remains in the unlisted country. As a result, higher dividend payout ratios will tend to reduce the value of this benefit. The benefit will also be reduced and may even be more than offset, by reductions in the amount of imputation credits payable to Australian shareholders. This may increase the effective tax rates imposed on Australian shareholders and could also reduce shareholder value. Companies that only have investments in listed countries would also receive no benefit from such a change.

For **mature Australian multinationals** that already have significant foreign investments and large numbers of foreign shareholders, international developments in dividend taxation are likely to have a much greater impact. Indeed, those international changes are likely to be more important than changes in Australia's taxation of dividend income. For such Australian companies at this stage of development:

- **reductions in tax rates**, both overseas and in Australia, will affect their operations. In particular:
  - **reductions in foreign company tax rates** will have a much more significant impact on companies that have investments in those countries. Those foreign tax reductions will reduce the effective tax rates imposed on shareholders and increase shareholder value, but are unlikely to reduce the cost of capital for those companies;
  - **eliminating foreign dividend withholding tax** imposed on foreign source income from listed countries such as the United States and the United Kingdom would also benefit those mature Australian multinationals that have investments in those countries by reducing effective tax rates imposed on shareholders and increasing shareholder value, but is unlikely to reduce the cost of capital for those companies;
  - **reductions in the rate of Australian company tax** will continue to benefit these companies by reducing the cost of capital, and increasing shareholder value. However, such reductions will not produce as great a benefit for Australian shareholders. Indeed, reductions in the company tax rate below 30 per cent, coupled with very high dividend payout ratios, could cause a slight increase the effective tax rates on Australian shareholders;
- any **shift away from dividend imputation** would still have important implications for mature Australian multinational companies. However, once again, such changes in the tax treatment of Australian shareholders would be less significant for mature Australian multinationals in view of their much higher proportions of foreign source income. In particular:
  - a **return to a classical tax regime** would increase the effective tax rates imposed on shareholders and decrease shareholder value;
  - replacing the current imputation regime with a **UK style notional tax credit regime** would reduce the effective tax rates imposed on Australian shareholders and increase shareholder value and the

magnitude of these effects would be greater the rate of notional tax credit. Once again, although this also has the potential to reduce the cost of capital, the magnitude of that reduction would decrease with increases in the rate of notional tax credit, since increasing the rate of notional tax credit reduces the tax advantage of debt over equity;

- **option A** would benefit those mature Australian multinationals with investments in listed countries by reducing Australian shareholders' effective tax rates and increasing shareholder value. The magnitude of that benefit would be greater the greater the rate of notional credit, the greater the amount of foreign source income the company earns from listed countries, and the greater the dividend payout ratio. As a result, mature Australian multinationals would be expected to derive greater benefits from this option than emerging Australian multinationals with lower levels of foreign source income from listed countries; and
- **option C** would benefit those mature Australian multinationals with investments in countries that levy withholding tax on dividends paid to Australia by reducing effective tax rates on shareholders and increasing shareholder value. The value of that benefit will be greater the greater the rate of foreign dividend withholding tax and the greater the amount of foreign source income subject to that tax. As a result, such an option would be more beneficial to those mature Australian multinationals that earn significant amounts of foreign source income that is subject to high rates of foreign dividend withholding tax;

- **clarification of the source of dividend income** via the introduction of option B has the potential to benefit mature Australian multinational companies by reducing the effective tax rates imposed on the income of foreign shareholders and increasing shareholder value. Once again, the effective tax rates imposed on Australian shareholders are unlikely to fall if companies are following the practice of deferring payments of dividends from the foreign dividend account until they have exhausted their imputation credits. Option B would be the more beneficial to those mature Australian multinational companies that have higher proportions of foreign source income and foreign shareholders. Indeed, option B is likely to be the most beneficial to foreign multinational companies that are considering setting up a regional headquarters in Australia since they would have greater amounts of conduit income; and
- **simplification of the measurement of foreign source income** through an extension of the list of countries exempted from the CFC provisions would potentially benefit those mature Australian multinational companies with investments in unlisted countries that are added to the exemption list. Once again, the magnitude of that benefit would be greater the lower the tax rate prevailing in the unlisted country, the greater the amount of foreign source income earned from the unlisted country and the greater the amount of time that income remains in the unlisted country. However, the magnitude of that benefit would be reduced by increases in the dividend payout ratio and reductions in the amount of imputation credits payable to Australian shareholders. Such an option would be of no assistance to mature Australian multinational companies that only have investments in listed countries.

Implications for Australian Tax Policy

Section 5 of the report relaxes the simplifying assumption made for the purposes of section 4 and analyses the implications of these key trends in dividend taxation for the real investment decisions and Australian tax policy under the assumption that the marginal investor in Australian companies is an Australian shareholder.

The approach adopted is similar to that used in section 4, only it uses a different set of analytical tools. In particular, it examines the implications of these key trends for:

- the **effective marginal tax rates** imposed on the income of Australian shareholders, as opposed to the effective tax rates;
- the **cost of capital**; and
- **national welfare** rather than shareholder value.

The results of that analysis and its implications for Australian tax policy are outlined below.

Need to reduce rates of personal income tax

Australia, like most other countries, has been seeking to improve the efficiency of its tax regime by raising a greater proportion of revenue through the imposition of an indirect tax on consumption (ie the GST) and reducing rates of income tax. In comparison with consumption taxes, income taxes are a much less efficient source of revenue since, in the course of raising revenue, they also have the unintended effect of discouraging saving and investment.

In view of the increasing mobility of capital, most small, open, net capital importing countries such as Australia have been seeking to reduce the rates of tax they impose on the income of foreign investors by reducing the rate of company tax and other withholding taxes imposed on that income. Those reforms are intended to:

- **reduce the effective marginal tax rates** on the income of those foreign investors, particularly income from portfolio debt and equity investments, since those investments are likely to be the most sensitive to tax;
- **reduce the domestic cost of capital**, by reducing the extent to which businesses have to pay a higher rate of return to attract foreign investment; and
- **increase national welfare** by reducing the extent to which the tax system deters investment, distorts patterns of investment, and encourages companies to relocate offshore.

At the same time, however, it is important to note that reducing the rates of tax imposed the income of foreign investors also:

- **increases the effective marginal tax rate** imposed on **domestic saving**; and
- **reduces the level of saving by residents**.

This is the reason why many countries have also reduced the rates of tax imposed on the income of their residents through a combination of:

- **reductions in personal rates of income tax**. As noted above, there has been a significant trend away from comprehensive income tax regimes that seek to tax all forms of income at the same rate of personal tax towards regimes that tax dividend income at a lower rate (eg ‘dual income tax’ regimes and ‘split rate’ tax systems); and
- **reforms to their dividend imputation regimes**. Many countries have been using reductions in the rate of personal tax on dividend income as a simple means of providing shareholders relief from double taxation. In particular, there has been a shift away from dividend imputation regimes to regimes that provide double tax relief through the application of a lower rate of tax on dividend income. For example, the United Kingdom has replaced its partial dividend imputation regime

with a regime that provides shareholders with a notional credit equal to 1/9th of the value of the dividend. This provides shareholders with a tax credit regardless of the amount of tax paid by the company on that income or whether the income is sourced from domestic or foreign investments. That is, in effect it provides all shareholders with a cut in the personal rate of tax they pay on their dividend income.

Those reforms are not intended to increase the overall level of investment in the economy. Rather, they are intended to reduce the extent to which the income tax system discourages residents from saving and investing and the ability of those countries to attract and retain highly mobile skilled labour.

By contrast, Australia continues to operate:

- **a comprehensive income tax regime** that seeks to tax the dividend income of Australian shareholders at the same personal rate of income tax that applies to their interest and labour income; and
- **a dividend imputation regime** that only provides Australian shareholders with a credit for the amount of Australian company tax paid on their dividend income.

As a result, the Australian income tax system continues to impose relatively high and disparate effective marginal tax rates on the dividend income of Australian shareholders. This:

- **deters Australians from saving and investing**;
- **distorts patterns of investment by Australian shareholders** across companies and alternative investments; and
- **may increase the cost of capital for some companies and reduce investment to some extent**. In theory, if capital markets operated perfectly, the rates of personal tax imposed on the income of Australian shareholders would have no impact on the domestic cost of capital in a small, open, net capital importing country such as Australia. Rather, the domestic cost of capital would be determined by the operation of the world capital markets and would be grossed up to some extent to compensate foreign investors for the amount of Australian tax levied on their income. In practice, however, imperfections in the operation of capital markets may mean that some Australian companies have difficulty obtaining funds from foreign shareholders and may have to rely on Australian shareholders to finance their marginal investments. In such cases, those companies may have to pay Australian shareholders a higher rate of return to compensate them for the high effective rates of personal tax imposed on their dividend income.

When reviewing and reforming the international tax regime, the Government therefore needs to consider not only options for reducing the domestic cost of capital and increasing investment in Australia. Rather, it also needs to consider possible options for reducing the disincentive for Australians to save and invest by reducing the effective marginal tax rates imposed on their income from capital.

In particular, consideration needs to be given to the following approaches to reducing rates of personal income tax:

- **Reduce the top marginal rate of personal income tax**. If Australia wants to reduce disincentives to save and invest, improve the quality of investment, increase its ability to attract and retain skilled labour, and enhance its prospects for increased growth and employment, the preferable approach it to implement lower and more uniform rates of personal income tax. In order to achieve the greatest possible improvement in the efficiency of the income tax system, this is best achieved through a reduction in the top personal rate of income tax since the deadweight costs of raising tax revenue rise more than proportionately as the rate of tax increases. In addition, most saving and investment in Australia is undertaken by individuals subject to that top marginal tax rate.

- **Implement a dual income tax regime**, which would subject income from capital to a low flat rate of tax, but would continue to tax all income from labour at current statutory marginal rates of tax. The main advantages of such an approach are that it would reduce the disincentive to save and invest while lowering the fiscal cost of such a reduction and preserving the perceived equity of the tax system. These advantages would be offset to some extent, however, by the potential efficiency losses from applying different rates of tax to income from capital and income from labour. This would encourage tax planning and distort individuals' decisions regarding the manner in which to organise their business activities (eg it would provide an incentive for individuals to incorporate and recharacterise their labour income as income from capital).
- **Implement of a split rate tax system**, which would apply a lower rate of personal tax to income from capital when it is distributed. The main advantage of such an approach is that it would potentially reduce the disincentive for individuals to save and invest in shares at lower revenue cost that the options outlined above. Once again, however, those advantages would be offset to some extent by the potential efficiency losses from taxing distributions of income at a rate lower than retained earnings (eg by distorting dividend policy and financing decisions).

Need to consider options for reforming the dividend imputation regime

In addition to the options for reform outlined above, consideration also needs to be given to other options for reducing rates of personal income tax on dividend income that would also overcome some of the problems inherent in the current dividend imputation regime.

Australia needs an income tax regime that does not inhibit the growth and expansion offshore of Australian companies. In particular, it is important to ensure that the income tax regime does not disadvantage Australian companies at a particular stage of their development or the location of their investment.

At the moment, Australia's dividend imputation regime works reasonably well for the large number of Australian companies in their early stages of development that have no foreign investments and few, if any, foreign shareholders.

However, as Australian companies expand their operations offshore and attract an increasing number of foreign shareholders, the current imputation regime has the adverse effect of discouraging Australian shareholders from investing offshore through Australian multinational companies.

This is because the imputation regime does not provide Australian shareholders with credits for the foreign taxes that are paid on the foreign source income they derive through their equity interests in Australian multinational companies. If Australian shareholders invest in foreign companies directly they are provided with a credit for foreign dividend withholding taxes levied on their foreign source income. However, once again, Australian shareholders do not receive credits for the underlying foreign company tax paid on that income. This has the potential to provide an overall bias against investment offshore, as well as a bias patterns of investment by Australian shareholders in favour of direct investment offshore, as opposed to investment offshore via an Australian multinational company.

There are a number of possible options for removing that bias:

- **Return to a classical tax system**. As noted in the Treasury consultation paper, the main problem with this option is that it would reintroduce all of the distortions the imputation regime was implemented to address. These include distortions in the choice of organisational form, financing decisions and dividend policy the regime was implemented to address. Those problems could be reduced to some extent by coupling a return to a classical tax system with the introduction of a much lower and more uniform rate of tax on income from capital (eg the approach being pursued in Ireland).

- **Replace the dividend imputation regime with a UK style notional tax credit regime** that would provide Australian shareholders with a tax credit equal to some proportion of the value of dividends paid by Australian companies, regardless of the amount of company tax paid on that income or the source of that income. Since this approach has been adopted by the UK and many other countries, it warrants much more detailed consideration than it has been given in Treasury's consultation paper. Treasury appears to have rejected this approach on the grounds that it would:

  - have a significant negative impact on company tax revenues;
  - provide taxpayers on low marginal rates of tax with less benefits than are currently available under the current imputation regime;
  - involve significant transitional issues (eg whether to allow companies with excess franking credits time to distribute those credits to shareholders).

  However, such an approach would:

  - be consistent with international trends;
  - reduce the disincentive for Australians to save and invest if the notional credit rate was set at a rate sufficiently high to reduce the effective marginal rates of tax on shareholder's income below their current levels;
  - reduce the cost of capital for those Australian companies with restricted access to international capital markets; and
  - reduce the current disincentive for Australian shareholders to invest offshore through Australian multinational companies by providing those shareholders with a notional credit for the amount of foreign company tax imposed on their foreign source income.

- **Implement 'option A'**. If the Government is reluctant to consider replacing the dividend imputation regime with a UK style notional tax credit regime, then it should consider implementing option A instead. This would involve retaining the dividend imputation regime, but providing Australian shareholders with an additional non-refundable notional credit equal to some proportion of the foreign source dividend income derived by Australian multinational companies from listed countries (ie the unfranked foreign source dividend income). That is, in effect it would involve applying a UK style notional credit regime to the foreign source income that Australian shareholders earn through their equity interests in Australian multinational companies that have investments in listed countries. The main advantages of such an approach are that it would:

  - enable the current dividend imputation regime to be retained for those companies that have no foreign source income;
  - reduce the effective marginal tax rate imposed on that foreign source income, thereby reducing the disincentive for Australian investors to invest offshore through Australian multinational companies;

  - reduce the cost of capital for those Australian companies with restricted access to international capital markets;
  - involve a lower revenue cost than replacing the current dividend imputation regime with a UK style notion credit regime.

  The main disadvantages of this approach are that it would:

  - not reduce the overall level of personal tax imposed on income from capital. It would only reduce the effective marginal tax rate on foreign source income from listed countries. This is the main reason why it would be less costly to implement than a move to a UK style regime;
  - provide the same amount of tax relief regardless of the amount of foreign tax paid. This could give rise to concerns that the regime favours those companies that pay little foreign tax on that foreign source income. However, such an approach would reduce the compliance costs associated with having to determine the amount of underlying foreign tax paid.

- **Implement 'option C'**. If option A is not feasible, then consideration should be given to implementing option C. This would involve retaining the dividend imputation regime, but providing Australian shareholders with franking credits for the amount of foreign dividend withholding tax imposed on their foreign source income. The main advantages of this approach are that it has the potential to:

  - reduce the effective marginal tax rate imposed on that foreign source income, thereby reducing the disincentive for Australian investors to invest offshore through Australian multinational companies;
  - reduce the cost of capital for those Australian companies with restricted access to international capital markets;
  - encourage the repatriation of profits back to Australia; and
  - potentially involve a lower revenue cost than option A, since no credit would be provided for the underlying company tax paid

  However, such an approach would:

  - not provide credits for any underlying foreign company tax paid; and
  - be largely redundant for many companies with investments in the US, UK and New Zealand once the new US protocol takes effect. However, it would still be of considerable assistance to those Australian multinationals with significant investments in countries that continue to apply relatively high rates of withholding tax on dividends paid to Australia.

- **Pursue a more strategic approach to double tax treaty negotiation**. Another option for reducing the international double taxation of the incomes of Australian shareholders is to pursue a more strategic approach to negotiating Australia's double tax treaties. In addition to considering whether the recently negotiated protocol to the Australia-United States tax treaty provides an appropriate basis for future treaty negotiations (option 3.5 of the Treasury consultation paper), the Government should be seeking to develop, and maintain, much more detailed information on:

  - the nature and extent of Australian investments in the treaty country and treaty country investments in Australia; and
  - the sensitivity of those investments to changes in the taxes governed by the treaty.

It is important to evaluate these options for reform from the point of view of their potential impact on both:

- the domestic cost of capital; and

- the extent to which they are likely to reduce personal tax rates and the disincentive for Australians to save and invest.

In particular, it is important:

- to consider the impact that these options for reform are likely to have on the cost of capital for those companies that are not able to access foreign capital due to imperfections in the capital market (eg due to the existence of asymmetric information between Australian companies and foreign shareholders); and
- not to reject either option A or C on the grounds that those options are unlikely to reduce the cost of capital and increase the overall level of investment in Australia. Even if those options have no effect on the cost of capital of Australian companies, they would still reduce the current disincentive for Australians to save and invest offshore through Australian multinational companies.

Need to clarify the source of dividend income

The expansion of Australian companies offshore is also inhibited by the lack of an appropriate 'conduit' regime that allows the foreign source income of foreign shareholders (ie 'conduit' income) to flow through Australian multinational companies without having any adverse effects tax consequences for those companies.

Australia has introduced foreign dividend account rules that allow such conduit income to flow through to foreign shareholders without being subject to Australian dividend withholding tax.

However, deficiencies in the current anti dividend streaming rules still mean that such conduit income flows:

- **reduce the value of imputation credits that can be attached to distributions of Australian source income to Australian shareholders**, since some of those credits have to be attached to distributions of foreign source income to foreign shareholders. This increases the effective marginal tax rates imposed on the Australian source income of Australian shareholders discouraging them from investing in those Australian companies; or
- **reduce the value of exempt dividends that can be paid to foreign shareholders out of the foreign dividend account**, since some of those credits have to be attached to dividends paid to Australian shareholders even though it might have been a distribution of foreign source income to foreign shareholders.

Those problems arise because the anti dividend streaming rules in effect treat the flows of conduit income through Australian companies as if it had an Australian source, when it is really the foreign source income of foreign shareholders and should not be subject to Australian tax.

As a result, it is important for the Government to:

- **implement 'option B'**, which would allow Australian multinational companies to stream the foreign source income of foreign shareholders. It is important not to regard option B as an alternative to options A and C. Regardless of the Government's decision in relation to options A and C, option B should be implemented. This would ensure that flows of foreign source income through Australian multinational companies to foreign shareholders do not reduce the value of franking credits that Australian multinational companies can attach to the dividends they pay to Australian shareholders out of Australian source income.

In particular, it would:

- **reduce the effective marginal tax rates** imposed on the foreign source income that foreign shareholders earn through Australian multinational companies;
- **reduce the cost of capital** for mature Australian multinational companies with significant offshore investments and numbers of foreign shareholders; and
- **improve national welfare** by reducing the current disincentive for foreign shareholders to invest in other countries via Australia, the incentive for mature Australian multinationals to shift their operations offshore, and the disincentive for foreign multinationals to establish their regional headquarters in Australia.

- **Implement the proposed trans-Tasman triangular tax reforms**. Implementation of these reforms would ensure that Australian shareholders in New Zealand multinational companies with investments in Australia could in effect receive franking credits for any Australian tax paid on that Australian source income. Similarly, it would ensure that New Zealand shareholders in Australian multinational companies with investments in New Zealand could obtain the benefits of New Zealand imputation credits.
- **Explore the scope for further trans-Tasman tax reform**. In addition to implementing the proposed trans-Tasman triangular tax reforms, the Government also needs to explore the scope for mutual imputation credit recognition. That is, allowing Australian franking credits to flow to the New Zealand shareholders of Australian multinational companies, and New Zealand imputation credits to flow to the Australian shareholders of New Zealand multinational companies.

Simplifying the measurement of foreign source income

The expansion of Australian companies offshore is also constrained to some extent by the high compliance costs associated with applying the complex CFC rules to income from investments in unlisted countries.

Those compliance costs could be reduced to some extent by:

- **Extending the list of countries exempt from the CFC regime.** This would benefit those Australian companies with significant investments in such unlisted jurisdictions. In particular, it would:
  - reduce the effective marginal tax rates imposed on the income that both Australian and foreign shareholders earn from the investments that Australian multinational companies have in those unlisted countries; and
  - potentially reduce the cost of capital for those companies with investments in those unlisted countries.
- **Undertaking a comprehensive review of both the CFC and FIF regimes**. Rather than introduce further piecemeal reforms to the current CFC and FIF regimes, however, it would be preferable to undertake a comprehensive review of those regimes. An important function of that review would be to clarify the policy objectives of those regimes and explore alternative options for reducing the compliance costs while ensuring that Australian shareholders are not able to defer tax by accumulating profits offshore in companies located in low tax jurisdictions.

1. Introduction

1.1 Pressures for Change

Over the last two decades, governments around the world have been phasing out policies aimed at insulating their domestic economies from the need to adjust to changes in the international environment and pursuing instead reforms aimed at:

- opening up their domestic economies to increased international competition (eg through trade liberalisation and the relaxation of controls over foreign investment); and
- improving the ability of their domestic economies to adjust to, and take advantage of, changes in the international environment (eg through the deregulation of financial markets, communications and transportation).

Coupled with rapid advances in communication and information technologies, this widespread market deregulation has increased the international mobility of final products, intermediate goods, raw materials, financial capital, and highly skilled labour. This has enabled companies to:

- gain access to larger foreign markets for their products and cheaper sources of inputs; and
- restructure their activities so they are located closer to the major markets for their products and the sources of their inputs.

As a result, there has been a rapid growth in foreign investment and the emergence of multinational companies that engage in economic activities in several jurisdictions. For example, many Australian companies now have significant investments in other countries as well as increasing numbers of foreign shareholders.

These developments have placed significant pressures on governments to review and reform their dividend taxation regimes, since those regimes were originally designed to suit the needs of closed, rather than increasingly open, economies.

In particular, governments have been introducing a myriad of dividend taxation reforms in order to:

- reduce the disincentive to save and invest;
- reduce the domestic cost of capital for resident companies;
- reduce distortions in patterns of investment; and
- improve international competitiveness.

1.2 Objectives and Scope of this Report

The main objectives of this report are to:

- outline the 'key challenges', or common problems, those dividend taxation reforms are intended to address;
- identify the key trends in the manner in which governments are seeking to deal with those problems; and
- analyse the implications of those key trends for Australian companies and their shareholders, and Australian tax policy.

It is important to note that this report does not seek to provide a comprehensive overview of all recent changes and trends in corporate and personal taxation.

Rather, the report focuses attention on a subset of those changes that have important implications for Australian companies and their shareholders. This is the set of changes that affect the tax treatment of the income that shareholders earn from their equity interests in companies – that is, the tax treatment of 'dividend income'.[1]

Specifically, this report focuses primarily on recent changes to the tax treatment of income that is either:

- distributed to shareholders in the form of dividend income; or
- retained in the company; or
- attributed to shareholders for tax purposes (eg as a result of the operation of international tax regimes such as the Controlled Foreign Corporation or Foreign Investment Fund regimes).

This includes a wide range of changes that jurisdictions have been making to the measurement and collection of tax, and the rates of tax applying to dividend income, such as the international trend to reduce company tax rates and shift away from dividend imputation regimes.

However, the report does not contain a detailed discussion of other important changes to company and personal tax regimes that also have important implications for Australian companies and tax policy. These include recent changes to:

- depreciation deductions (eg the movement away from the provision of accelerated rates of depreciation towards the implementation of economic rates of depreciation);
- transfer pricing and restrictions on interest deductions (eg the introduction of 'thin' and 'fat' capitalisation rules to allocate interest expense across jurisdictions);
- entity taxation (eg attempts to achieve a more consistent approach to treating companies and alternative forms of business organisation including trusts and partnerships); and
- corporate consolidation rules, which allow corporate groups to be treated as one entity for tax purposes.

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1 The term 'dividends' is used in this report to refer to all of the income a company generates that is available for distribution to shareholders, rather than just the amount that is actually paid out to shareholders in the form of cash dividends.

1.3 Report Structure

Most international tax surveys summarise developments on a country by country basis. Although such summaries provide a useful guide to the tax treatment of dividend income in each jurisdiction, typically they provide little information on:

- the fundamental policy objectives underlying any changes to the tax treatment of dividend income;
- whether similar reforms are being pursued in other jurisdictions. Often similarities in the regimes being pursued by different jurisdictions are obscured by differences in the terminology used to describe those regimes; and
- the implications of those reforms for companies and their shareholders.

As a result, we have adopted a somewhat different approach for the purposes of this report:

- **Section 2, Key Challenges in Dividend Taxation** outlines the common problems that all governments are trying to deal with when reviewing and reforming the manner in which they tax the income that shareholders derive from their equity interests in companies. This helps identify the fundamental policy objectives underlying the myriad of different dividend tax reforms being pursued internationally.
- **Section 3, Key Trends in Dividend Taxation** identifies the key trends in the way in which governments are seeking to address those problems. This highlights the similarity between many reforms that appear, at first sight, to be quite different. It also places the reforms to dividend taxation outlined in Treasury's *Review of International Taxation Arrangements* consultation paper into context with other related reforms being pursued internationally. This helps identify other potential options for reform that have not been canvassed in the consultation paper.
- **Section 4, Implications for Australian Companies and their Shareholders**, examines the implications of these key trends in dividend taxation for the effective tax rates imposed on the income earned by Australian companies and their shareholders, the cost of capital, and shareholder value, under the simplifying assumption that there is no change in their real investment decisions; and
- **Section 5, Implications for Australian Tax Policy**, concludes the report by examining the implications of these key trends for investment decisions and Australian tax policy. This involves consideration of the impact of those changes on the effective marginal tax rates imposed on the incomes of shareholders in Australian companies, the cost of capital, and national welfare.

2. Key Challenges in Dividend Taxation

Before examining international trends in dividend taxation, it is useful to identify:

- the fundamental tax policy objectives governments are trying to achieve when they are in the process of reviewing and reforming their dividend taxation regimes; and
- the common problems, or 'key challenges', that are encountered by governments in that process.

As discussed in section 1.3, this approach helps us to:

- classify the myriad of apparently different tax reform initiatives according to their fundamental policy objectives; and
- identify key trends in the way in which governments are seeking to address those problems.

2.1 Tax Policy Objectives

When reviewing and reforming their income tax regimes, and the rules governing the taxation of shareholders' income, governments are seeking to improve the ability of those regimes to achieve three fundamental, but potentially conflicting, tax policy objectives:

- efficiency;
- equity; and
- sustainability.

2.1.1 Efficiency

Ideally, the income tax regime should be 'efficient'. That is, it should be capable of performing its role of raising and redistributing income without imposing any net cost on the nation as a whole.

In practice, however, all real world income tax regimes are inefficient to some extent since, in the course of raising and redistributing revenue, they inevitably reduce the efficiency with which the economy operates by distorting decisions to work, consume, save, invest, produce and use resources.

For example, in the course of raising revenue, an income tax regime unintentionally:

- reduces levels of saving and investment;
- distorts patterns of investment, thereby reducing the overall quality of investment;
- distorts business choices regarding the most appropriate form in which to organise their business activities;
- distorts the manner in which companies decide to distribute their profits to shareholders;
- distorts business choices regarding the most appropriate source of finance to use; and
- imposes significant compliance costs on businesses and administrative costs on government. These costs increase with increases in the complexity of the income tax regime.

These unintended effects of an income tax all reduce the overall efficiency with which the economy operates, thereby imposing a cost on the nation as a whole.

This is the reason why an income tax regime is often described as a 'leaky bucket'. In the course of raising and redistributing income, some of that income is lost due to the adverse effects that the income tax regime has on the overall efficiency with which the economy operates. That loss of income is typically referred to as the 'excess burden' or 'deadweight' costs of taxation.

In general, the deadweight costs of raising an additional dollar of income tax revenue are greater:

- the higher the levels of effective marginal tax rates of tax imposed on that income – the deadweight costs of taxation increase more than proportionally with increases in the rate of income tax;
- the greater the differences in those effective marginal tax rates across alternative activities and investments; and
- the more responsive decisions to work, save, consume, produce and invest are to the rate of tax and differences in the rates of tax applying to income from alternative investments and activities.

This is the reason why most governments sought throughout the 1980s and 1990s to:

- reduce their reliance on income taxes by collecting a greater proportion of their revenue via the imposition of indirect taxes on consumption; and
- implement comprehensive income tax regimes that impose a lower and more uniform rate of tax on all forms of income from capital, including income from human capital (ie labour income).

More recently, however, there has been a shift away from such comprehensive income tax regimes towards tax regimes that apply a lower rate of tax to certain forms of income from capital, particularly those forms of sensitive to tax, such as the portfolio interest and dividend income of foreign investors. This trend is discussed further in section 3.1.

2.2.2 Equity

Ideally, the tax system should also be 'equitable'. That is, it should be capable of performing its roles of raising and redistributing income in a manner that is consistent with the government's equity objectives.

Many countries seek to improve the perceived equity of their income tax regimes by subjecting the incomes of individuals to a scale of increasing statutory marginal rates of personal tax. This is intended to produce a 'progressive' income tax system, under which individuals on low incomes pay a smaller proportion of their income in tax than individuals on higher incomes.

It is important to note, however, that even a flat rate of personal income tax, when combined with a tax free threshold, or the provision of a universal benefit, produces a progressive income tax regime. A scale of increasing statutory marginal rates of personal income tax just produces more progressive rates of tax.

Once again, however, many countries have recognised that imposing steeply progressive rates of person tax on income from capital discourages individuals from saving and investing, thereby reducing the efficiency of the tax system. As a result, they have been seeking to implement lower and more uniform rates of personal tax on the incomes that individuals derive from capital. This trend is also discussed further in section 3.1.

2.1.3 Sustainability

An ideal income tax regime should also be sustainable. That is, it should be capable of providing a stable and reliable source of revenue for the government into the future at the lowest cost possible.

The high and increasing deadweight costs of taxing income from capital have raised questions about the longer term sustainability of income tax as an efficient source of revenue. Indeed, the sustained international trend of reducing rates of tax on income from capital has prompted concerns in the OECD that harmful tax competition between countries could erode the sustainability of income tax as a source of revenue.

Although most countries have been able to reduce their reliance on income taxes through the introduction of indirect taxes on consumption, most countries still have to rely on income taxes for a significant source of their revenue.

As a result, most countries are faced with the complex task of having to review and reform their income tax regimes in order to reduce the costs of raising revenue and the scope for erosion of the income tax base.

2.2 Key challenges

When seeking to improve the overall efficiency, equity and sustainability of their income tax regimes, governments worldwide face a common set of problems with the redesign of their dividend taxation regimes.

Those ‘key challenges’ arise from the practical problems associated with:

- the accurate measurement of the amount of income shareholders derive from their equity interests in companies (section 2.2.1);
- the collection of tax on that income (section 2.2.2); and
- ensuring that income is taxed at the appropriate rates (section 2.2.3).

2.2.1 Accurate measurement of shareholders’ income

Measuring shareholders’ income as it accrues

In principle it is desirable to measure the income that each shareholder in a company accrues from their equity interest in a company. This would include any:

- cash or non-cash payments when they are received; and
- changes in the value of the shareholder’s equity interest when they accrue (ie any accrued capital gains and losses).

In practice, however, such a ‘full accruals’ approach to the measurement of shareholders’ income is impractical.

Although cash dividends are easy to value, other forms of shareholder income are much more difficult to measure including:

- non-cash dividends; and
- accrued changes in the value of shares, particularly the income that shareholders accrue from their equity interests in foreign companies.

As discussed further in section 2.2.2, those practical problems with the measurement of shareholders' income impose significant constraints on when it is possible to assess and collect the amount of tax payable on that income. In particular, it has meant that governments have had to assess and collect tax on shareholders' income when it is either received, in the case of dividend income, or when it is realised, in the case of capital gains made on the sale of shares.

Determining the source of shareholders' income

The increasing globalisation of world markets has also highlighted major deficiencies in the simple rules used by most countries to determine the source of dividend income.

In principle, the actual economic source of dividend income is the country in which the value adding activity that produces that income is performed.

In practice, however, most countries use dividend source rules that assume the source of dividend income is the country in which the company paying those dividends is resident. That is, those rules assume that all of the dividend income distributed to shareholders was generated by economic activities undertaken by that company in the country in which it is resident.

In the past, such a simple rule for determining the source of dividend income provided a reasonably accurate indication of the actual source of dividend income since most companies only undertook domestic investments and had resident shareholders.

Over the last few years, however, the accuracy of that simple rule has been eroded significantly by increases in foreign equity investment and the emergence of multinational companies that engage in economic activities and have shareholders in several different countries.

Many companies have expanded their operations offshore and have an increasing number of foreign shareholders. As a result a significant proportion of the income earned by those companies is actually the foreign source income of foreign investors. That is, it is 'conduit' income that flows from foreign investments through the domestic company to foreign shareholders. Such 'conduit' income should not be subject to domestic tax since it is does not have a domestic source. Rather, such 'conduit' income is the foreign source income of foreign shareholders. However, the application of the simple dividend source rule deems such 'conduit' income to have a domestic source, thereby making it potentially subject to domestic tax in the absence of any explicit relief from tax.

Conversely, many residents now own shares in foreign companies that have significant investments in their country of residence. As a result, a significant proportion of the income earned by those foreign companies is actually the domestic source income of those resident shareholders. That is, it is the 'conduit' income that flows from the domestic investments through the foreign company back to the resident shareholders. Such 'conduit' income should not be subject to foreign tax since it is the domestic source income of resident shareholders. Rather, it should be subject to domestic tax and have imputation credits attached. However, the application of the simple dividend source rule deems this 'conduit' income to be domestic source income of the foreign company and denies the resident shareholder any imputation credits for the domestic tax paid on that income. This problem is often referred to as the ‘triangular tax’ problem.

As a result, the residence of a company for tax purposes is now no longer a reliable guide for determining the actual economic source of the dividend income it distributes. On the contrary, it can produce significant inaccuracies in the measurement of the amount of domestic and foreign source income earned by companies.

Most countries have recognised these fundamental deficiencies in their dividend source rules and have sought to implement a range of reforms aimed at refining their dividend source rules.

It is important to note, however, that it is difficult for any one country to alter this simple dividend source rule unilaterally, since it is embodied in OECD double tax treaties. Any changes to that simple rule would have to be renegotiated with all double tax treaty partners.

As a result, most countries have pursued alternative approaches to providing tax relief for such ‘conduit’ income flows. As discussed further in section 3.3, those approaches do not change the simple dividend source rule. Rather, they involve the application of lower rates of tax to those conduit income flows. The provision of such conduit tax relief, however, creates another potential problem – the risk that such regimes will be used to stream domestic source income free of tax to foreign shareholders. As a result, conduit income flows are often not exempted from tax. Rather, a low rate of tax is often applied to those flows to collect at least some tax on any domestic source income that might flow offshore to foreign shareholders.

The relief of the ‘triangular tax’ problem also involves an additional complication. Unlike the simple conduit problem outlined above, it cannot be resolved unilaterally by a country. Rather, it can only be addressed by entering into agreements with other countries to provide reciprocal relief of such ‘triangular tax’ conduit problems. As discussed further in section 3.3, such an approach is being pursued by Australia and New Zealand to ensure that franking and imputation credits flow to resident shareholders who earn conduit income through companies located in each others’ countries.

2.2.2 Collecting tax on shareholders’ income

The practical problems associated with the measurement of shareholders’ income identified in section 2.2.1 impose create significant problems for the collection of tax on that income.

Collecting tax on the domestic source income of resident shareholders

Since it is impractical to measure shareholders’ income as it accrues, governments have had to defer the assessment and collection of tax on that income until it is received by shareholders in the form of cash dividends and capital gains realised on the sale of shares.

In the absence of company tax, shareholders therefore would be able to reduce their tax liabilities by retaining their earnings in a company and thereby deferring the payment of tax on that income.

This explains the reluctance of most jurisdictions to abolish their company tax regimes. The company tax regime provides a mechanism for levying an interim withholding tax on the income that shareholders accrue from the retained earnings of the company.

In addition to reducing the scope for tax avoidance by shareholders, the company tax regime also reduces:

- the scope for shareholders to evade tax. In effect, the company tax regime operates as a final withholding tax regime for shareholders with marginal rates of tax equal to the rate of company tax, and an interim withholding tax regime for taxpayers with marginal rates of tax above or below the company tax rate; and
- the administrative costs associated with the collection of income tax. Since there are far more shareholders than companies, it is potentially more efficient to collect tax on the dividend income of shareholders at the company level rather than at the shareholder level.

At the same time, however, retention of a company tax regime also creates a number of additional problems for governments. In particular, as discussed in section 2.2.4, it means that the company and personal income tax regimes need to be integrated to avoid the double taxation of shareholders' income.

Collecting tax on the foreign source income of resident shareholders

Governments face even greater problems assessing and collecting tax on the income resident shareholders earn from their equity interests in foreign companies.

In this case, governments are not able to rely on those foreign companies to levy a withholding tax on that income. Rather, in the absence of any special rules, governments would have to wait until those companies repatriate profits to resident shareholders in the form of dividends, or until the resident shareholder realises a gain on the sale of those shares, before they can collect tax on that income.

This would provide resident shareholders with significant scope to avoid domestic tax on their foreign source income by accumulating that income offshore, particularly in low tax jurisdictions.

This is the reason why many countries have introduced special rules, such as controlled foreign company (CFC) and foreign investment fund (FIF) regimes, to reduce the scope for resident shareholders to accumulate income in offshore companies and avoid domestic tax. In effect, those rules seek to measure and assess tax on the income that resident shareholders accrue from specified offshore investments. In order to reduce the compliance costs associated with these regimes, the scope of those regimes is typically limited to 'passive' investments located in low tax countries, where the scope for avoidance of tax is the greatest.

As discussed further in section 3.4, however, in view of the complexity of those regimes many governments are now seeking to simplify those regimes to reduce the high compliance and administrative costs arising from their operation.

Collecting tax on the domestic source income of foreign shareholders

Governments also face significant problems collecting tax on the income foreign shareholders earn from their equity interests in companies.

Most countries use a combination of company tax and dividend withholding taxes to collect tax on the domestic source income of foreign shareholders. Once again, the company tax acts as a final withholding tax on company income as that income accrues to shareholders. By contrast, dividend withholding taxes only apply on distribution of that income.

In contrast to the tax treatment of the domestic source income of resident shareholders, no country attempts to tax foreign shareholders at increasing statutory marginal rates of tax. Rather, their income is subject to a flat rate of tax.

However, as discussed further in section 2.2.4, the application of both company tax and dividend withholding tax can give rise to problems of double taxation of the domestic source income of foreign shareholders.

2.2.3 Taxing shareholders' income at the appropriate rates

Perhaps the greatest challenge facing governments when reviewing and reforming their dividend taxation regimes is the determination of the 'appropriate' rates of tax to impose on shareholders' income.

There is increasing recognition of the significant 'deadweight' costs associated with taxing income from capital and that those costs are likely to be rising in view of the due to the increasing international mobility of capital and the flexibility of international capital markets. As a result, most countries have been seeking to reduce the rates of tax imposed on income from capital, particularly dividend income.

Determining the rates of tax to impose on the domestic source income of resident shareholders

When determining the appropriate rates of tax to impose on the domestic source income of resident shareholders and other forms of income from capital, governments need to determine:

- how much revenue they need to raise; and
- the most efficient way to raise that revenue.

Up until the early 1980s most governments regarded the income tax system as a convenient means of raising the revenue required to finance government spending. As a result, rates of company tax and personal tax rose significantly over time to meet the continually increasing expenditure needs of government, with little regard for the economic costs of raising that revenue.

By the early 1980s, however, many governments were recognising that their income tax regimes, which imposed very high rates of tax on a relatively small base of income, were no longer a sustainable source of revenue. In addition, there was increasing recognition of the significant disincentive effect that high rates of tax were having on saving and investment.

As a result, over the two decades, most countries have been reforming their tax regimes by introducing broadly based indirect consumption taxes and moving towards more 'comprehensive' income tax regimes that subject a wider range of income from capital to a lower and more uniform rate of tax. More recently, however, there has been an increasing trend away from such comprehensive income tax regimes towards regimes that impose a lower rate of tax on income from certain forms of capital, particularly dividend income. Those trends are discussed further in section 3.1.

Determining the rates of tax to impose on the foreign source income of resident shareholders

A key issue when determining the appropriate rates of tax to impose on the foreign source income of residents is whether the government's objective should be to maximise national welfare or world welfare.

One approach is to seek to maximise national welfare by the application of the 'residence principle'. This involves taxing residents' foreign source income at the same rate of domestic tax as their domestic source income and providing a tax deduction for any foreign taxes paid on that income. The rationale underlying this approach is that national welfare will be maximised by ensuring that residents only invest offshore when the rate of return after the payment of foreign taxes is more than the rate of return from domestic investments before the payment of domestic taxes.

An alternative approach is to seek to maximise world welfare by pursuing a 'capital export neutrality' approach. Under this approach residents would be taxed on their foreign source income and receive a tax credit for foreign taxes. In effect, this approach seeks to ensure that investment decisions world wide are unaffected by the taxes of all countries.

In practice, most countries are precluded from pursuing the residence principle by their existing double tax treaties with other countries. However, this does not mean that the appropriate approach is to seek to maximise world welfare by following a capital export neutrality approach.

Between these two extremes is a third approach that seeks to maximise national welfare while recognising the constraints imposed by existing double tax treaty arrangements. That 'second best' approach to maximising national welfare recognises that there is an inverse relationship between the rate of tax that should be applied to residents' foreign source income and the rate of tax that should be applied to foreign investors' domestic source income. For example, if the rate of tax on the domestic source income of foreign investors is too high and is raising the domestic cost of capital, this inefficiency can be offset by lowering the rate of tax imposed on the foreign source income of residents.

Most governments seek to tax the worldwide income of their resident shareholders at the same tax rates as are applied to their domestic source income in order to ensure that the tax system does not unintentionally distort choices between alternative domestic and offshore investments.

In view of the practical problems associated with the accurate measurement of that foreign source income, however, this is not always possible. Most governments have introduced special rules to measure the income that resident shareholders accrue from their foreign investments.

However, the complexity of those rules has meant that they have had to be confined to those investments where the scope for avoidance of domestic tax is greatest. In other words, governments face the problem of having to make complex trade-offs between the potential efficiency gains from improving the measurement of the foreign source income of resident shareholders, against the potential losses in efficiency arising from the high compliance and administrative costs associated with those rules.

Determining the rates of tax to impose on the domestic source income of foreign shareholders

In view of the increasing international mobility of capital, a key focus of most governments has been on reducing the rates of tax imposed on the income of foreign investors by reducing rates of company tax and dividend withholding tax.

For small open capital importing nations such as Australia, imposing tax on the domestic source income of foreign shareholders has the potential to raise the domestic cost of capital to some extent. This is because foreign investors will demand a higher pre-tax rate of return on their investments in order to compensate them for any domestic tax levied on the income they derive from that investment. That is, some, or all, of the economic burden of Australian taxes on foreign investors is shifted back onto Australians in the form of a higher cost of capital. In effect, taxing the income of foreign investors results in the 'double taxation' of the income of all Australian investors – once when they raise the finance they require to undertake the investment (due to the higher cost of capital) and again when they earn the income from that investment.

The extent to which taxing the domestic source income of foreign investors increases the domestic cost of capital depends on:

- the extent to which changes in the rate of Australian tax alter the total tax rate imposed on the foreign investors' income. This will depend on the extent to which foreign investors are able to claim credits for Australian tax against their home country tax liabilities. If foreign investors are able to claim credits for the full amount of Australian tax, then reducing the rate of Australian tax on their income will have no impact on the total amount of tax payable by those foreign investors and hence no impact on their investment decisions. Rather, any reductions in Australian tax would be offset by increases in the amount of foreign tax payable. Changes in the rate of Australian tax will only alter the total tax rate payable by foreign investors if they are either unable or unwilling to claim credits for the full amount of Australian tax against their home country tax liabilities; and
- the sensitivity of that foreign investments to changes in the rate of return. That sensitivity is likely to vary considerably across investments. For example, foreign portfolio debt and equity investments is likely to be more sensitive to tax than foreign direct investments. In addition, new foreign direct investment is likely to be more sensitive to tax than existing investments and empirical evidence suggests that the sensitivity of foreign direct investment to tax is increasing over time.

There are two main reasons why the governments of small capital importing nations such as Australia are reluctant to exempt the domestic source income of foreign investors from tax:

- the availability of foreign tax credits. Such foreign credits are available only if the government continues to tax the domestic source income of foreign investors. That is, in effect foreign tax credits are a subsidy from foreign governments which is only provided if the government continues to tax the domestic source income of foreign investors; and
- the existence of economic rents. Foreign direct investment may be relatively insensitive to tax when there are significant economic rents to be extracted from the domestic market.

2.2.4 Reducing the double taxation of shareholders' income

In addition to determining the appropriate rates of tax to apply to the income of shareholders, governments also face the problem of ensuring there is no double taxation of that income.

Reducing the double taxation of the domestic source income of resident shareholders

As noted in section 2.2.2, most governments have retained their company tax regimes in order to reduce:

- the scope for shareholders to avoid tax by accumulating their income in companies;
- the scope for shareholders to evade tax on that income; and
- the administrative and compliance costs associated with the collection of tax on shareholder income.

At the same time, however, the retention of a company tax regime also creates scope for the double taxation of shareholders income:

- once at the company level when it is earned; and
- again at the shareholder level when that income is received in the form of dividends or realised in the form of capital gains made on the sale of shares.

In order to eliminate this double taxation of income, it is necessary to 'integrate' the company and personal income tax regimes to ensure that the income each shareholder earns from their equity interests in a company is taxed at the appropriate statutory marginal tax rate set by the government.

As discussed in section 3.2, governments used many different methods to integrate their company and personal income tax regimes. None of these approaches fully integrates the company and personal income tax regimes due to the problems associated with:

- measuring the income of the company as it accrues; and
- attributing that accrued income to individual shareholders, which is particularly problematic when there are different classes of shares, and the ownership of shares is constantly changing, as is the case for most publicly listed companies.

Rather, most countries have implemented partial integration regimes that only provide relief from double taxation for the proportion of the company's income that is distributed to shareholders in the form of dividends.

For example, Australia is one of four countries that operate full dividend imputation regimes which provide resident shareholders with an imputed credit up to the full amount of tax paid by the company on that dividend income.

The company and personal income tax regimes are easiest to integrate when individuals are taxable at a single flat rate equal to the company tax rate. In this case, the company tax rate can be used as a final withholding tax on the income of individuals so that there is no additional personal income tax to pay by individuals.

Until recently, however, most governments imposed increasing statutory marginal rates of personal tax on the incomes of individuals and set the company tax rate at a level somewhere between the top and bottom rates of personal tax. This has required the development of more complex integration regimes that have imposed significant compliance costs on taxpayers and administrative costs on governments.

As a result, over the last few years, many governments have been seeking to reduce the costs of integrating their company and personal income tax regimes by shifting away from dividend imputation regimes to:

- dual income tax systems which apply a low flat rate of tax to all income from capital (section 3.1.3);
- split rate tax systems that apply a lower flat rate of tax to dividend income (section 3.1.3);
- modified classical income tax regimes which impose a lower rate of personal tax on dividend income (section 3.2.3); and
- modified imputation regimes which provide shareholders with a notional tax credit equal to some proportion of the value of the dividend paid (section 3.2.3).

Reducing the double taxation of the foreign source income of resident shareholders – the provision of foreign tax credits

In addition to relieving shareholders from the double taxation of their domestic source income, most countries have introduced regimes aimed at reducing the double taxation of shareholders' foreign source income.

Resident shareholders can earn their foreign source income either:

- directly through their shareholdings in foreign companies; or
- indirectly through their shareholdings in resident multinational companies with offshore investments.

As a result, resident shareholders are potentially exposed to three main sources of double taxation on their foreign source income:

- **foreign double taxation** of the foreign source income they earn directly from foreign companies – that is, the imposition of foreign company tax and foreign withholding tax on the same foreign source income;
- **international double taxation** of the foreign source income they earn either indirectly through resident companies, or directly from foreign companies – that is, the imposition of both foreign tax and domestic tax on the same foreign source income; and
- **domestic double taxation** of the foreign source income they earn through their shareholdings in resident multinational companies – that is, the imposition of both domestic company tax and domestic personal income tax on the same foreign source income.

Until recently, most countries used a combination of two separate regimes to reduce these two sources of double taxation:

- **partial integration regimes** (eg dividend imputation regimes) to reduce the domestic double taxation of both the domestic and foreign source income that resident shareholders earn from resident companies; and
- **foreign tax credit regimes** to reduce:
  - the **foreign double taxation** of foreign source income;
  - the **international double taxation** of the foreign source income of individual resident shareholders
  - the **domestic double taxation** of the foreign source income of resident companies.

For example, in Australia:

- individual Australian shareholders receive relief from:
  - **international double taxation** on the foreign source income they earn directly from foreign companies through the provision of foreign tax credits for foreign dividend withholding taxes levied on their foreign source income (but not for the underlying foreign tax imposed on that income);
  - **domestic double taxation** of the foreign source income they earn through Australian companies through the dividend imputation regime which provides franking credits for any Australian tax paid on that income;
- Australian companies are relieved from international and domestic double taxation of their foreign source income though the provision of:
  - a tax exemption for the non-portfolio dividends they received from investments in the 63 'listed' countries (ie a 'dividend exemption' method is used to provide relief at the company level from domestic double taxation);
  - a 'direct' foreign tax credit is provided for foreign tax paid on other dividend income (ie portfolio dividends), up to the amount of Australian tax payable on that income; and
  - an 'indirect' or 'underlying' foreign tax credit for the foreign company tax that the company is deemed to have paid on the distributable profits out of which the dividend was paid.

Until recently, the dividend imputation regimes operating in most countries, including Australia, did not provide resident shareholders with relief from the double international taxation of the foreign source income they earn through domestic companies. That is, no franking credits were provided for the foreign tax paid on that income. As a result, there was a tax bias against investment offshore through resident multinational companies.

As discussed in section 3.2, in order to reduce that bias, many countries have abandoned their dividend imputation regimes in favour of modified imputation regimes and modified classical tax regimes that provide double tax relief to shareholders regardless of the source of dividend income.

It is important to recognise, however, that in seeking to improve world welfare through the provision of foreign tax credits a government might reduce national welfare by distorting the pattern of investment by domestic shareholders. That is, governments face a complex trade-off between their national welfare objectives on the one hand, and their world welfare maximisation objectives on the other.

3. Key Trends in Dividend Taxation

Having identified the common problems, or 'key challenges', all countries face when designing or redesigning their dividend taxation regimes, we now focus attention on the key trends in the way those problems are being addressed both internationally and in Australia.

Our objective here is not to provide a comprehensive overview of all of the approaches being pursued. Rather, it is to identify the key trends that are likely to have the most significant implications for Australian companies and their shareholders, as well as Australian tax policy. Those implications are then analysed in sections 4 and 5 respectively.

The **most significant and sustained international trend** is the ongoing **reductions in rates of tax** imposed on the incomes shareholders derive from their equity interests in companies, which is discussed further in **section 3.2**. Such reductions in tax rates are intended to reduce the economic costs of raising tax revenue that were discussed in sections 2.1 and 2.2.3. That is, they are intended to reduce the extent to which the tax system reduces saving, raises the domestic cost of capital, deters investment, distorts patterns of investment, and reduces international competitiveness.

A closely related, but **more recent international trend** is the **shift away from dividend imputation regimes**, which is discussed further in **section 3.3**. An increasing number of countries have been replacing their dividend imputation regimes with regimes that provide shareholders with some relief from double taxation on their dividend income regardless of the source of that income or the amount of company tax paid on that income. That relief is provided at the shareholder level by reducing the amount of personal tax payable on dividend income regardless of the source of that income or the amount of company tax paid on that income. Such reductions in personal tax rates are intended not only to reduce the disincentive for residents to save and invest, but also to reduce the additional compliance and administrative costs arising from the operation of dividend imputation regimes.

In addition to reducing tax rates and implementing simpler regimes to provide shareholders with some relief from the double taxation of their dividend income, many countries have also been pursuing reforms aimed at improving the measurement of the income that shareholders derive from their equity interests in companies.

In particular, countries have been introducing reforms aimed at **clarifying the source of dividend income**, which are discussed further in **section 3.4**. As discussed in section 2.2.1, the rules governing the determination of the source of dividend income in most countries are deficient since they were designed to suit the needs of closed, rather than increasingly open, economies. A major problem with those rules is that they often treat 'conduit' income that flows from offshore investments, through a resident company, to foreign shareholders, as domestic source income rather than the foreign source income of non-residents. As a result, many countries have been introducing 'conduit' regimes to address that problem.

Many countries are also pursuing reforms aimed at **simplifying the measurement of foreign source income**, which are discussed further in **section 3.5**. As discussed in section 2.2.2, in order prevent residents from accumulating their income offshore and avoiding domestic taxes, many countries have introduced complex regimes which assess and collect tax on the income that companies and individuals accrue in low tax jurisdictions (controlled foreign company and foreign investment fund regimes). However, in view of the complexity of those regimes and the high compliance and administrative costs, those countries are now pursuing reforms aimed at simplifying the assessment and collection of tax on that foreign source income.

3.1 Reductions tax rates

Perhaps the most significant and sustained international trend in dividend taxation is the reduction in the rates of tax applying to income from capital, particularly dividend income.[2]

3.1.1 Shift away from income taxes to alternative tax bases

In recognition of the high cost of taxing income from capital, most countries have implemented indirect tax regimes (ie GST and VAT) as a means of reducing their reliance on income tax as a source of revenue. This is intended to reduce the extent to which the tax system discourages saving and investment.

Although no country has completely replaced its income tax regime with a tax on consumption, it is this widespread introduction of indirect consumption taxes has enabled many countries to implement significant reductions in the statutory marginal rates of tax applying to dividend income and other forms of income from capital.

In addition, some countries, including the United State and the United Kingdom have also been exploring the feasibility of replacing their income tax regimes with cash flow taxes, which are equivalent to taxes on consumption, or implementing taxes on pure profits through an Allowance for Corporate Equity (ACE) regime.

3.1.2 Reductions in rates of company tax and other withholding taxes

Reductions in statutory rates of company tax

One of the most noticeable, significant and sustained trends is the significant decline in statutory or 'headline' rates of company tax.

In view of the increasing mobility of capital, most countries have been reducing their company tax rates to reduce the domestic cost of capital in their countries, increase investment and their international competitiveness.

Between 1985 and 2002, statutory rates of company tax have fallen from around:

- 45 per cent to 31 per cent in the European Union;
- 42 per cent to 28 per cent in the OECD; and
- 36 per cent to 27 per cent in ASEAN.

Indeed, this trend has been so significant and sustained that it has raised concerns within the OECD that harmful tax competition could undermine the sustainability of income taxes as a source of revenue.

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2 The main focus of this section is on key trends in rates of taxation, not on the overall levels of taxation that currently apply in different countries. For a detailed comparison of the overall levels of tax (dividend, capital gains, and wealth tax) imposed on shareholders income from publicly listed companies in 30 OECD countries see the Swedish Shareholders' Association (2002) report.

Reductions in rates of interest and dividend withholding taxes

In addition to reducing rates of company tax, most countries have also been unilaterally reducing the rates of withholding tax impose on income from capital, particularly the interest and dividend income foreign investors earn from their portfolio investments.

For example, Australia and New Zealand have reduced the rates of withholding tax they impose on the interest and dividend income of non-residents. Australia removed dividend withholding tax on franked dividends in 1987 and has exempted from withholding tax the interest income of an increasing range of corporate bonds. Similarly, New Zealand has implemented an Approved Issuers Levy regime and a Foreign Investor Tax Credit regime that respectively provide foreign debt and equity investors with relief from New Zealand withholding taxes when they are unable to claim credits for those taxes.

These reductions in rates of withholding tax are primarily intended to reduce the cost of capital by reducing the total rate of domestic tax on the income of foreign investors. However, those withholding tax reductions also provide some degree of partial integration of the company and personal income tax regimes for foreign investors. In effect, foreign equity investors in most countries including Australia are usually subject to a classical tax regime. That is, their income is potentially subject to double domestic taxation – once at the company tax rate when it is earned and again at the dividend withholding tax rate when it is distributed.

As a result, most countries seek to provide some relief from double domestic taxation of that income by reducing the rates withholding tax imposed on dividend income that has already been subject to company tax. For example, Australia exempts fully franked dividends paid to foreign shareholders from dividend withholding tax. As discussed further below, much the same technique is now being employed by many countries to provide relief from domestic double taxation for the domestic source income of resident shareholders. That is, partial integration of the company and personal income tax regimes is achieved by reducing the amount of personal tax imposed on that income.

In addition, many countries have been seeking to renegotiate their double tax treaties with a view to reducing the foreign dividend withholding taxes that are imposed on the income that their resident companies and individuals derive from those countries.

Australia, like most other OECD countries, has an extensive range of double tax treaties that are intended to reduce the double taxation of income flowing between Australia and its treaty partners by limiting the rates of tax imposed on that income.

At the time most of those treaties were negotiated, there was general agreement within the OECD that a 15 per cent rate of withholding tax on dividends and a 10 per cent rate on interest struck an acceptable balance between reducing international double taxation and preserving source countries' rights to tax that income. Since then, however, most countries have been seeking to renegotiate their treaties to reduce their rates of interest and dividend withholding taxes to much lower levels in recognition of the increasing mobility of capital and the high and increasing deadweight costs arising from taxing income from capital.

In particular, Australia recently signed a Protocol with the United States that:

- eliminates the 15 per cent dividend withholding tax currently imposed on dividend income that Australian publicly listed companies earn from those US subsidiaries in which they have 80 per cent or more voting power;

- reduces from 15 per cent to 5 per cent the rate of dividend withholding tax imposed on the dividend income that Australian companies earn from US subsidiaries in which they have a 10 per cent or greater interest;
- eliminates the 10 per cent withholding tax on the interest income US financial institutions earn from their Australian investments and Australian financial institutions earn from their US investments; and
- reduces the 10 per cent withholding tax on royalties to 5 per cent.

As noted in Treasury's *Review of International Taxation Arrangements* consultation paper, once this protocol takes effect, little of no foreign dividend withholding tax will be paid by Australian companies on the dividend income they earn from their investments in the United States, the United Kingdom and New Zealand.

3.1.3 Reductions in rates of personal tax

Another significant international trend that has not received much attention in Australia to date is the imposition of much lower rates of personal tax on income from capital, particularly dividend income.

As outlined below, in addition to reducing the rates of company tax and withholding tax imposed on the income of foreign shareholders, many countries have also significantly reduced the rates of personal tax they impose on the dividend income individuals below the personal tax rate applying to income from labour.

This trend is in recognition of the high and increasing deadweight costs associated with taxing income from capital and is intended to:

- reduce the disincentive for residents to save and invest;
- reduce the extent of domestic double taxation of dividend income. As discussed further in section 3.2, reductions in the rates of personal tax on dividend income are being used as an alternative to more complex dividend imputation regimes such as those currently operating in Australia and New Zealand; and
- preserve the perceived equity of the tax system and limit the revenue costs of such tax reductions. Some countries, such as New Zealand, have sought to implement a low flat rate of income tax on all income from capital, including wage and salary income from human capital. However, the revenue costs of such an approach are considerable and such approaches are often opposed by sections of the community who believe that much more progressive rates of tax should apply to the income of individuals.

By contrast, Australia and New Zealand both still have comprehensive income tax regimes and full dividend imputation regimes that seek to apply the same rate of tax to all forms of income from capital and labour.

Application of a lower flat rate of personal tax to income from capital – 'dual income tax' regimes

In the 1990s, there was a major shift away from comprehensive income tax regimes in Scandinavian countries and Austria towards **dual income tax regimes**.

Under a comprehensive income tax regime, all of the income of individuals is subject to tax at their respective statutory marginal rates of tax, regardless of the source of that income.

By contrast, under a dual income tax regime, the income of individuals is taxed at different rates depending on its source:

- **income from labour** continues to be taxed at the progressive statutory marginal rates of personal income tax; and
- **income from capital** is taxed at a flat rate, which is usually set at the lowest rate of tax applicable to labour income.

Dual income tax systems currently apply in Norway, Finland, Denmark, Italy, Croatia, and Austria. In contrast to these other countries, Austria provides a deduction based on the annual increase in equity. This is intended to reduce the initial revenue cost of the regime.

For example, in Norway, the dual income tax system involves imposing:

- a 28 per cent flat rate of tax on the total net income of individuals (including realised capital gains and imputed rental income from owner-occupied housing) at the company tax rate of 28 per cent;
- an additional surtax of 13.5 percent on income that is not eligible for deductions (labour, self employed labour, and pension income);
- an additional social security contribution levy of:
  - 7.8 per cent on labour income;
  - 10.7 per cent on self-employed labour income; and
  - 3 per cent on pension income.

This dual income tax regime produces:

- a flat rate of tax of 28 per cent on income from capital; and
- the following top marginal tax rates on labour income:
  - 49.3 per cent for a salaried worker;
  - 52.2 per cent for a self-employed worker; and
  - 44.5 per cent for a pensioner.

The fundamental policy objectives of the dual income tax system are to reduce the extent to which the tax system:

- discourages saving and investment by lowering the rate of tax applying to income from capital in the hands of individuals;
- distorts patterns of investment, since it applies a uniform flat rate of tax to all forms of income from capital; and
- discourages individuals to from investing via intermediaries rather than investing directly, since the income from capital derived by a company is taxed at the same rate as the income from capital of an individual investor.

In effect, a dual income tax regime seeks to improve the efficiency of the tax system at the expense of a potential reduction in the perceived equity of the tax system since income from capital is no longer taxed at 'progressive' rates of personal income tax.[3] It not only reduces the rates of tax applying to income from capital, but it also removes the need for complex dividend imputation regimes to avoid the double taxation of dividend income. Since the dual income tax system levies a flat rate of tax on dividend income, it is possible to avoid double taxation simply by exempting dividend income from tax.

However, it is important to note that the Nordic dual income tax systems are not neutral with respect to the choice of organisational form. Rather, such systems encourage incorporation since company profits are taxed at a lower rate than non-corporate profits.

In order to address that problem, some Nordic countries treat closely held companies with active shareholders (Norway), or non-listed companies (Finland) in the same manner as individuals, or tax dividend income in the hands of individuals.

By contrast, the Italian dual income tax system adopts a different approach. It combines features of both the Nordic dual income tax regimes and the Allowance for Corporate Equity in an attempt to overcome some of the problems with both regimes.

Like the ACE regime, the Italian dual income tax regime:

- splits profits into two components – an imputed rate of return (normal profit) and a residual component (extra-profits); and
- taxes any extra profits in both the corporate and non-corporate sector at a higher rate of tax

However, unlike the ACE regime which exempts normal profits from tax, the Italian regime taxes normal profits at the basic income tax rate as is the case under the Nordic dual income tax regimes. This is intended to overcome one of the main problems with the proposed ACE regime, which is the need to apply a very high rate of tax to extra profits in order to raise sufficient revenue.

Similarly, like the Nordic dual income tax regimes, the Italian regime taxes the normal profits of companies at the basic income tax rate. However, unlike the Nordic dual income tax regimes, the Italian regime also:

- taxes any extra profits at a higher rate of tax; and
- applies to all types of business activities. This is intended to ensure that the tax system is neutral in respect to the choice of corporate form and to overcome the inherent bias in favour of companies that exists under Nordic dual income tax systems.

Application of a lower flat rate of personal tax dividend income – 'split rate' regimes

Rather than implement a dual income tax regime, which would apply a lower rate of tax to income from capital, some countries have sought instead to reduce the rate of tax imposed on dividend income distributed to shareholders via the introduction of **split rate regimes**.

Under a split rate regime:

- the retained earnings of a company are taxed at the company rate; and

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3 It is important to note that even a flat rate of tax is still progressive since individuals deriving more income from capital will still pay a greater amount of tax on that income than individuals deriving less income from capital.

- income distributed to shareholders in the form of dividends is taxed at a lower flat rate.

That is, split rate regimes involve imposing a flat and final rate of withholding tax at the company level that is typically below the top statutory rate of personal income tax. It can be thought of as dual income tax regime that applies the lower rate of tax only to one form of income from capital – dividend income distributed to shareholders.

As discussed further in section 3.2, split rate regimes also provide a means of partially integrating the company and personal income tax regimes and are equivalent in effect to a partial dividend deduction regime.

3.2 Shift away from dividend imputation regimes

Another significant and closely related international trend in dividend taxation is the recent shift away from dividend imputation regimes.

As outlined below, up until the 1970s, most countries operated classical tax systems that resulted in the double taxation of dividend income – once at the company level when it was earned, and again at the shareholder level when it was distributed to shareholders as a dividend (section 3.2.1).

Throughout the 1970s and 1980s, however, most countries sought to integrate their company and personal income tax regimes to eliminate, or at least reduce, the double taxation of dividend income.

As indicated in Table 3.1, integration regimes fall into a broad spectrum of regimes ranging from:

- classical tax regimes, which provide no explicit relief from double taxation;
- through to full integration regimes which would relieve all forms of income that shareholders derive from their equity interests in companies from double taxation.

While no country has been able to implement a full integration regime for all companies (3.2.2), most countries have chosen to implement partial integration regimes that provided relief from the double taxation of dividend income.

These partial integration regimes operated by providing either:

- dividend relief at the shareholder level through:
  - full imputation regimes;
  - partial imputation regimes; or
  - modified imputation regimes;
  - modified classical tax regimes
- dividend relief at the company level through the provision of:
  - full dividend deduction regimes; or
  - partial dividend deduction regimes; or
  - reverse imputation regimes.

Table 3.1: Trends in the integration of company and personal tax 1989-2002

Method of Integration	1989	2000	2002
Full imputation	Australia Germany New Zealand	Australia Germany New Zealand Malaysia Singapore Taiwan	Australia New Zealand Malaysia Singapore Taiwan
Parial imputation	Belgium Canada Denmark France Ireland Italy United Kingdom	France	
Modified imputation	Japan Spain	Japan Spain Italy Portugal Canada Finland Norway United Kingdom	Japan Spain Italy Portugal Canada Finland Norway United Kingdom France
Modified classical	Austria	Austria Belgium Denmark Greece Luxembourg Netherlands Sweden	Austria Belgium Denmark Germany Greece Luxemburg Netherlands Sweden
Partial dividend deduction	Germany* Greece Norway		
Classical	Finland Luxembourg Netherlands Portugal Sweden Switzerland United States	Switzerland United States Ireland	Switzerland United States Ireland

Sources: Genser (2001), European Federation of Accountants (2002), Ernst & Young (2002).

Over the last few years, however, there has been a significant trend:

- away from both imputation and dividend deduction regimes, that provide relief for a proportion of the company tax paid on that dividend income;
- towards the implementation of regimes that provide shareholders with relief from double taxation through the application of a reduced rate of personal tax on dividend income.

As indicated in Table 3.1, most countries now employ either a modified classical tax system or a modified imputation regime which both provide partial relief from double taxation for dividend income regardless of:

- whether the income comes from domestic or foreign sources; and
- how much tax was paid at the company level on that income.

That dividend relief is provided via the application of a lower rate of personal tax on dividend income than the rate of tax that applies to income from labour. That is, in addition to reducing rates of company tax to reduce the domestic cost of capital and increase the overall level of investment, many countries have also implemented reductions in the rates of personal tax on dividend income as a means of reducing both:

- the disincentive for residents to save and invest; and
- the extent to which the dividend income of shareholders is subject to double domestic and double international taxation.

3.2.1 No integration – the classical tax system

Up until the 1970s, most industrialised countries operated **classical tax systems,** which resulted in the double taxation of the incomes of shareholders – once at the corporate level and again at the shareholder level. In other words, by the time shareholders received their income, that income had been subjected to total taxes well in excess of the statutory marginal rates of tax they would have had to pay had they undertaken such investments directly rather that through a company.

By the year 2000, however, **Ireland** was the only country within the European Union to retain a classical tax system, along with the **United States** and **Switzerland**. The need to integrate the company and personal income tax regimes has received considerable attention in the United States.[4] Indeed, currently there are several bills before Congress proposing changes to dividend taxation including:

- H.R. 5463 (25 September 2002) which would allow companies to deduct dividends paid;
- H.R. 5466 (25 September 2002), which would exclude from the gross income of individuals 55 per cent of dividends; and
- H.R. 5413 (19 September 2002), which would give companies a deduction for dividends paid and exclude dividends from gross income.

Netherlands also used to operate a classical tax regime. However, in 2001 Netherlands introduced a presumptive tax on capital income from personal assets (eg shares and bank deposits) and that income

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4 See for example US Treasury (1992).

is taxed at a flat rate on the presumed rate of return on those assets (4%). Since company tax is still imposed on corporate profits, the Netherlands tax regime is now best described as a modified classical tax regime, which is discussed further below.

3.2.2 Full integration – relief for all shareholder income

In principle, it is possible to integrate the corporate and personal income tax systems fully to ensure that the income of shareholders is only taxed once at the respective statutory marginal rates of tax of each shareholder.

Such **full integration** of the corporate and personal income tax regimes involves treating the company not as a separate legal entity, but rather as a **conduit** through which shareholders can invest.

In effect, a full integration regime seeks to ‘look though the corporate veil’. That is, it seeks to allocate all of the profits of the company, including both distributed and undistributed profits, to individual shareholders as those profits accrue. This ensures that all of the income shareholders earn from their shares in the distributed and undistributed profits of the company is taxed only once in the hands of each shareholder at their respective statutory marginal rates of tax.

Although many countries use full integration regimes to tax partnerships and some closely held companies, no county has applied full integration to all widely held companies in view of the practical problems associated with:

- measuring income as it accrues; and
- attributing that income to each shareholder, given constant changes in share ownership for publicly listed companies.

3.2.3 Partial integration – ‘dividend relief’

Since full integration regimes are impractical, most countries now use some form of **partial integration** of the corporate and personal income tax to relieve the double taxation of shareholder income.

The term ‘partial integration’ is used to describe such regimes since they only provide double tax relief for part of the income that shareholders earn from companies – dividend income (ie distributed profits but not undistributed profits). For this reason, partial integration regimes are also often referred to as **dividend relief** regimes.

In effect, partial integration regimes are a pragmatic response to the practical difficulties associated with measuring the undistributed profits of a company as they accrue and attributing those undistributed profits to individual shareholders. By confining relief to profits distributed in the form of dividends, partial integration regimes avoid those practical difficulties.

As outlined below, these partial integration regimes seek to provide dividend relief at either:

- the shareholder level, through the provision of an ‘imputation’ credit to the shareholder for all (full imputation) or part (partial imputation) of the tax paid on that income by the company; or
- the corporate level, through the provision of a deduction to the company for dividends paid to shareholders.

Dividend relief at the shareholder level – full and partial dividend imputation regimes

One common approach to partial integration is to provide shareholders with an 'imputed' credit for either:

- all of the company tax paid on their income via a 'full' dividend imputation regime; or
- part of the company tax paid via a partial dividend imputation regime.

In 1989, most countries either operated full or partial dividend imputation regimes, or retained a classical tax system.

By contrast, in 2002, the only countries that continue to operate such dividend imputation regimes are Australia, New Zealand, Malaysia, and Taiwan.

Singapore also currently operates a dividend imputation regime, but on 3 May 2002 announced its intention to move to a one-tier corporate tax system from 1 January 2003.

Dividend relief at the shareholder level – 'modified imputation' and 'modified classical tax' regimes

One of the most significant international trends in dividend taxation over the last few years has been the movement away from dividend imputation regimes to 'modified imputation' regimes and 'modified classical tax' regimes.

Modified imputation regimes and **modified classical tax regimes** provide dividend relief at the shareholder level by applying a reduced rate of personal income tax to dividend income regardless of:

- whether the income comes from domestic or foreign sources; and
- how much tax was paid at the company level on that income.

Modified imputation regimes achieve this through the provision of a tax credit to the shareholder equal to some fixed proportion of the value of the dividend.

Modified imputation regimes now apply in the United Kingdom, France, Canada, Japan, Finland, Norway, Spain, Portugal and Italy. For example:

- United Kingdom, as from 6 April 1999, provides a tax credit equal to $1/9^{th}$ of the value of the dividend paid; and
- France provides, as from 1 January 2002, a tax credit equivalent to 50 percent of the value of the dividend paid to individual shareholders.

In addition, the Australian Treasury has recently proposed two options for the reform of the imputation regime, option A and option C, which would retain the current dividend imputation regime, but extend a modified imputation regime to the foreign source income of Australian shareholders. As discussed further below, those options for reform are intended to reduce the international double taxation of that income and the current bias at the shareholder level against investment offshore through Australian multinationals.

Modified classical tax regimes achieve much the same result through the application of a lower rate of personal income tax to dividend income.

As a result, modified imputation and modified classical tax regimes can be thought of as partial dividend imputation regimes that provide an imputation credit to shareholders that is independent of the amount of tax paid by the company. That is, shareholders are given a notional credit equal to some proportion of the value of the dividend regardless of its source.

Modified classical tax regimes now apply in Austria, Belgium, Denmark, Germany, Greece, Luxembourg, Netherlands and Sweden.

For example:

- Austria, Belgium, Denmark tax dividend income at a flat personal income tax rate of 25 percent and Sweden taxes dividend income at a rate of 30 percent. These rates are one half, or less than one half, of personal income tax rates. Such flat rates of tax allow these countries to collect the tax as a withholding tax without further assessment procedures. However, taxpayers are given the option of having an assessment if their tax liabilities would be less than those flat rates;
- Germany and Luxembourg apply half of the rate of personal income tax to dividend income; and
- Greece exempts dividend income from personal tax, and Singapore plans to exempt dividends from 2003. That is, a **dividend exemption** regime is just another variant of a modified classical tax regime. Such an approach will only succeed in integrating the company and personal income tax regimes when the company tax rate is equal to the rate of tax payable by shareholders. In effect, under a dividend exemption regime, the company tax regime becomes a final withholding tax for the income (dividends and capital gains) that shareholders derive from their equity investments.

Dividend relief at the shareholder level – Australian Treasury Options A and C

As noted above, Australia is also in the process of exploring options for providing some relief at the shareholder level from double international taxation in order to reduce:

- the current bias at the shareholder level against investment offshore through Australian multinationals; and
- the consequent disincentive for Australian companies to invest offshore.

Chapter 2 of the consultation paper notes that this bias could be removed by abolishing imputation, but rejects this option on the grounds that it would:

- impose considerable costs on the large number of Australian companies that earn no foreign source income (only around 16,700 Australian companies reported earning foreign source income in 1999-2000, whereas around 600,000 reported no foreign source income);
- re-introduce the problems imputation was implemented to address, including distortions in:
  - corporate finance (eg the bias in favour of the use of debt finance);
  - corporate distribution policy (eg the bias in favour of retaining profits in the company, rather than distributing them in the form of dividend payments to shareholders);
  - investor portfolio choices (eg the bias in favour of companies that generate capital gains rather than dividend income);
- remove the incentive that the imputation regime provides for Australian multinationals to pay Australian, rather than foreign, company tax.

Chapter 2 also notes that this bias could be removed by following the international trend of replacing the dividend imputation regime with a modified imputation regime that provides relief at the shareholder level regardless of the source of that income and the amount of company tax paid.

The consultation paper recognises that such a reform would:

- be consistent which recent international trends;
- simpler for business; and
- reduce any shareholder bias against investment offshore.

Despite these advantages, however, the consultation paper appears to reject that approach on the grounds that:

- removing the link between the amount of Australian company tax paid and the amount of tax relief provided to the shareholder could have a significant negative impact on company tax revenues;
- the effects on different shareholder classes would also vary depending on the nature and extent of the shareholder relief provided. In particular, taxpayers on low marginal tax rates and tax exempt entities that benefit from franking credit refunds would be likely to receive less direct benefits than currently available under the dividend imputation system; and
- there would be significant transitional issues. For example, whether companies with large existing stores of franking credits should have a transitional period to distribute existing credits to shareholders.

However, the consultation paper does propose three 'alternative' options for reform to reduce the bias at the resident shareholder level against investment offshore through Australian multinational companies:

- **Option A**, which involves providing Australian non-corporate resident shareholders with a non-refundable **credit for unfranked dividends paid out of foreign source income** by an Australian company (eg set at a rate of say one-ninth of the dividend). That is, in effect it involves the application of a modified imputation regime similar to that applying in the United Kingdom since it would provide shareholders with a level of credits regardless of the amount of foreign tax paid on those dividends. However, unlike the UK regime, that relief would be restricted to the unfranked dividends paid out of foreign source income.
- **Option B**, which involves allowing **dividend streaming of foreign source income to foreign shareholders** without adverse consequences for the amount of franking credits that can be paid to resident shareholders.
- **Option C**, which involves providing Australian shareholders **with franking credits for foreign dividend withholding taxes** paid on the foreign source dividend income received by Australian companies. That is, in effect it involves extending the imputation credit regime to provide credits for foreign dividend withholding taxes.

All three options are 'alternative' in the sense that they all seek to reduce the bias at the resident shareholder level against direct investment offshore by Australian companies.

However, it is important to note that options A and C seek to address a different source of that bias than option B.

Options A and C are alternative options since they both seek to reduce the extent to which the tax credits provided to Australian shareholders are reduced by the amount of foreign source income that flows through Australian companies to **Australian shareholders** (ie inflows of foreign source income). The only real difference between these two options is the manner in which they determine the amount of relief to be provided:

- Option A provides an amount of relief equal to some proportion (eg $1/9^{th}$) of the value of the unfranked dividends paid by an Australian company out of foreign source income.
- Option C provides an amount of relief equal to the amount of foreign dividend withholding tax paid on that dividend income. This option for reform was recommended by the Review of Business Taxation in its July 1999 report to the Australian government.

By contrast, option B seeks to reduce the extent to which the tax credits provided to Australian shareholders are reduced by the amount of foreign source income that flows through Australian companies to **foreign shareholders** (ie 'conduit' flows of foreign source income). In effect, option B seeks to ensure that Australian companies are able to stream the foreign source income of a foreign subsidiary through to foreign shareholders without any adverse consequences for the amount of franking credits that can be paid to resident shareholders.

As such, option B is really seeking to correct for a deficiency in Australia's existing dividend source rules which requires Australian companies to treat the foreign source income of foreign shareholders as if it was Australian domestic source income and attach imputation credits to that income. Unlike options A and C, it is not directed at providing Australian shareholders with relief from the double international taxation of their foreign source income. Rather, it is directed at ensuring that Australian companies are not forced to attach franking credits to the foreign sourced income of foreign investors that flows through the Australian company.

As a result, option B should not be regarded as an alternative to options A and C. Rather, option B should be considered along with the other options raised in the chapter 3 of the consultation paper for clarifying the source of dividend income, which include options for improving the conduit income arrangements and the residency rules for companies. This is the reason why we have grouped all of these options together in section 3.3 of our report which discusses international trends relating to the clarification of the source of dividend income.

It is also important to note that the consultation paper makes all three options for reform conditional upon further consideration of the effect that the dividend imputation bias at the shareholder level have on Australian companies. Specifically, option 2.1 of the consultation paper is worded as follows:

> **Option 2.1 for consultation:** after further considering the effect on Australian companies of the dividend imputation bias at the shareholder level, to consider three alternative options:
>
> A: providing domestic shareholder tax relief for unfranked dividends paid out of foreign source income;
>
> B: allowing dividend streaming of foreign source income; and
>
> C: providing franking credit for foreign dividend withholding taxes.

Dividend relief at the company level - full dividend deduction regimes

Rather than provide dividend relief at the shareholder level, an alternative approach to partially integrating the company and personal tax regimes is to provide dividend relief at the company level.

The most common approaches at the company level to reducing the double taxation of dividend income are variants of a dividend deduction regime.

Under a full **dividend deduction regime** companies would be allowed to claim a tax deduction for the dividends paid to shareholders. In effect, a dividend deduction regime treats dividends in the same manner that interest is treated for tax purposes. Companies would be able to deduct the cost of paying dividends to shareholders in much the same manner as they deduct the cost of paying interest to lenders. Dividend income would then be assessable in the hands of shareholders at their respective personal rates of income tax as is interest income. Of course, this would not preclude requiring resident companies to withhold tax on their payments of dividend income to shareholders, just as banks withhold tax on their payments of interest income to lenders.

Dividend relief at the company level - partial dividend deduction regimes

Although no country operates a full dividend deduction regime for all corporate dividends, many countries use partial dividend deduction regimes as a means of providing shareholders with relief from double taxation of their dividend income.

This can be achieved through a variety of different methods including:

- split rate method;
- dividend exemption;
- Annell deduction;
- deferred company tax; and
- allowance for corporate equity.

The **split rate method** used to be the most common form of relief at the company level.

Under the split rate method, the income earned by companies is taxed at the company rate if that income is retained in the company, or at a lower rate if it is distributed to shareholders in the form of dividends. For this reason, the split rate method is also often called the **'flat rate' method**, since it involves imposing a flat and final rate of withholding tax at the company level that is typically below the top statutory rate of personal income tax.

The effect of the split rate method is equivalent to providing the company with a tax deduction for a proportion of the dividends paid to shareholders. In other words, the split rate method can be thought of as a **partial dividend deduction** regime.

The split rate method used to operate in:

- Germany up until 2001 in conjunction with its full imputation regime. Germany now uses a modified classical tax regime under which imputation credits are provided for 50% of the dividend; and
- Japan up until 1989.

The **Annell deduction** is another variant of the dividend deduction regime which was used in **Sweden** from the early 1960s to 1993. Under this approach, Swedish companies were allowed to claim a deduction against their current profits for dividends paid in relation to **newly issued shares**. That deduction was limited to a maximum of 10 percent of the value of the new shares for a maximum of 20 years. A similar regime was proposed for the US by the American Law Institute in 1989.

The **Deferred company tax (DCT) regime** is yet another variant. Rather than reduce the statutory rate of tax, the DCT regime seeks to reduce the effective rate of company tax by allowing companies to defer the payment of tax. For example, Sweden used a 'periodization fund' which in effect allowed Swedish companies to defer taxation on 25 percent of each years income for up to 5 years, after which the fund would have to be returned as taxable income.

The **Allowance for corporate equity (ACE)** is another variant of a dividend deduction regime which was originally proposed by the Capital Taxes Group of the UK Institute of Policy Studies. It is important to note, however, that the ACE regime is not a normal income tax regime. Rather, it is intended to be a tax on pure profits.

Dividend relief at the company level – reverse imputation regimes

Rather than provide the company with deductions for dividends paid, an alternative method at the corporate level for reducing double taxation of dividend income is a **reverse imputation regime**.

Under a reverse imputation regime, companies would be allowed a credit for personal taxes paid by shareholders on dividend income and capital gains on shares.

Although this system is not currently in use, it was raised as a possible option in the tax debates in Sweden in the 1990's.

3.3 Clarifying the source of dividend income

As discussed in section 2.2.1, the current rules used by most countries to determine the source of dividend income are deficient. The location of a company no longer provides an accurate guide to the source of its income.

For companies with significant offshore investments and shareholders, a large part of the dividends they pay to foreign shareholders will be foreign source income. However, the existing dividend source rules assume that all of the dividends paid by a company have a domestic source. As a result, flows of foreign source income through a multinational company to foreign shareholders are potentially subject to tax unless some relief is provided for such flows of 'conduit' income.

3.3.1 Overview of conduit relief mechanisms

As indicated in Table 3.2, the manner in which conduit income is treated differs significantly across countries.

Many countries, including Germany, Japan, and the United States still have no special rules.

Other countries use a variety of techniques to override the dividend source rules to provide some relief from tax for that conduit income. The methods vary significantly across countries and include:

- **full** or **partial dividend exemption**. Under this approach, all or part of the dividend is exempt from tax. This is the approach used in the UK, Argentina, Brazil, China, Croatia, Malaysia and

Mexico. China exempts foreign source dividends distributed by foreign investment enterprises to non-residents;

- application of a **reduced rate of withholding tax**. Under this approach, a reduced rate of withholding tax is applied and the rate of that tax is often altered by tax treaty. This is the approach used in Canada, Taiwan, Belgium, Denmark, Israel, Italy and Norway. China also follows this approach for distributions by companies other than foreign investment enterprises;
- **offset of inbound against outbound withholding taxes**. Under this approach, the foreign withholding tax imposed on the inbound income can be offset against the dividend withholding tax payable on the outbound income, subject to certain restrictions. This is the approach used in France. Finland and South Korea both allow imputation credits to be offset against withholding taxes on distribution;
- provision of a **foreign tax credit**. Under this approach, foreign source income is taxable, but a credit for the foreign tax paid on that income is provided to the foreign shareholder on distribution. This is the approach used in Chile;
- exemption of income passing through **foreign dividend account**. This is a more limit variant of a dividend exemption approach. That is, it confines tax exemption to income flowing through a specific foreign dividend account. This is the approach employed in Australia; and
- implementation of a separate **conduit provisions**. This involves the implementation of separate tax provisions governing the provision of tax relief to conduit income and is the approach used in New Zealand. Under this approach, conduit income is not exempt from tax. Rather, a reduced rate of withholding tax continues to apply to provide partial relief from tax, while protecting the tax base from possible erosion if the conduit rules are used to steam domestic source income to foreign shareholders.

Table 3.2: Alternative approaches to providing conduit relief

No special rules	Full or partial dividend exemption	Reduced rate of withholding tax	Offset of inbound against outbound withholding taxes	Foreign tax credit	Foreign dividend account rules	Separate conduit provisions
Germany Ireland Japan Singapore Sweden	UK Argentina Brazil China Croatia Malaysia Mexico	Canada Taiwan Belgium China* Denmark Israel Italy Norway	France Finland South Korea	Chile	Australia	New Zealand

Source: Review of Business Taxation (1998)

3.3.2 Improving conduit income arrangements – Australian Treasury options for reform

Chapter 3 of the consultation paper sets out a range of options for reform to improve tax relief for conduit income. The primary objective of those reforms is to provide conduit relief for companies of CGT and dividend withholding tax.

Relief from CGT for regional holding companies – option 3.10

Under the Australian CGT rules, if a non-resident directly invests in a foreign subsidiary and then subsequently sells that foreign subsidiary, it is exempt from Australian CGT on that sale, since the capital gains made are the foreign source income of that non-resident.

By contrast, if the non-resident invests indirectly in the foreign subsidiary through an Australian regional holding company, then:

- the Australian holding company may pay CGT on the sale of its interests in the regional foreign subsidiary (referred to in the consultation paper as ‘Interest A’); and
- the non-resident investor may pay CGT on the sale of its interests in the Australian regional holding company (referred to in the consultation paper as ‘Interest B’).

This application of Australian CGT to the foreign source capital gain income that non-residents earn through Australian regional holding companies acts as a disincentive for multinationals to set up regional holding companies to assist in the more efficient management of their operations in Australia and the Australasian region.

The consultation paper notes that other countries’ domestic tax regimes also provide CGT relief on conduit income flows. For example:

- New Zealand does not have a general capital gains tax;
- Germany generally exempts the sale of one company’s portfolio interests in another company; and
- the United Kingdom is proposing to exempt the sale of interests in trading companies.

However such ‘generalised’ options for reform are dismissed on the grounds that they would have ‘significant domestic tax consequences’.

As an alternative to those ‘generalised’ approaches, the consultation paper proposes three alternative options to provide Australian regional holding and joint-venture companies with more specific relief from tax on this conduit capital gains income (option 3.10):

- introducing a general holding company regime;
- providing an exemption for the sale of a non-portfolio interest in a foreign company with an underlying active business; and
- providing conduit restructure relief.

The consultation paper notes that the introduction of a **general holding company regime** would exempt from CGT capital gains made on the sale of both ‘Interest A’ and ‘Interest B’ and would cater for joint venture companies. However, the consultation paper also expresses concern that ‘such a conduit holding company regime would be complex, have significant compliance and administration costs, raise valuation problems, and potentially benefit non-conduit cases. It also may raise harmful tax practice issues'. In addition, the consultation paper notes that such a conduit holding company regime could be extended to provide tax relief for conduit income arising from non-resident portfolio interests in Australian multinationals, as does the New Zealand conduit holding company regime. However, once again the paper expresses concern that this 'would increase design and compliance problems'.

In view of the perceived problems with a general holding company regime, the consultation paper proposes two alternative options for providing relief from CGT when Australian holding companies sell their interests in foreign regional subsidiaries ('Interest A').

The consultation paper notes that the **provision of a CGT exemption for the sale of a non-portfolio interest in a foreign company with an underlying active business**, in conjunction with the foreign income account reforms proposed in option 3.11, would:

- alleviate most 'Interest A' concerns;
- benefit Australian multinational companies;
- avoid many conduit holding company design problems;
- be justified since Australia's foreign source income rules already exempt disposals of underlying active businesses assets by controlled foreign companies (referred to in the consultation paper as 'Interest C').

However, the consultation paper also notes that this approach 'raises design and compliance issues of its own that need to be explored further'. In particular, it notes that it might be difficult to:

- legislate such an approach; and
- apply an active/passive business distinction under such an approach since this would require Australian companies to look through layers of controlled foreign companies in order to determine the extent to which an underlying active business exists. Although the paper notes that an Australian company is likely to have sufficient information in relation to its CFCs to undertake this inquiry, problems could arise when trying to value the active and passive assets.

If such a CGT exemption was also extended to the capital gains realised by non-resident investors on the sale of their interests in an Australian holding company ('Interest B'), this would implement a conduit holding company regime. However, the consultation paper argues that 'major valuation problems would occur in administering such an exemption, as non-residents would need to calculate the extent to which their gain is due to the Australian companies' unrealised gains in foreign subsidiaries'. In particular, the paper notes that these problems with a holding company regime arise due to difficulties in:

- accurately attributing and exempting foreign gains to various taxpayers due to the mixed combinations of resident and non-resident shareholders and domestic and foreign assets;
- inadequate information on values, changes in ownership, and the retention of exempt gains; and
- the need for unequal distribution policies.

In view of these problems with a conduit holding company regime, the consultation paper proposes an alternative approach that provides **conduit restructure relief** – that is, relief when a conduit structure is unwound.

Such conduit restructure relief would allow a non-resident shareholders to swap an indirect interest in the foreign subsidiary of an Australian company for a direct interest, which would not be subject to CGT when sold. The paper notes that this approach would:

- provide relief from CGT on conduit income arising in both the sale of 'Interest A' and 'Interest B' cases; and
- avoid many of the problems associated with a conduit holding company regime;
- not have to be limited to the sale of significant interests in an Australian company; and
- be simpler to legislate.

However, the consultation paper notes that such conduit restructure relief:

- is limited as it only extends CGT relief to circumstance where the non-resident exits the investment;
- requires investors to restructure in order to gain access to conduit relief; and
- is a much less transparent mechanism for providing conduit relief.

Establish foreign income accounts – option 3.11

At the moment, Australia's foreign dividend account rules do not provide relief from tax for all conduit income flowing through Australian companies to foreign shareholders. Rather, those rules only provide an exemption from withholding tax for unfranked dividend paid out of non-portfolio dividends received from:

- listed countries; and
- unlisted countries to the extent that foreign tax credits are available.

As a result, the Review of Business Taxation recommended replacing foreign dividend account with a foreign income account that would provide an exemption from withholding tax for all conduit income distributed by an Australian company.

Option 3.11 of the Treasury consultation paper involves the consideration of whether to:

- proceed with the foreign income account rules recommended by the Review of Business Taxation; and
- allow the tax-free flow-through of foreign income account amounts along a chain of Australian companies subject to Option 2.1.

The consultation paper notes that an 'in-principle' case exists to establish conduit taxation relief. However, it also states that 'a final decision on the foreign income account, and its design, can only be made as part of a final consideration of the imputation options in chapter 2'.

The important relationship between these imputation options and the provision of conduit relief is discussed further below.

Relevance of the imputation options A, B and C to conduit relief

It is important to note that if conduit relief is to be provided to Australian companies, then it will be necessary to implement not only the foreign income account rules outlined above, but also:

- option B in order to ensure that conduit income flowing through foreign income accounts does not reduce the amount of franking credits that Australian companies can attach to their dividends that are paid out of Australian source income; and
- either option A or option C to provide relief from Australian tax for the foreign source income of foreign shareholders that flows through several Australian companies before it reaches those foreign shareholders.

That is, the imputation option B in conjunction with either option A or option B, all have an important role to play in the provision of conduit relief.

That 'conduit relief' role of options A and C needs to be considered separately from the other 'international double tax relief' role which is to provide Australian shareholders with relief from the foreign tax imposed on their foreign source income earned through Australian multinationals.

In particular, if the Government decides not to introduce either option A or option C to relieve the international double taxation of the foreign source income of Australian shareholders, it still needs to consider the use of either option as a means of relieving the conduit income of foreign shareholders from Australian tax.

Trans-Tasman triangular tax

Another variant of the conduit problem is referred to as the 'triangular tax' problem.

This problem is the reverse of the conduit problem. It arises due to the fact that many companies now have significant foreign investments and foreign shareholders located in the same country.

For example, many Australian companies have significant investments in New Zealand and significant numbers of New Zealand shareholders. As a result, much of the income of the Australian company is actually the New Zealand source income of New Zealand shareholders. However, those shareholders do not receive any imputation credits for the New Zealand tax paid on their New Zealand source income.

Conversely, many New Zealand companies now have significant investments in Australia and significant numbers of Australian shareholders. However, those Australian shareholders do not receive franking credits for the amount of Australian tax paid on that Australian source income.

Options for dealing with this trans Tasman triangular tax problem were outlined in a discussion document released by the Australian and New Zealand governments.

3.3.3 Refining corporate residence – Australian Treasury options 3.12

The place of residence of a company has an important impact on the manner in which that company is taxed and the tax treatment of its dividends.

In particular, the place of residence of a company is still used to determine the source of dividend income distributed by a company. As discussed in section 2.1.2, this arbitrary rule for determining the source of dividend income worked relatively well in the past when companies only earned income from investments in their country of incorporation. However, it does not provide a particularly good indication of the source of dividend income since the emergence of multinational companies that have investments and shareholders in many countries.

At the moment, a company is treated as resident if it is:

- incorporated in Australia; or
- carries on a business in Australia and either has its central management and control in Australia, or Australian residents control its voting power.

As noted in Treasury's consultation paper, these corporate residence tests were introduced in 1930 and have remained unchanged since then. In addition, there is some uncertainty surrounding as to whether the tests of 'carrying on a business' and 'central management and control' are separate tests or whether they both have to be satisfied. As a result, the consultation paper includes option 3.12 which proposes that options should be considered to clarify the test of company residency so that exercising central management and control alone does not constitute the carrying on of a business.

The consultation paper also proposes to reduce the scope for dual resident problems under Australia's double tax treaties by overriding the current rules when a company is deemed to be non-resident as a result of the treaty tie-breaker tests. That is, option 3.13 proposes that once a company is deemed to be resident in another country under a tie-breaker test, it would be treated as being non-resident for all income tax purposes.

3.4 Simplifying the measurement of foreign source income

3.4.1 Introduction of CFC regimes

Many countries, including Australian, have introduced controlled foreign company (CFC) and foreign investment fund (FIF) regimes aimed at assessing and collecting tax on the foreign source income that resident shareholders earn from their foreign investments as it accrues, rather than when it is paid (eg Denmark, Finland, France, Germany, Italy, Portugal, Spain, Sweden and the United Kingdom). Those rules are intended to reduce the scope for shareholders to avoid tax on their foreign source income by accumulating their income in foreign companies.

For example, a number of different approaches are used to provide the legal basis for taxing the shareholder's sheltered income including the:

- 'deemed dividend' approach, under which the income is deemed to be distributed as a dividend (ie the income is recognised as it accrues rather than when it is received);
- 'piercing the veil' approach, under which the income is deemed to have arisen in the hands of the shareholders; and

- ‘increased ability to pay’ approach, under which the shareholders are deemed to have an increased ability to pay tax because the income is at their disposal.[5]

In order to reduce the compliance costs associated with those regimes, most countries restrict the application of these rules to those cases where the scope for such avoidance is greatest (eg ‘passive’ income form portfolio investments located in low tax jurisdictions). For example, Australia’s CFC rules require residents who control foreign companies to include in their assessable income a proportion of the company’s ‘tainted’ income (ie passive income such as dividends, interest and capital gains, as well as ‘tainted’ sales and services income). If the CFC is located in a ‘broad exemption listed country’ then Australian residents only have to include a narrower range of income in their assessable income.

3.4.2 Focus on simplifying measurement of foreign source income

Despite the limitations on the scope of these regimes, however, most countries recognise that those regimes are too complex and impose significant compliance costs on taxpayers.

As a result, most countries have been exploring alternative approaches to further reducing compliance costs. Of these, the Netherlands use of a ‘presumed’ income approach is the most interesting. In effect, this involves assuming that investors make a risk free rate of return on their investments and levying tax on that income. Such a ‘risk free rate of return’ is also being explored in New Zealand.

The Treasury consultation paper also proposes a range of further reforms to the Australian CFC regime including:

- expanding rollover relief for corporate restructuring (option 3.1);
- better targeting the tainted services income rules (option 3.2); and
- expanding the number of broad exemption listed countries (option 3.3).

5 For a detailed survey of CFC regimes in the European Union see European Federation of Accountants (2002).

4. Implications for Australian Companies and their Shareholders

Having identified the key trends in dividend taxation in section 3, we now turn our attention to analysing the implications of those trends for Australian companies and their shareholders.

Once again, our analysis is not intended to be comprehensive. Rather, as discussed further in section 4.1, it focuses attention on the implications of the key trends in dividend taxation identified in section 3. This includes a range of options for the reform outlined in the Australian Treasury's *Review of International Taxation Arrangements* consultation paper that was released in August 2002.

Our approach to analysing the implications of those key trends for Australian companies and their shareholders is outlined in section 4.2. In brief, it involves determining the impact of those changes under the simplifying assumption that Australian companies and shareholders do not alter their behaviour in response to those changes. In particular, we focus attention on the implications of each of those trends for:

- the effective rates of tax imposed on the income of Australian companies and their shareholders;
- the cost of capital for Australian companies; and
- shareholder value.

The results of our analysis under that simplifying assumption are then presented in sections 4.3 to 4.6.

Section 5 of the report then relaxes that simplifying assumption to determine the implications of these tax changes for investment decisions. As discussed further in section 5, this involves a similar approach, but the use of different analytical tools.

4.1 Key trends analysed

The implications of four key trends are analysed:

- reductions in tax rates (section 4.3);
- shift away from dividend imputation (section 4.4);
- clarification of the source of dividend income (section 4.5); and
- simplification of the measurement of foreign source income (section 4.6).

4.1.1 Reductions in tax rates

The first key trend analysed is the international trend towards reducing tax rates on income from capital, particularly dividend income. As discussed in section 3.2, this is probably the most significant and sustained trend the dividend taxation.

Reductions in company tax rates

Australia, like most other countries, has been reducing its rate of company tax in order to reduce the cost of capital, increase investment and increase international competitiveness. Although Treasury's *Review of International Taxation Arrangements* consultation paper does not propose any further reductions in the company tax rate in Australia, Chapter 1 of that paper did highlight the significance of this worldwide trend towards reducing company tax rates, particularly in the European Union. In addition, it pointed out that Australia's headline rates of company tax are relatively competitive in relation to those applying in other countries.

However, it is also important to note that those reductions in rates of company tax in other countries have been accompanied by significant reductions in the rates of personal tax imposed on dividend income. By contrast, in Australia, the dividend income of most shareholders continues to be subject to the top personal rate of 47 per cent.

In view of the significance of this international trend towards lower rates of tax, we have analysed the implications of both:

- international reductions in rates of company tax, which have reduced rates of company tax in the OECD from around 33 to 29 percent, and company tax rates in the EU reduce from around 35 percent to 31 percent; and
- Australia's reduction in its company tax rate from 36 to 30 percent.

As noted by Treasury, this international trend towards reducing company tax rates also shows no signs of abating. Company tax rates are continuing to fall in some countries:

- Ireland intends to tax trading income at a rate of 12.5 percent by 2003;
- Singapore, which recently reduced its rate from 25.5 percent to 24.5 percent, aims to reduce its rate of company tax to 20 percent by 2005;
- Belgium plans to reduce the basic company tax rate from 39 percent to 33 percent; and
- Canada expects to reduce its federal company tax rate from 28 percent to 21 percent by 2004 (although a surtax and provincial taxes would continue to apply).

As a result, we also examine the implications of further reductions in company tax rates both internationally, and in Australia, to around 20 percent.

Reductions in rates of foreign dividend withholding tax

As noted in section 3.1.2, Australia, like most OECD countries also has numerous double tax agreements with other countries to relieve international double taxation. Those treaties were negotiated at a time when there was general agreement within the OECD that a 15 per cent rate of withholding tax on dividends and a 10 per cent rate on interest was appropriate. Since then, however, most countries have been seeking to renegotiate their treaties to reduce dividend withholding taxes to much lower levels in recognition of the increasing mobility of capital and the high and increasing deadweight costs arising from taxing income from capital.

In particular, the protocol Australia recently signed with the United States has important implications for the rates of foreign withholding tax imposed on the foreign source interest and dividend income of most Australian multinational companies. Once it takes effect, little or no foreign dividend withholding tax will be paid by Australian companies on the dividend income they earn from their investments in the United States, the United Kingdom and New Zealand.

As a result, in addition to analysing the impact of reducing rates of Australian company tax, we also analyse the implications of eliminating the 15 per cent withholding taxes currently imposed on dividend income Australian multinational companies earn from such listed countries.

4.1.2 Shift away from dividend imputation

The next key trend analysed is the shift away from dividend imputation regimes towards regimes that provide shareholders with relief from double taxation by reducing the rate of personal tax imposed on dividend income through either:

- the provision of imputation credits equivalent in value to some fixed proportion of the value of dividends paid (ie via a 'modified' dividend imputation regime such as that used in the United Kingdom); or
- the imposition of a lower statutory rate of tax on dividend income (ie via a 'modified' classical tax regime, a 'dual' income tax system, or a 'split rate' tax system).

In effect, these regimes all partially integrate the company and personal tax regimes by reducing the personal tax rate imposed on dividend income regardless of the source of that income or the amount of company tax paid on that income.

As discussed in section 3.2, it is important to note that this shift away from dividend imputation is part of the international trend towards reducing rates of tax on income from capital. Many countries have reduced their personal tax rates on dividend income below the rates of tax applying to labour income as a means of reducing both:

- the disincentive to save and invest; and
- the scope for double domestic taxation of dividend income.

The implications of four main changes to Australia's dividend imputation regime are analysed.

The first two changes analysed were raised and rejected by the Australian Treasury in its *Review of International Taxation Arrangements* consultation paper:

- a return to a classical tax system; and
- the implementation of a UK style modified imputation regime that provides shareholders with tax credits regardless of the source of dividend income or the amount of company tax paid on that income.

The last two changes analysed are the options for reform of proposed by the Australian Treasury in chapter 2 of its *Review of International Taxation Arrangements* consultation paper:

- option A, which involves the provision of a notional tax credit to Australian shareholders for the unfranked dividends they receive from listed countries. In effect, this option involves the provision of a UK style notional tax credit for dividends paid out of foreign source dividend income from listed jurisdictions, which is exempt from Australian company tax; and
- option C, which involves the provision of franking credits for foreign dividend withholding taxes levied on their foreign source income.

4.1.3 Clarification of the source of dividend income

Australia already has implemented a foreign dividend account system to provide relief from dividend withholding tax for the foreign source income of foreign shareholders that flows through Australian multinational companies (ie 'conduit' income flows).

As noted in section 3.3.2, however, Australia's imputation regime is deficient to the extent that it requires Australian multinational companies to allocate imputation credits to all of the dividends they pay in equal proportion, even though some of those dividends are the foreign source income of foreign shareholders. In effect, this means that flows of conduit income through an Australian multinational company reduce the imputation credits available to Australian shareholders for the company tax paid on their Australian source income.

Australian multinational companies can overcome this problem to some extent by choosing not to pay any dividends from their foreign dividend account until they have exhausted their imputation credits.

However, once an Australian multinational has exhausted its imputation credits and tries to use its foreign dividend account credits to pay dividends to its foreign shareholders out of its foreign source income, it is required to allocate a proportion of those credits to Australian shareholders. That is, the current foreign dividend account rules in effect reduce the amount of exempt foreign dividends that can be paid to foreign shareholders.

The Treasury consultation paper proposes to address this problem via 'option B', which would allow Australian multinational companies to stream the foreign source income derived from listed countries to foreign shareholders, without reducing either:

- the imputation credits available to Australian shareholders; or
- the amount of exempt foreign dividends that can be paid to foreign shareholders.

As a result, in this section we assume that Australian multinationals follow a policy of exhausting their imputation credits prior to paying any dividends out of their foreign dividend accounts. Then we analyse the impact that the implementation of option B would have on the effective tax rates imposed on the income of Australian multinational companies, their cost of capital and shareholder value.

4.1.4 Simplification of the measurement of foreign source income

The last key change analysed is the simplification of the measurement of the foreign source income of Australian shareholders.

As noted in section 3.4, most countries have implemented complex rules to reduce the scope for resident shareholders to avoid tax by accumulating income offshore, particularly in companies located in low tax jurisdictions. Those rules are highly complex since, in effect, they seek to measure the amount of income that shareholders accrue, rather than receive, from their equity interests in such companies.

In order to reduce compliance costs, the scope of these regimes is usually restricted to those forms of investment where the scope for such deferral of tax is greatest (eg passive investments in low tax jurisdictions) and investments in countries with comparable tax systems are typically exempted. However, most countries, including Australia, recognise the need to reduce compliance costs even further while not increasing the scope for tax avoidance.

To this end, the Treasury consultation paper raises for consultation the issue as to whether additional countries should be included on the broad exemption country list (option 3.3).

As a result, we have analysed the impact of expanding the broad exemption country list to include a country that is not currently listed. Specifically, we have analysed the implications for Australian multinational companies of changing the status of their unlisted subsidiary to a listed subsidiary. This is analysed by assuming that all of the investments of the multinational are in listed country, as opposed to a combination of listed and unlisted countries.

4.2 Approach adopted

What implications do these important trends in dividend taxation have for Australian companies and their shareholders?

In order to answer this question, we have adopted a two step process of analysis:

- The first step is to analyse the impact of those trends for Australian companies and shareholders under the simplifying assumption that these tax changes have no effect on the investment decisions of either Australian companies or their shareholders. The remainder of section 4 presents the results of that analysis.
- The second step, which is undertaken in section 5, is to relax that simplifying assumption with a view to identifying how those changes might affect patterns of real investment and national welfare. As discussed in section 5.1, this involves a similar approach, but different analytical tools.

4.2.1 Tax Impact Model

For the purposes of the analysis in section 4, we have used Ernst & Young's *Tax Impact Model*.

As outlined in Appendix 1, the *Tax Impact Model* is a stylised model of a group of companies comprising an Australian parent company that operates wholly owned subsidiaries in:

- Australia
- a listed country; and
- an unlisted country.

The *Tax Impact Model* is used to determine the impact of the key trends in dividend taxation outlined in section 4.1 on:

- the effective tax rates imposed on the income shareholders derive from Australian companies;
- the cost of capital of Australian companies; and
- shareholder value.

4.2.2 Determining the impact on effective tax rates

What effect do these key trends in dividend taxation have on the effective rate of tax that Australian companies and their shareholders have to pay on their income?

The answer to this question depends on a number of factors including:

- the extent of foreign investment by the company and foreign ownership;
- the location of that foreign investment;
- the location of those foreign shareholders; and
- the company's dividend distribution policy (eg the extent to which profits are distributed to shareholders or retained by the company).

This means that the impact of each of the proposed options for reform on the effective tax rates imposed on shareholders' income will vary significantly across companies.

Extent of foreign investment and foreign ownership

In order to illustrate the implications that differences in the extent of foreign investment and foreign ownership have for the impact of international trends in dividend taxation on the effective tax rates of Australian companies and their shareholders, we have created 3 hypothetical corporate groups for analysis:

- **Australian corporate group**. This corporate group has been set up to illustrate the impact on Australian companies that have no foreign investments and only a few foreign shareholders (assumed to be 1 per cent of total shareholders). This 'Australian corporate group' comprises an:
  - Australian resident parent which holds 50 per cent of the group's assets;
  - a wholly owned Australian subsidiary which has the remaining 50 per cent of the groups assets.
- **Emerging Australian Multinational**. This corporate group has been set up to illustrate the impact on emerging Australian multinationals – that is, Australian corporate groups that have some foreign investments and foreign shareholders (assumed to be 10 per cent of total shareholders). Specifically, we assume that the Emerging Australian Multinational comprises:
  - an Australian parent company that has 40 per cent of the group's assets;
  - an Australian subsidiary that has 40 per cent of the group's assets;
  - two foreign subsidiaries which have the remaining 20 per cent of the group's assets
- **Mature Australian Multinational.** This corporate group has been set up to illustrate the impact on a mature Australian multinational that has a greater proportion of foreign investments and shareholders (assumed to be 20 per cent of foreign shareholders). In particular, the Mature Australian Multinational is assumed to comprise:
  - an Australian parent company that has 30 per cent of the group's assets;
  - an Australian subsidiary that has 20 per cent of the group's assets;
  - two foreign subsidiaries which have the remaining 50 per cent of the group's assets.

Each of these corporate groups is assumed to have the following mix of Australian shareholders:

- the **Australian Corporate Group** has:
  - 89 per cent of its shares owned by Australian taxpayers who are subject to the top marginal tax rate of 47 per cent;
  - 10 per cent of its shares owned by Australian superannuation funds that are subject to a rate of tax of 15 per cent.
- the **Emerging Australian Multinational** has:
  - 65 per cent of its shares owned by Australian taxpayers who are subject to the top marginal tax rate of 47 per cent;
  - 25 per cent of its shares owned by Australian superannuation funds that are subject to a rate of tax of 15 per cent.
- the **Mature Australian Multinational** has:
  - 30 per cent of its shares owned by Australian taxpayers who are subject to the top marginal tax rate of 47 per cent;
  - 50 per cent of its shares owned by Australian superannuation funds that are subject to a rate of tax of 15 per cent.

Location of foreign investment

The location of Australian companies' foreign investments will obviously differ considerably across companies and this will influence the both the foreign and domestic tax treatment of the income Australian companies earn from those investments.

For the purposes of our analysis, we have assumed that both the Emerging and the Mature Australian multinational companies undertake their foreign investments in those countries that are the most common destinations for foreign direct investments by Australian companies.

As noted by Treasury:

- foreign portfolio equity and debt investments are generally made directly by individuals or through unit trusts; and
- foreign direct investment is undertaken primarily by Australian companies, and over 95 percent of that investment is in the 63 'listed' countries and the dividend income from those non-portfolio direct investments is exempt from Australian company tax.

This means that the location of Australia's foreign direct investment offshore should provide a reasonably good indication of the destination of Australian corporate investment offshore.

Table 4.1 indicates that the two most important destinations for foreign direct investment are the United States (54.7 %), the United Kingdom (17.4%), which are both 'listed' countries. These countries are also the two most important destinations for foreign investment in the form of equity capital and retained earnings.

Table 4.1: Australian equity investment abroad by destination 2000-01

Country	Equity capital and reinvested earnings	Total direct investment	County List
United States	54.0%	54.7%	Broad exemption listed
United Kingdom	17.9%	17.4%	Broad exemption listed
New Zealand	7.1%	7.2%	Broad exemption listed
Central America and Carribean	5.8%	0.0%	Unlisted
Hong Kong	2.8%	3.0%	Unlisted
Asia (not elsewhere stated)	2.2%	2.3%	Mix (limited exemption and unlisted)
Singapore	1.1%	1.8%	Limited exemption listed
Canada	1.4%	1.4%	Broad exemption listed
America (not elswhere stated)	0.0%	1.0%	Mix (limited exemption and unlisted)
Other	7.66%	11.3%	Mixed
Total	**100.0%**	**100.0%**	

Source: Australian Bureau of Statistics (2002) Cat No. 5352.0

As a result, for the purposes of our analysis, it is assumed that both the Emerging Australian Multinational and the Mature Australian Multinational have a foreign subsidiary located in a listed jurisdiction that is either the United Kingdom or the United States. Specifically, it is assumed that:

- the Emerging Australian Multinational has 10 per cent of its total assets in a foreign subsidiary located in a listed country; and
- the Mature Australian Multinational has 40 per cent of its total assets in a foreign subsidiary located in a listed country.

Although over 95 per cent of foreign direct investment is in listed countries, many Australian multinationals also have investments in ‘unlisted’ countries and the proportion of assets those companies hold in unlisted as opposed to listed countries will vary significantly across companies. As indicated in Table 4.1, the two most important destinations for foreign equity investment in ‘unlisted’ countries are Central American and Carribean countries as well as Hong Kong.

This raises the issue as to what assumption should be made about the proportion of foreign investment that Australian multinationals undertake in listed as opposed to unlisted countries.

One approach would be to assume that all Australian multinationals have a pattern of foreign investment that is the same as Australia’s overall pattern of foreign investment. Under this approach, Australian multinationals would be assumed to hold around 95 per cent of their foreign assets in listed as opposed to unlisted countries. Such an approach, however, would mean that the results of our analysis would not be of much relevance to those Australian multinationals that do have much greater investments in unlisted countries (eg countries involved in the extraction of natural resources from unlisted countries).

As a result, we have assumed instead that both the Emerging and the Mature Australian multinationals have 10 per cent of their total assets in a foreign subsidiary located in such unlisted countries. That is, we are assuming that:

- Emerging Australian Multinationals have 50 per cent of their foreign investments in listed countries and 50 per cent in unlisted countries (ie they have 10 per cent of their total assets in listed countries and 10 per cent in unlisted countries); and
- Mature Australian Multinationals have 80 per cent of their foreign investments in listed countries and 20 per cent in unlisted countries (ie they have 40 per cent of their total assets in listed countries and 10 per cent in unlisted countries).

Once again, such an assumption is unlikely to be representative of all Australian multinational companies. Some Australian multinational companies have no investments in unlisted countries, whereas other Australian multinationals have significantly greater investments in unlisted countries.

However, such an approach does allow us to highlight the extent to which some of the reforms proposed by Treasury would benefit those Australian multinationals that do have more significant investments in unlisted countries. By contrast, those implications would not be readily apparent if we assumed that all Australian multinationals undertake 95 per cent of their foreign investment in listed countries.

Another important issue is the assumption that should be made about the rates of tax applying to the foreign source income that Australian multinational companies derive from their investments in both listed and unlisted countries. In this regard, it is important to note that the recent US protocol amending the Australia-USA double tax agreement has implications for the future rates of foreign withholding tax imposed on the foreign source income of Australian multinationals.

As noted in section 3.1.2, that protocol will eliminate the rate of foreign dividend withholding tax imposed on the US source non-portfolio dividend income of Australian multinational companies from their US subsidiaries in which they have at least an 80 per cent interest. In addition, this reduction in rates of withholding tax can be expected to flow on to dividends received from other countries as a result of the most favoured nation clause.

For the purposes of the analysis in this section, however, we have assumed that the current rates of foreign withholding taxes apply to the interest and dividend income that Australian multinational companies derive from their investments in listed countries. That is, we have assumed that:

- interest income from the foreign subsidiary in the listed country is:
  - subject to foreign interest withholding tax at a rate of 10 per cent; and
  - is subject to Australian company tax;
- dividend income from the foreign listed subsidiary is:
  - subject to foreign dividend withholding tax at a rate of 15 per cent; and
  - dividends received from listed countries are exempt from Australian company tax.

However, we have also analysed the effects of eliminating the foreign dividend withholding tax imposed on the dividend income Australian multinational companies derive from their investments in the listed country. It is also assumed that:

- interest income from the foreign subsidiary in the unlisted country is subject to foreign interest withholding tax at a rate of 15 per cent; and

- dividend income from the foreign unlisted subsidiary is subject to foreign dividend withholding tax at a rate of 30 per cent.

Location of foreign shareholders

The location of Australian companies' foreign shareholders is also likely to differ considerably across companies and once again will affect the manner in which those shareholders are taxed on the income they derive from Australian companies. For the purposes of our analysis, we have assumed that foreign shareholders comprise:

- 1 per cent of shareholders in the Australian Corporate Group;
- 10 per cent of shareholders in the Emerging Australian Multinational; and
- 20 per cent of shareholders in the Mature Australian Multinational.

Some indication of the location of foreign shareholders in Australian companies can be obtained from Australian Bureau of Statistics' data on foreign portfolio equity investment in Australia. Table 4.2 indicates that the main sources of foreign portfolio equity securities investment in Australia in 2000-01 from listed countries were the United Kingdom (43.2%) and the United States (35%).

Table 4.2: Source of foreign equity investment in Australia 2000 - 2001

Country	Portfolio equity securites	Total direct investment
United States	35.0%	29.6%
United Kingdom	43.2%	27.5%
Japan	1.9%	8.0%
Netherlands	0.8%	6.4%
Germany	0.7%	3.3%
France	0.3%	2.9%
Europe (not elsewhere stated)	1.2%	2.5%
New Zealand	2.6%	2.3%
Switzerland	1.7%	2.2%
Central America and Carribean	0.2%	1.6%
Hong Kong	1.6%	0.0%
Singapore	1.3%	1.3%
Canada	0.0%	0.9%
Malaysia	0.1%	0.9%
Belgium and Luxemburg	0.5%	0.6%
Other	8.91%	10.0%
Total	**100.0%**	**100.0%**

Source: Australian Bureau of Statistics (2002) Cat No. 5352.0

The United States and the United Kingdom are also the major sources of foreign direct investment in Australia. However, Japan, the Netherlands, Germany and France are more significant sources of foreign direct investment in Australia than foreign portfolio equity investment.

From the ABS data, it is also possible to determine the extent to which foreign shareholders in Australian companies reside in countries that provide credits for foreign taxes or countries that exempt Australian dividend income from tax.

Table 4.3 indicates that around 95 per cent of foreign portfolio equity security investment in Australia that can be allocated readily between credit and exemption countries comes from shareholders located in countries that provide a credit for Australian tax, whereas only around 5 per cent comes from shareholders in countries that exempt Australian dividend income from tax.

As a result, we have assumed that:

- Australian Corporate Groups have all of their foreign shareholders in countries that provide a credit for Australian taxes (ie they have 1 per cent of their total shareholders in credit countries); and

- Emerging Australian Multinationals have 90 per cent of their foreign shareholders in countries that provide a credit for Australian taxes and 10 per cent in countries that provide an exemption from tax for Australian sourced dividend income (ie they have 9 per cent of their total shareholders in credit countries and 1 per cent in exemption countries); and

- Mature Australian Multinationals have 75 per cent of their foreign shareholders in countries that provide a credit for Australian taxes and 25 per cent in countries that provide an exemption from tax for Australian sourced dividend income (ie they have 18 per cent of their total shareholders in credit countries and 2 per cent in exemption countries).

Table 4.3: Source of foreign portfolio equity security investment in Australia 2000 - 2001

Country	Weight	Foreign tax credit rules
United States	39.1%	Credits Australian tax
United Kingdom	48.2%	Credits Australian tax
Japan	2.1%	Credits Australian tax
Netherlands	0.9%	Credits Australian tax
Germany	0.8%	Exempts Australian-source income
France	0.4%	Exempts Australian-source income
New Zealand	2.9%	Credits Australian tax
Switzerland	1.9%	Exempts Australian source income
Hong Kong	1.8%	Exempts Australian source income
Singapore	1.4%	Credits Australian tax
Belgium and Luxemburg	0.6%	Exempts Australian source income
Total	**100.0%**	

Source: Australian Bureau of Statistics (2002) Cat No. 5352.0

The income that foreign shareholders in Australian companies earn is subject to:

- Australian company tax and dividend withholding tax;
- foreign income tax.

In the case of foreign shareholders who reside in countries which exempt Australian income from tax, the amount of tax paid in Australia will have no effect on the amount of foreign tax paid in those jurisdictions.

By contrast, in the case of foreign shareholders who reside in countries that provide their residents with credits for Australian tax, the amount of foreign tax paid will be reduced by the value of those foreign tax credits for Australian which will depend on a number of factors including:

- the tax rules prevailing in the foreign shareholder's home country, in particular, whether there is an imputation regime in that country;
- whether or not the foreign shareholder is a taxpayer. Credits for Australian tax paid are worthless to tax exempt foreign pension funds; and
- how that other country treats foreign taxes. This can be quite complex for some countries. For example, Japan and the United States both allow surplus credits on income from countries other than Australia to be used to offset against tax payable on Australian source income. This potentially reduces the value of Australian tax credits.

This raises the issue as to what assumption should be made about the value of credits for Australian tax to foreign shareholders resident in credit countries.

This is a difficult issue to resolve in the absence of detailed information on the value of Australian tax credits to shareholders in credit countries. Clearly, not all shareholders will be able to claim credits for the full amount of Australian tax paid on their income. As a result, for the purposes of this section, it is assumed that 40% of Australian tax credits cannot be used by shareholders resident in credit countries.

Dividend distribution policy

Another factor that influences the impact that changes in dividend taxation have on Australian companies and their shareholders is the dividend distribution policy of companies. Once again, this will vary significantly across Australian companies. Indeed, it is likely that dividend payout ratios will vary significantly even within our three categories of Australian companies.

As a result, rather than assume a fixed dividend payout ratio, we have calculated our results for dividend payout ratios of 25 per cent, 50 per cent, 75 per cent and 100 per cent (ie full distribution).

All subsidiaries distribute their dividends to the parent company, which then distributes dividends to both domestic and foreign shareholders.

Calculation of effective tax rates

Given the assumptions outlined above, we then used the *Tax Impact Model* to determine the impact of the changes in dividend taxation on the effective tax rate for the corporate group and its shareholders.

The corporate 'effective tax rate' is a measure of the present value of all taxes forecast to be paid by the company less the present value of benefits to shareholders, all expressed as a proportion of the present value of forecast earnings before tax:

$$\frac{\text{(Present value of taxes paid by the company)} - \text{(Present value of benefits to shareholders)}}{\text{Present value of earnings before tax}}$$

The **present value of taxes paid by the company** is the discounted sum of all of the domestic and international taxes the Australian company anticipates paying in future years, including company tax and withholding tax payments to the ATO and overseas revenue authorities.

The **present value of benefits to shareholders** is the discounted sum of all reductions in taxes at the shareholder level which result from the payment of tax by the company, along with any other benefits to shareholders arising out of the company's payment of tax. It includes benefits such as franking credits that can be provided to resident shareholders and withholding tax credits that can be provided to non-resident shareholders.

The **present value of earnings before tax** is the discounted sum of all of the income of the corporate group before domestic and foreign taxes.

The **corporate effective tax rate** indicates the extent to which a change in dividend taxation alters the amount of tax payable by the company and its shareholders, after taking into account any change in benefits to shareholders (eg any change in imputation credits attached to dividends). For example, a corporate effective tax rate of 10 percent indicates that a $1m increase in the present value of a company's taxable income will result in an increase in the tax payable by its shareholders by $100,000.

As a result, if a particular change in dividend policy decreased the corporate effective tax rate from 10 percent to 8 percent, then this would mean that the tax payable by the company's shareholders would decrease from $100,000 to $80,000 for each $1m earned by the company.

The *Tax Impact Model* is also used to calculate the impact of changes in dividend taxation on the income earned by each of following categories of shareholders:

- Australian resident shareholders who are subject to the top statutory marginal rate of personal income tax;
- foreign shareholders who are able to credit dividend withholding taxes against their home country tax liabilities; and
- foreign shareholders resident in countries that exempt Australian dividends from tax.

These **shareholder effective tax rates** indicate the impact of a particular change in dividend taxation on the total amount of tax payable by that class of shareholders. For example, if a particular class of shareholders has an effective tax rate of 10 percent, then this means that if their dividend income increased by $100, they would have to pay additional tax of $10.

As a result, if a particular change in dividend policy reduced their effective tax rate from 10 percent to 8 percent, then this would mean that their tax on each $100 of dividend income would be reduced from $10 to $8.

4.2.3 Determining the impact on the cost of capital

Having estimated the impact of the key trends in dividend taxation on effective tax rates, the *Tax Impact Model* then uses those estimated changes in effective tax rates to determine the implications for:

- the cost of debt and equity finance for the Australian company; and
- the weighted average cost of capital.

The *Tax Impact Model* assumes that companies will employ capital up to the point where the rate of return on the marginal investment is equal to the user cost of capital, which is equal to:

- the price of a unit of capital, relative to the price of output;
- multiplied by the sum of:
  - the opportunity cost of finance to the firm, which is the rate of return that the company's debt and equity holders could earn by investing elsewhere; and
  - the economic rate of depreciation.

In principle, taxes levied both on the company and its shareholders, or changes in those taxes, can alter the user cost of capital and the extent of that effect depends on a number of factors including:

- who determines rates of return on Australian capital markets;
- who is the 'marginal' investor;
- what is the source of funds; and
- what is the company's dividend policy.

Those factors, and their implications for the calculation of the cost of capital, are discussed further below.

Who determines rates of return on Australian capital markets?

A key issue when determining the impact of changes in dividend taxation on the cost of capital of Australian companies is who determines the prevailing required rates of return on Australian capital markets. Are those required rates of return set by foreign investors or Australian investors?

For the purposes of this section of the report, it is assumed that Australia is a small, open, net capital importing nation and that world capital markets set the required rates of return prevailing on Australian capital markets and Australia has no influence over those world rates of return. This means that if Australia:

- taxes the income of foreign shareholders, then Australian companies will have to offer those foreign shareholders higher pre-Australian tax rates of return to compensate them for that Australian tax so that they still earn the prevailing world rate of return. That is, Australian companies will have to be prepared to bear the burden of Australian tax on foreign shareholders via a higher cost of capital if they want to attract foreign equity investment; and
- taxes the income of Australian companies and their Australian shareholders, it will reduce levels of domestic saving and investment by reducing the returns to domestic saving and investment.

However, this will not reduce the overall supply of savings to Australia or the overall level of investment in Australia. Rather, the reduction in domestic saving and investment will be offset by an increase in the inflow of foreign saving and investment into Australia.

Who is the marginal investor?

Another key issue when determining the impact of any tax change on the cost of capital is the identify of the 'marginal investor' – that is, the investor that supplies the last dollar of equity finance.

The identify of the marginal investor is crucial to the determination of the cost of capital of a company since it is the marginal investor who determines the equilibrium rate of return that prevails in a capital market and hence the cost of capital for the company. In order for a capital market to be in equilibrium, the return from investing in debt instruments must equal the return from investing in shares for the marginal investor. That is, it must not be possible for the marginal shareholder to gain by either buying more bonds or more shares (ie the 'non-arbitrage' condition must be satisfied for a capital market to be in equilibrium).

Obviously, Australian and foreign investors face vastly different tax treatment of their income from bonds and shares. As a result, changes in dividend taxation in Australia or overseas can have vastly different effects on the cost of capital of Australian companies depending on whether the marginal investor is an Australian or a foreign shareholder.

For the purposes of the analysis undertaken in this section, we adopt the 'traditional' assumption that is made for an open economy such as Australia – that the marginal investor is a foreign shareholder.

It is important to note, however, that although Australia is a small, open, net capital importing nation it does not necessarily follow that marginal investor in all Australian companies must be a foreigner.

In a closed economy, the marginal investor must, by definition, be a domestic shareholder since there are no foreign shareholders.

By contrast, in an open economy such as Australia, it is possible for the marginal investor to be either an Australian or a foreign shareholder. In addition, although the location of a company's shareholders might provide some guidance as to the potential identity of the marginal shareholder, it might not provide a reliable guide in all circumstances. For example, the marginal shareholder may be a foreign shareholder even though an Australian company only has a few foreign shareholders. Alternatively, an Australian multinational with significant numbers of foreign shareholders might still have an Australian marginal shareholder for some investments. It is for this reason that our analysis in section 5 also considers the impact of changes in dividend taxation on Australian companies under the alternative assumption that the marginal investor is an Australian shareholder.

Having assumed that the marginal investor is a foreign shareholder, we also need to make some assumptions about the manner in which the marginal shareholder is taxed. This will depend on the country in which the foreign shareholder is resident. Rather than assume the marginal investor is located in a particular country, in effect the *Tax Impact Model* allows for the marginal investor to be a shareholder in any of the foreign countries in which the Australian multinational has a subsidiary. It does this by assuming that the marginal investor is a foreign shareholder who requires a rate of return equal to the base cost of equity of the company grossed up by the average effective tax rate imposed on non-resident shareholders. This is discussed further below.

What is the source of funds?

The impact that changes in dividend taxation have on the cost of capital of Australian companies is also influenced by the company's source of funds.

It is assumed that each of the Australian corporate groups analysed uses a mix of debt, equity and retained earnings to finance its activities. Specifically, it is assumed that:

- all of the Australian corporate groups analysed have a constant debt equity ratio of 39 per cent, both before and after the impact of any change to dividend taxation; and
- the subsidiaries of these companies have a 20 per cent debt to asset ratio and 40 per cent of finance comes from the parent company.

What is the company's dividend policy?

The company's dividend policy will also have a significant impact on the effect of changes in dividend taxation on the company's cost of capital.

Once again, rather than assume a fixed dividend payout ratio, we have calculated the cost of capital for dividend payout ratios of 25 per cent, 50 per cent, 75 per cent and 100 per cent.

Calculation of the weighted average cost of capital

As noted above, the *Tax Impact Model* assumes that the cost of equity capital is determined on world markets. This means that foreign shareholders who supply capital to Australian companies will require compensation for any:

- expected inflation; and
- taxes they are not able to credit against their home country tax liabilities.

As a result, the *Tax Impact Model*:

- increases the cost of equity capital by the inflation rate in Australia, on the assumption that movements in the exchange rate conform to 'purchasing power parity' theory; and
- grosses up the resulting number by the weighted average of the effective tax rates applying to the Australian source income of foreign shareholders.

That is, the *Tax Impact Model* calculates the cost of equity capital as:

$$\textbf{Cost of equity} = (\mathbf{r_f} + \boldsymbol{\beta}(\ 1 + \mathbf{A})\ \mathbf{x}\ \mathbf{MP}\ + \mathbf{i})/(\mathbf{1\text{-}ETR})$$

where:

$\mathbf{r_f}$ = the risk free rate of interest in the absence of Australian taxes. It is the long term return from debt securities regarded as free from credit risk (assumed to be 3%);

β = equity beta. This is the risk associated with the Australian company's shares (assumed to be 1 on the assumption that the company in question is assumed to be no more, or no less, risky than the share market as a whole);

A = the advantage of debt over equity = (1-etrgroup)L/(1-L) where etrgroup is the average effective tax rate for the group as a whole and L is the overall ratio of debt to market value (ie D/V);

MP = the market risk premium for the Australian share market as a whole in the absence of Australian taxes. It is the reward for investors for putting their money in shares generally (assumed to be 4.4%);

i = the rate of inflation (2.5%); and

ETR = the average effective tax rate imposed on the Australian source income of foreign shareholders (varies).

The **cost of debt finance** to the company is assumed to equal the nominal rate of interest prevailing in Australia.

Having determined the cost of equity and cost of debt, the *Tax Impact Model* then calculates the weighted average cost of capital (WACC).

The approach used by the *Tax Impact Model* to determine the effects of taxes on the weighted average cost of capital is based on the approach used by Monkhouse (1996) to examine the impact of Australia's dividend imputation system on the cost of capital.[6] Under this approach:

- the before tax cost of debt finance is reduced by the effective tax rate;
- equity values are determined by adding benefits to shareholders back into after-tax, before interest, cash flows; and
- the cost of equity finance is estimated taking into account the effective tax rate on foreign shareholders.

As a result, the Tax Impact Model calculates the weighted average cost of capital as:

WACC = Cost of debt(1-etr)(D/V) + Cost of equity(E/V)

where:

D/V = the ratio of debt to the market value of the company;

E/V = the ratio of equity to the market value of the company; and

etr = the effective tax rate for the Australian corporate group as a whole.

4.2.4 Determining the impact on shareholder value

Having determined the impact of the tax changes on the weighted average cost of capital, the *Tax Impact Model* then calculates how the total value of equity of the company will respond to those changes in the weighted average cost of capital. This is determined by using the new weighted average cost of capital to calculate the net present value of all cash flows after tax and shareholder benefits. This provides an overall indication on the impact those tax changes have on shareholder value.

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[6] Peter H.L Monkhouse (1996), The valuation of project under dividend imputation tax system, *Accounting and Finance*, 36, pp. 185-212.

4.3 Reductions in rates of tax

What are the implications of the international trend towards reducing tax rates for Australian companies and their shareholders?

In this section, we use the *Tax Impact Model* to analyse the implications of tax reductions brought about by reductions in statutory rates of company tax, both overseas and in Australia.

The specific tax rate reductions analysed are:

- reductions in the rate of foreign company tax in the listed country from 35 per cent down to 20 per cent;
- reductions in the rate of foreign company tax in the unlisted country from 25 per cent to 20 per cent;
- elimination of the foreign dividend withholding tax (FDWT) imposed on dividend income from the unlisted country; and
- reductions in the rate of Australian company tax from 36 per cent down to 20 per cent.

4.3.1 Impact on effective tax rates

The impact of changes in foreign and Australian tax rates on the effective tax rates imposed on shareholders in Australian companies is set out in Tables 4.4, 4.5 and 4.6.

As noted in section 4.2.2, the effective tax rates calculated in this section measure the total amount of Australian and foreign taxes paid by the corporate group net of any benefits provided to shareholders. As a result, an effective tax rate of 0 per cent indicates that either the corporate group did not pay any tax, or that the corporate group did pay tax but was able to provide the shareholder with benefits (eg imputation credits) sufficient to completely offset that tax.

Impact on Australian shareholders

Table 4.4 outlines the effective tax rates imposed on the income of Australian shareholders, expressed in percentage terms, under different rates of foreign and personal tax. As a result, it indicates how reductions in those tax rates alter the effective tax rates imposed on the income of Australian shareholders in the Australian Corporate Group, the Emerging Australian Multinational, and the Mature Australian Multinational, assuming dividend payout ratios ranging from 25 per cent to 100 per cent.

Table 4.4: Impact of tax reductions on Australian shareholders (ETR%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Reductions in foreign company tax rates:												
Listed country												
35%	19.2	11.4	4.3	1.5	21.1	14.2	9.1	8.3	26.5	22.6	24.4	24.6
30%	19.2	11.4	4.3	1.5	20.5	13.5	8.5	7.8	24.1	20.4	21.9	22.5
25%	19.2	11.4	4.3	1.5	19.9	12.8	7.8	7.2	21.6	18.2	19.8	20.5
20%	19.2	11.4	4.3	1.5	19.2	12.1	7.2	6.7	19.1	16.0	17.6	18.4
Unlisted country												
25%	19.2	11.4	4.3	1.5	20.5	13.5	8.9	8.5	24.1	20.9	22.6	23.2
20%	19.2	11.4	4.3	1.5	20.5	13.5	8.5	7.8	24.1	20.4	21.9	22.5
Elimination of listed country FDWT	19.2	11.4	4.3	1.5	20.1	12.6	7.4	6.7	22.5	18.0	18.7	18.6
Reductions in the Australian company tax rate:												
36%	23.3	13.8	5.4	2.2	24.0	15.4	9.0	7.8	25.8	20.5	21.8	22.3
34%	21.9	13.0	5.0	1.9	22.8	14.8	8.8	7.8	25.3	20.4	21.8	22.4
30%	19.2	11.4	4.3	1.5	20.5	13.5	8.5	7.8	24.1	20.4	21.9	22.5
25%	15.9	9.4	3.4	1.1	17.6	11.9	8.1	7.9	22.6	20.3	22.0	22.7
20%	12.6	7.4	2.6	0.8	14.7	10.4	7.9	8.2	21.1	20.2	22.1	22.9

Before examining the impact of tax reductions, it is important to note the pattern of effective tax rates across the three corporate groups. The effective tax rates imposed on the income that Australian shareholders derive from their investments in the Australian Corporate Group are lower than those applying to income from investment in the Emerging Australian Multinational company, which are in turn lower than those applying to income from investments in the Mature Australian Multinational company. This is the result of a combination of factors including the additional foreign taxes imposed on the income that Australian shareholders derive from offshore, the absence of full international double tax relief, and the absence of imputation credits for foreign taxes. As a result, Australian shareholders bear a higher total effective tax burden when they invest in Australian companies earning foreign source income and that tax burden tends to increase the greater the amount of foreign source income earned by the company.

In addition, the effective tax rates imposed on the dividend income of Australian shareholders are lower the higher the dividend payout ratio. This illustrates the impact of Australia's dividend imputation regime which partially integrates the company and personal income tax regimes.

When a company distributes some of its income, the amount of tax paid by the company is offset by the benefits provided to shareholders in the form of imputation credits. Indeed, for Australian shareholders in the Australian corporate group that distributes all of its income in the form of dividends, the effective tax rates on their income are almost reduced to zero.

However, Australia's dividend imputation regime does not provide credits for foreign taxes. As a result, the benefits of dividend imputation are reduced as the proportion of foreign source income of the company increases. Indeed, for the Mature Australian Multinational, increasing the dividend payout ratio actually increases the effective tax rate imposed on the income of Australian shareholders. This is because the value of the additional imputation credits generated by a higher dividend payout ratio are more than offset by the additional tax that must be paid on that income for which no imputation credits are available (eg foreign dividend withholding tax).

Now consider how those effective tax rates will change in response to changes in foreign and Australian taxes.

For Australian shareholders in the Australian Corporate Group:

- reductions in rates of foreign company or withholding tax would not affect the effective tax rates imposed on their income, since that corporate group is assumed not to earn any foreign source income
- reductions in the rates of Australian company tax would reduce the effective tax rates imposed on their income regardless of the dividend distribution policy of the company.

By contrast, the effective tax rates imposed on the income of Australian shareholders in the Emerging Australian Multinational and Mature Australian Multinational would be reduced by reductions in both rates of foreign and Australian tax.

Reductions in rates of foreign company tax and the elimination of foreign FDWT on dividends from listed countries would produce greater reductions in effective tax rates for Australian shareholders in those companies that derive a greater proportion of their total income from listed countries. That is, Australian shareholders in Mature Australian Multinational companies would experience a greater reduction in their effective tax rates than Australian shareholders in Emerging Australian Multinationals.

Similarly, reductions in the rate of Australian company tax produce greater reductions in effective tax rates the greater the proportion of Australian source income earned by the corporate group. As a result, reductions in the rate of Australian company tax would produce the greatest reductions in effective tax rates for Australian shareholders in the Australian Corporate Group.

Impact on foreign shareholders in credit countries

Table 4.5 outlines the impact of reductions in foreign and Australian company tax on the effective tax rates imposed on the income of foreign shareholders who are located in those countries that provide credits for Australian taxes (foreign credit country shareholders).

These foreign shareholders do not receive imputation credits for Australian tax. However, they do receive credits for any Australian withholding taxes imposed on their income. However, not all shareholders in those credit companies are able to use those credits. For example, some shareholders will be exempt pension funds. As a result, it is assumed for the purposes of this model that 40 per cent of credits cannot be used. This means that the effective tax rates imposed on the dividend income of foreign shareholders located in credit countries will increase with increases in the dividend payout ratio. It also means that those effective tax rates are much more uniform across the different types of Australian companies since, in effect, these shareholders are already subject to classical tax treatment.

Table 4.5: Impact of tax reductions on foreign shareholders in credit countries (ETR%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Reductions in foreign company tax rates:												
Listed country												
35%	27.2	27.4	28.1	30.9	28.8	29.5	30.5	33.0	33.8	35.6	37.5	40.3
30%	27.2	27.4	28.1	30.9	28.3	28.9	29.9	32.5	31.7	33.4	35.3	38.2
25%	27.2	27.4	28.1	30.9	27.8	28.3	29.3	31.9	29.4	31.1	33.1	36.1
20%	27.2	27.4	28.1	30.9	27.2	27.8	28.7	31.4	27.1	28.7	30.7	33.9
Unlisted country												
25%	27.2	27.4	28.1	30.9	28.3	28.9	29.9	32.6	31.7	33.4	35.4	38.4
20%	27.2	27.4	28.1	30.9	28.3	28.9	29.9	32.5	31.7	33.4	35.3	38.2
Elimination of listed country FDWT	27.2	27.4	28.1	30.9	28.0	28.2	28.8	31.1	30.2	30.3	31.0	33.0
Reductions in the Australian company tax rate:												
36%	33.0	33.3	34.1	37.1	33.5	34.2	35.2	37.9	35.2	36.8	38.6	41.8
34%	31.0	31.3	32.1	35.0	31.8	32.4	33.4	36.1	34.0	35.7	37.5	40.6
30%	27.2	27.4	28.1	30.9	28.3	28.9	29.9	32.5	31.7	33.4	35.3	38.2
25%	22.5	22.6	23.2	25.8	24.0	24.6	25.6	28.1	28.8	30.6	32.7	35.4
20%	17.9	18.0	18.4	20.8	19.8	20.4	21.5	23.8	25.8	27.9	30.2	32.8

Tax reductions have much the same effect on foreign shareholders in credit countries as they do on Australian shareholders.

For foreign credit country shareholders in the Australian Corporate Group:

- reductions in rates of foreign company or withholding tax would not affect the effective tax rates imposed on their income, since that corporate group is assumed not to earn any foreign source income
- reductions in the rates of Australian company tax would reduce the effective tax rates imposed on their income regardless of the dividend distribution policy of the company.

Reducing both foreign and Australian taxes would also reduce the effective tax rates imposed on the income of foreign credit country shareholders in the Emerging Australian Multinational and Mature Australian Multinational.

Reductions in rates of foreign company tax and the elimination of foreign FDWT on dividends from listed countries would produce greater reductions in effective tax rates for foreign credit country shareholders in those Australian companies that derive a greater proportion of their total income from listed countries. That is, foreign credit country shareholders in Mature Australian Multinational companies would experience a greater reduction in their effective tax rates than foreign credit country shareholders in Emerging Australian Multinationals.

Similarly, reductions in the rate of Australian company tax produce greater reductions in effective tax rates the greater the proportion of Australian source income earned by the corporate group. As a result, reductions in the rate of Australian company tax would produce the greatest reductions in effective tax rates for foreign credit country shareholders in the Australian Corporate Group.

Impact on foreign shareholders in exemption countries

Table 4.6 outlines the impact of reductions in foreign and Australian company tax on the effective tax rates imposed on the income of foreign shareholders who are located in those countries that exempt foreign source dividend income from tax (foreign exemption country shareholders).

These foreign shareholders do not receive imputation credits for Australian tax. However, they are completely exempted from having to pay tax in their home country on Australian source dividends. Once again, this means that the effective tax rate imposed on the dividend income of foreign shareholders located in exemption countries will increase with increases in the dividend payout ratio.

Table 4.6: Impact of tax reductions on foreign shareholders in exemption countries (ETR%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Reductions in foreign company tax rates:												
Listed country												
35%	na	na	na	na	28.8	29.5	30.7	34.3	33.8	35.6	37.5	41.0
30%	na	na	na	na	28.3	28.9	30.1	33.7	31.7	33.4	35.6	38.8
25%	na	na	na	na	27.8	28.3	29.6	33.2	29.4	31.1	33.3	36.7
20%	na	na	na	na	27.2	27.8	29.0	32.6	27.1	28.7	31.0	34.5
Unlisted country												
25%	na	na	na	na	28.3	28.9	30.3	34.1	31.7	33.4	35.8	39.2
20%	na	na	na	na	28.3	28.9	30.1	33.7	31.7	33.4	35.6	38.8
Elimination of listed country FDWT	na	na	na	na	28.0	28.2	29.1	32.5	30.2	30.3	31.5	34.3
Reductions in the Australian company tax rate:												
36%	na	na	na	na	33.5	34.2	35.4	38.9	35.2	36.8	38.8	42.3
34%	na	na	na	na	31.8	32.4	33.6	37.2	34.0	35.7	37.7	41.1
30%	na	na	na	na	28.3	28.9	30.2	33.7	31.7	33.4	35.6	38.8
25%	na	na	na	na	24.0	24.6	26.0	29.7	28.8	30.6	33.1	36.3
20%	na	na	na	na	19.8	20.4	22.1	26.6	25.8	27.9	31.0	34.2

It is assumed that the Australian Corporate Group does not have any shareholders located in countries that exempt Australian dividend income from tax. As a result, the impact of reductions in tax rates on this type of foreign shareholder is not applicable to the Australian Corporate Group.

Reducing both foreign and Australian taxes reduces the effective tax rates imposed on the income of foreign exemption country shareholders in the Emerging Australian Multinational and Mature Australian Multinational.

Reductions in rates of foreign company tax and the elimination of foreign FDWT on dividends from listed countries would produce greater reductions in effective tax rates for foreign exemption country shareholders in those Australian companies that derive a greater proportion of their total income from listed countries. That is, foreign exemption country shareholders in Mature Australian Multinational companies would experience a greater reduction in their effective tax rates than foreign exemption country shareholders in Emerging Australian Multinationals.

Similarly, reductions in the rate of Australian company tax produce greater reductions in effective tax rates the greater the proportion of Australian source income earned by the corporate group. As a result, reductions in the rate of Australian company tax would produce the greatest reductions in effective tax rates for foreign exemption country shareholders in the Emerging Australian Multinational.

4.3.2 Impact on the cost of capital

Table 4.7 outlines the cost of capital of each of the Australian corporate groups under alternative rates of foreign and Australian tax. As a result, it provides an indication of the impact of reductions in foreign and Australian tax rates on the cost of capital of the Australian Corporate Group, the Emerging Australian Multinational, and the Mature Australian Multinational under dividend payout ratios ranging from 25 per cent to 100 percent.

Table 4.7: Impact of tax reductions on the cost of capital (%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Reductions in foreign company tax rates:												
Listed country												
35%	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.8	11.0
30%	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.8	10.9
25%	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.8	10.9
20%	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.7	10.8	10.9
Unlisted country												
25%	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.8	10.9
20%	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.8	10.9
Elimination of listed country FDWT	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.7	10.7	10.8
Reductions in the Australian company tax rate:												
36%	10.7	11.2	11.6	11.9	10.7	11.1	11.4	11.6	10.7	10.9	11.0	11.1
34%	10.7	11.1	11.5	11.8	10.7	11.0	11.3	11.5	10.6	10.9	10.9	11.0
30%	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.8	10.9
25%	10.6	10.9	11.1	11.4	10.5	10.8	11.0	11.1	10.5	10.7	10.7	10.8
20%	10.5	10.7	11.0	11.1	10.5	10.7	10.8	10.9	10.4	10.6	10.6	10.7

The cost of capital of the Australian Corporate Group is not affected by reductions in foreign rates of company tax or foreign dividend withholding taxes since it does not earn any foreign source income.

The cost of capital of the Emerging Australian Multinational will be reduced to some extent by reductions in foreign tax rates, but the effect is so small that it is not noticeable in the degree of precision of the results presented in Table 4.7. This is because the Emerging Australian Multinational still earns the bulk of its income from Australian investments and the returns from those investments are not affected by these reductions in foreign tax rates.

Similarly, the cost of capital of the Mature Australian Multinational is reduced to some extent by reductions in foreign company tax rates and the elimination of foreign dividend withholding tax on income from listed countries. However, the impact is relatively small (less than 0.1 percentage points). Once again, this is because the Mature Australian Multinational still earns a significant proportion of its income from Australian investments and the rate of return on those investments is not affected by reductions in foreign tax rates.

By contrast, reductions in the Australian company tax rate reduce the cost of capital for all Australian companies, regardless of their dividend payout ratios. This is because the Australian company tax rate sets the required rates of return on the Australian market and each of these corporate groups have significant investments in Australia.

4.3.3 Impact on shareholder value

Table 4.8 outlines the value of shareholders' initial equity interest in each of the corporate groups under alternative rates of foreign and Australian company taxes. As a result, it provides an indication of the overall impact that reductions in foreign and Australian tax rates have on the value of shares held in the Australian Corporate Group, the Emerging Australian Multinational and the Mature Australian Multinational under payout ratios ranging from 25 per cent to 100 per cent.

Table 4.8: Impact of tax reductions on shareholder value ($000)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Reductions in foreign company tax rates:												
Listed country												
35%	1410	2065	2325	1957	1298	1919	2203	1947	1144	1721	1997	1679
30%	1410	2065	2325	1957	1312	1936	2221	1962	1202	1798	2067	1740
25%	1410	2065	2325	1957	1328	1954	2239	1977	1265	1880	2138	1840
20%	1410	2065	2325	1957	1345	1973	2258	1993	1333	1967	2211	1873
Unlisted country												
25%	1410	2065	2325	1957	1317	1943	2232	1952	1208	1811	2069	1730
20%	1410	2065	2325	1957	1312	1936	2221	1962	1202	1798	2067	1740
Elimination of listed country FDWT	1410	2065	2325	1957	1323	1961	2260	2000	1244	1916	2213	1903
Reductions in the Australian company tax rate:												
36%	1310	1919	2160	1842	1225	1806	2068	1822	1161	1728	1966	1649
34%	1343	1967	2214	1879	1254	1849	2118	1866	1174	1750	1999	1680
30%	1410	2065	2325	1955	1312	1936	2221	1960	1202	1798	2066	1739
25%	1493	2189	2469	2059	1386	2046	2354	2109	1240	1862	2151	1824
20%	1575	2314	2619	2140	1459	2159	2493	2577	1280	1929	2234	1929

The value of shares held in the Australian Corporate Group is not affected by reductions in rates of foreign company tax or the elimination of foreign dividend withholding tax since it is assumed that corporate group does not earn any foreign source income.

By contrast, reductions in foreign tax rates increase the value of shares in both the Emerging Australian Multinational and the Mature Australian Multinational, regardless of the dividend payout ratio. In general, the greatest increases in shareholder value will be experienced by those companies deriving the highest proportions of foreign source income.

Reductions in the Australian company tax rate increase the value of shares in all Australian companies, regardless of their dividend payout ratios. In general, the greatest increases in shareholder value will be experienced by those Australian companies with the highest proportions of Australian source income.

4.4 Shift away from dividend imputation

What are the implications of the international shift away from dividend imputation regimes for Australian companies and their shareholders?

This section analyses the implications of Australia following this international trend and:

- replacing its dividend imputation regime with a classical tax system that has the same personal and company rates of tax;
- replacing its dividend imputation regime with a UK style notional tax credit regime that provides Australian shareholders with a tax credit equal to some proportion (10 to 30 per cent) of the value of the dividend paid, regardless of the amount of company tax paid on that income or whether the income comes from Australian or foreign sources;
- retaining the current dividend imputation regime, but providing Australian shareholders with a UK style notional tax credit regime to foreign source income from listed countries (Option A); or
- retaining the current dividend imputation regime, but providing a franking credit for the amount of foreign dividend withholding tax (FDWT) levied on that income (Option C).

4.4.1 Impact on effective tax rates

The impact of changes in foreign and Australian tax rates on the effective tax rates imposed on shareholders in Australian companies is set out in Tables 4.9, 4.10 and 4.11.

Impact on Australian shareholders

Table 4.9 outlines the effective tax rates imposed on the income of Australian shareholders, expressed in percentage terms, under different rates of foreign and personal tax. As a result, it indicates how a shift away from dividend imputation in Australia would alter the effective tax rates imposed on the income of Australian shareholders in the Australian Corporate Group, the Emerging Australian Multinational, and the Mature Australian Multinational, assuming dividend payout ratios ranging from 25 per cent to 100 per cent.

Table 4.9: Impact of shift away from dividend imputation on Australian shareholders (ETR%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	19.2	11.4	4.3	1.5	20.5	13.5	8.9	8.5	24.1	20.9	22.6	23.2
Classical tax system	27.5	27.9	28.5	30.6	28.5	29.3	30.1	32.2	31.8	33.6	35.4	38.0
UK style regime:												
10% credit	25.3	23.5	22.0	22.5	26.5	25.1	24.1	24.7	29.8	29.7	29.9	31.1
20% credit	22.7	18.2	14.1	12.3	23.8	20.0	16.6	15.2	27.3	25.0	23.0	22.5
30% credit	19.2	11.4	4.0	-0.8	20.5	13.5	7.1	2.9	24.1	18.8	14.1	11.3
Option A:												
10% credit	19.2	11.4	4.3	1.5	20.3	13.1	8.2	7.7	23.3	19.3	20.1	20.1
20% credit	19.2	11.4	4.3	1.5	20.1	12.5	7.5	6.7	22.4	17.3	17.1	16.1
30% credit	19.2	11.4	4.3	1.5	19.7	11.9	6.5	5.4	21.1	14.7	13.1	11.0
Option C	19.2	11.4	4.3	1.5	20.5	13.5	8.5	7.6	24.1	19.8	19.8	19.7

As indicated in Table 4.9, Australia's current dividend imputation regime provides Australian shareholders in Australian Corporate Groups that only have Australian investments with a significant amount of tax relief when dividend payout ratios are high. For example, the effective tax rate on the income of Australian shareholders in the Australian Corporate group reduces from 19.2 per cent under a dividend payout ratio of 25 per cent, to 1.5 per cent if all income is distributed.[7]

However, as discussed in section 4.3.1, the benefits of the dividend imputation regime to Australian shareholders diminish as the proportion of foreign source income earned by the company increases, since imputation credits are not provided for foreign taxes paid on their income.

As a result, shareholders in Emerging Australian multinational companies face much higher effective rates of tax on their dividend income than do Australian shareholders in the Australian Corporate Group, and the Australian shareholders in Mature Australian Multinationals face even higher effective rates of tax (assuming the same dividend payout ratio).

Moving away from the current dividend imputation regime back to a **classical tax system** with the same rates of company and personal tax would impose much more uniform effective rates of tax on the income Australian shareholders derive from different types of Australian companies. However, it would also significantly increase the effective tax rates imposed on the income of Australian shareholders in all corporate groups. The magnitude of that increase in effective tax rates would be greatest for Australian shareholders in those Australian Corporate Groups with the highest dividend payout ratios, since such shareholders currently receive the greatest benefits from the current dividend imputation regime.

Replacing the current dividend imputation regime with a **UK style notional tax credit regime** would also impose much more uniform effective tax rates on the income Australian shareholders derive from different types of Australian companies. As would be the case with a return to a classical tax system,

7 Note that the figures for the current imputation regime are calculated under the assumption that the Australian company tax rate is 30%, the company tax rate in the listed country is 30% and the company tax rate in the unlisted country is 25%.. By contrast, it was assumed that the unlisted company tax rate was 20% for the purposes of determining the impact of reductions in the Australian company tax rate in Tables 4.4 to 4.8.

the implementation of a UK style notional tax credit regime would significantly increase the effective tax rates imposed on Australian shareholders in all types of Australian companies if the rate of notional tax credit was low (eg 10 per cent).

However, a notional tax credit of greater than 30 per cent would be required to reduce the effective tax rates imposed on the dividend income of Australian shareholders in all Australian companies.

These results highlight the **economic substance of a UK style notional tax credit regime**. It is really just a **classical tax system combined with a reduced rate of personal tax on dividend income**.

Retaining the current dividend imputation regime and providing Australian shareholders with a notional tax credit set at some proportion of the value of their foreign source dividend income from listed countries (ie **implementing option A**) would:

- not affect Australian shareholders in Australian Corporate Groups, since those corporate groups are assumed not to have any foreign source income; and
- reduce the effective tax rates imposed on the income Australian shareholders derive from Emerging Australian Multinationals and Mature Australian Multinationals regardless of their dividend payout ratios. The greatest reductions in effective tax rates would be experienced by Australian shareholders in those Australian multinationals that earn the highest proportions of their income from investments in listed countries (ie Mature Australian Multinationals). In addition, the magnitude of that reduction will be greater the greater the dividend payout ratio.

Retaining the current dividend imputation regime and providing Australian shareholders with a franking credit for foreign dividend withholding tax (ie **implementing option C**) would:

- not affect Australian shareholders in Australian Corporate Groups, since those corporate groups are assumed not to have any foreign source income; and
- reduce the effective tax rates imposed on the income Australian shareholders derive from Emerging Australian Multinationals and Mature Australian Multinationals. The greatest reductions in effective tax rates would be experienced by Australian shareholders in those Australian Multinationals that earn the highest proportions of their income from investments in countries that impose relatively high rates of foreign dividend withholding tax. In addition, the magnitude of that reduction will be greater the greater the dividend payout ratio. We note, however, that most of the benefits illustrated in this example come from providing credits for FDWT imposed on income from listed countries. After the new US protocol is introduced, those benefits would not be as significant.

Impact on foreign shareholders in credit countries

Table 4.10 outlines the impact of Australia shifting away from the current dividend imputation regime on the effective tax rates imposed on the income of foreign shareholders who are located in those countries that provide credits for Australian taxes (foreign credit country shareholders).

Although these foreign shareholders do not receive imputation credits for Australian tax they do receive credits for any Australian withholding taxes imposed on their income. For the purposes of this model it is assumed that 40 per cent of credits cannot be used. This means that the effective tax rates imposed on the dividend income of foreign shareholders located in credit countries will increase with increases in the dividend payout ratio. It also means that those effective tax rates are much more uniform across the different types of Australian companies since, in effect, these shareholders are already subject to classical tax treatment.

Table 4.10: Impact of shift away from dividend imputation on foreign shareholders in credit countries (ETR%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	27.2	27.4	28.1	30.9	28.3	28.9	30.0	32.6	31.7	33.4	35.4	38.4
Classical tax system	29.7	32.3	35.1	39.2	30.5	33.2	35.9	39.6	33.7	37.2	40.6	44.5
UK style regime:												
10% credit	27.4	27.7	28.3	31.2	28.5	29.1	30.1	33.0	31.8	33.5	35.6	38.5
20% credit	27.3	27.6	28.2	31.1	28.4	29.0	30.1	32.9	31.7	33.5	35.6	38.6
30% credit	27.2	27.4	28.1	30.9	28.3	28.9	30.0	32.9	31.7	33.5	35.5	38.6
Option A:												
10% credit	27.2	27.4	28.1	30.9	28.3	28.9	30.0	32.6	31.7	33.4	35.4	38.4
20% credit	27.2	27.4	28.1	30.9	28.3	28.9	30.0	32.7	31.7	33.4	35.5	38.4
30% credit	27.2	27.4	28.1	30.9	28.3	28.9	30.0	32.7	31.7	33.4	35.5	38.5
Option C	27.2	27.4	28.1	30.9	28.3	28.9	29.9	32.5	31.7	33.4	35.3	38.1

Returning to a classical tax system with the same rates of company and personal tax would only result in a slight increase the effective rates of tax imposed on the income foreign credit country shareholders derive from different types of Australian companies, since those shareholders are already subject to classical tax treatment.

Replacing the current dividend imputation regime with a **UK style notional tax credit regime** at a rate of 10 per cent would slightly increase the effective tax rates imposed on the income that foreign credit country shareholders earn on their income from all Australian companies, regardless of their dividend payout ratios. If the notional credit rate was set at 30 per cent, their effective tax rates would remain largely unchanged.

Retaining the current dividend imputation regime and providing Australian shareholders with a notional tax credit set at some proportion of the value of their foreign source dividend income from listed countries (ie **implementing option A**) would:

- not affect foreign credit country shareholders in Australian Corporate Groups, since those corporate groups are assumed not to have any foreign source income; and
- slightly increase the effective tax rates imposed on the income foreign credit country shareholders derive from Emerging Australian Multinationals and Mature Australian Multinationals at relatively high notional credit rates and high dividend payout ratios.

Retaining the current dividend imputation regime and providing Australian shareholders with a franking credit for foreign dividend withholding tax (ie **implementing option C**) would:

- not affect foreign credit country shareholders in Australian Corporate Groups, since those corporate groups are assumed not to have any foreign source income; and
- slightly reduce the effective tax rates imposed on the income foreign credit country shareholders derive from Emerging Australian Multinationals and Mature Australian Multinationals.

Impact on foreign shareholders in exemption countries

Table 4.11 outlines the impact of Australia shifting away from its current dividend imputation regime on the effective tax rates imposed on the income of foreign shareholders who are located in those countries that exempt foreign source dividend income from tax (foreign exemption country shareholders).

These foreign shareholders do not receive imputation credits for Australian tax. However, they are completely exempted from having to pay tax in their home country on Australian source dividends. Once again, this means that the effective tax rate imposed on the dividend income of foreign shareholders located in exemption countries will increase with increases in the dividend payout ratio.

Table 4.11: Impact of shift away from dividend imputation on foreign shareholders in exemption countries (ETR%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	na	na	na	na	28.3	28.9	30.3	34.1	31.7	33.4	35.8	39.2
Classical tax system	na	na	na	na	33.8	39.6	45.3	51.7	36.9	43.2	49.1	55.0
UK style regime:												
10% credit	na	na	na	na	28.5	29.1	30.4	34.3	31.8	33.5	35.9	39.2
20% credit	na	na	na	na	28.4	29.0	30.4	34.3	31.7	33.5	35.9	39.3
30% credit	na	na	na	na	28.3	28.9	30.4	34.3	31.7	33.5	35.9	39.3
Option A:												
10% credit	na	na	na	na	28.3	28.9	30.3	34.1	31.7	33.4	35.8	39.2
20% credit	na	na	na	na	28.3	28.9	30.3	34.1	31.7	33.4	35.9	39.3
30% credit	na	na	na	na	28.3	28.9	30.3	34.1	31.7	33.4	35.9	39.3
Option C	na	na	na	na	28.3	28.9	30.2	33.7	31.7	33.4	35.5	38.4

It is assumed that the Australian Corporate Group does not have any shareholders located in countries that exempt Australian dividend income from tax. As a result, the impact of a shift away from dividend imputation on this type of foreign shareholder is not applicable to the Australian Corporate Group.

Returning to a classical tax system with the same rates of company and personal tax would increase the effective rates of tax imposed on the income foreign exemption country shareholders derive from their interests in Emerging and Mature Australian Multinational companies.

Replacing the current dividend imputation regime with a **UK style notional tax credit regime** at a rate of 10 per cent would only slightly increase the effective tax rates imposed on the income that foreign exemption country shareholders earn on their income from all Australian companies, regardless of their dividend payout ratios. If the notional credit rate was set at 30 per cent, their effective tax rates would remain largely unchanged.

Retaining the current dividend imputation regime and providing Australian shareholders with a notional tax credit set at some proportion of the value of their foreign source dividend income from listed countries (ie **implementing option A**) would:

- not affect foreign exemption country shareholders in Australian Corporate Groups, since those corporate groups are assumed not to have any foreign source income; and
- have little effect on the effective tax rates imposed on the income foreign exemption country shareholders derive from Emerging Australian Multinationals and Mature Australian Multinationals.

Retaining the current dividend imputation regime and providing Australian shareholders with a franking credit for foreign dividend withholding tax (ie **implementing option C**) would:

- not affect foreign exemption country shareholders in Australian Corporate Groups, since those corporate groups are assumed not to have any foreign source income; and
- slightly reduce the effective tax rates imposed on the income foreign exemption country shareholders derive from Emerging Australian Multinationals and Mature Australian Multinationals at high dividend payout ratios.

4.4.2 Impact on the cost of capital

Table 4.12 outlines the cost of capital of each of the Australian corporate groups under the alternative dividend imputation regimes. As a result, it provides an indication of the impact of Australia shifting away from its current dividend imputation regime on the cost of capital of the Australian Corporate Group, the Emerging Australian Multinational, and the Mature Australian Multinational under dividend payout ratios ranging from 25 per cent to 100 percent.

Table 4.12: Impact of a shift away from dividend imputation on the cost of capital (%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.8	10.9
Classical tax system	10.4	10.5	10.6	10.8	10.4	10.5	10.6	10.7	10.4	10.5	10.6	10.7
UK style regime:												
10% credit	10.4	10.5	10.6	10.7	10.4	10.5	10.5	10.7	10.4	10.5	10.5	10.6
20% credit	10.5	10.7	10.9	11.1	10.5	10.7	10.8	11.0	10.5	10.6	10.8	10.9
30% credit	10.6	11.0	11.4	11.7	10.6	10.9	11.2	11.6	10.6	10.8	11.1	11.4
Option A:												
10% credit	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.9	11.0
20% credit	10.6	11.0	11.4	11.6	10.6	11.0	11.2	11.4	10.6	10.9	11.0	11.2
30% credit	10.6	11.0	11.4	11.6	10.6	11.0	11.3	11.4	10.7	11.0	11.2	11.4
Option C	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.9	11.0

Returning to a classical tax system with the same rates of company and personal tax would result in a slight reduction in the cost of capital since it would reduce the cost of equity finance by increasing the tax advantage to debt finance. This highlights one of the advantages of the dividend imputation regime. It reduces the tax advantage to debt finance. Returning to a classical tax system would increase that tax advantage to debt.

Replacing the current dividend imputation regime with a **UK style notional tax credit regime** would have much the same effect on the cost of capital as a return to a classical tax system if the notional tax credit rate is low (eg 10 per cent). That is, it would reduce the cost of capital for Australian companies. However, at higher rates of notional tax credit, the magnitude of that reduction would be smaller and could even be more than offset for Emerging and Mature Australian Multinationals with very high dividend payout ratios if the notional credit rate is 30 per cent. This is because increases in the notional credit rate have much the same effect as the introduction of partial imputation credits. Those credits reduce the tax advantage to debt finance, thereby increasing the cost of equity and hence the cost of capital.

Retaining the current dividend imputation regime and providing Australian shareholders with a notional tax credit set at some proportion of the value of their foreign source dividend income from listed countries (ie **implementing option A**) would:

- not affect the cost of capital for Australian Corporate Groups, since those corporate groups are assumed not to have any foreign source income; and
- have little effect on the cost of capital for Emerging Australian Multinationals and Mature Australian Multinationals and could slightly increase the cost of capital for Mature Australian multinational companies at high dividend payout ratios.

Retaining the current dividend imputation regime and providing Australian shareholders with a franking credit for foreign dividend withholding tax (ie **implementing option C**) would:

- not affect the cost of capital for Australian Corporate Groups, since those corporate groups are assumed not to have any foreign source income; and
- slightly increase the cost of capital for Emerging Australian Multinationals and Mature Australian Multinationals at higher dividend payout ratios. Once again, this is because these additional imputation credits would slightly reduce the tax advantage of debt, thereby increasing the cost of equity and therefore the cost of capital.

4.4.3 Impact on shareholder value

Table 4.13 outlines the value of shareholders' initial equity interest in each of the corporate groups under alternative imputation regimes. As a result, it provides an indication of the overall impact that a shift away from dividend imputation in Australia would have on the value of shares held in the Australian Corporate Group, the Emerging Australian Multinational and the Mature Australian Multinational under payout ratios ranging from 25 per cent to 100 per cent.

Table 4.13: Impact of a shift away from imputation on shareholder value ($000)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	1410	2065	2325	1955	1317	1943	2231	1952	1208	1811	2069	1730
Classical tax system	1060	1664	1965	1558	1011	1583	1875	1519	962	1501	1781	1450
UK style regime:												
10% credit	1186	1869	2223	1744	1111	1749	2084	1676	1029	1613	1924	1556
20% credit	1290	1964	2272	1829	1206	1841	2143	1763	1110	1696	1983	1639
30% credit	1410	2065	2322	1924	1317	1943	2204	1860	1208	1790	2047	1732
Option A:												
10% credit	1410	2065	2325	1955	1323	1948	2232	1955	1230	1829	2075	1744
20% credit	1410	2065	2325	1955	1331	1953	2234	1956	1256	1852	2083	1766
30% credit	1410	2065	2325	1955	1340	1961	2236	1960	1290	1879	2092	1790
Option C	1410	2065	2325	1955	1317	1943	2227	1963	1208	1799	2086	1772

Returning to a classical tax system with the same rates of company and personal tax would reduce the value of shares held in all Australian companies.

Replacing the current dividend imputation regime with a **UK style notional tax credit regime** would have much the same effect on shareholder value as a return to a classical tax system if the notional tax credit rate is low (eg 10 per cent). That is, it would reduce the value of shares held in all Australian companies. A notional tax credit of around 30 per cent would be required to maintain shareholder at the levels prevailing under the current dividend imputation regime.

Retaining the current dividend imputation regime and providing Australian shareholders with a notional tax credit set at some proportion of the value of their foreign source dividend income from listed countries (ie **implementing option A**) would:

- not affect the value of shares in Australian Corporate Groups, since those corporate groups are assumed not to have any foreign source income; and
- increase the value of shares held in Emerging Australian Multinationals and Mature Australian Multinationals, regardless of the dividend payout ratio. The magnitude of that increase would be higher the greater the rate of notional tax credit.

Retaining the current dividend imputation regime and providing Australian shareholders with a franking credit for foreign dividend withholding tax (ie **implementing option C**) would:

- not affect shareholder value for Australian Corporate Groups, since those corporate groups are assumed not to have any foreign source income; and
- slightly increase shareholder value for Emerging Australian Multinationals and Mature Australian Multinationals at high dividend payout ratios.

4.5 Clarification of the source of dividend income

What are the implications of clarifying the source of dividend income so that the foreign source income of foreign shareholders in Australian multinational companies can flow through those companies without any adverse tax consequences for Australian or foreign shareholders?

This section analyses the implications of Australia **implementing Option B**, which would allow Australian multinationals to stream the foreign source income derived from listed countries to foreign shareholders, without reducing either the imputation credits available to Australian shareholders or the amount of exempt foreign dividends that can be paid to foreign shareholders.

4.5.1 Impact on effective tax rates

The impact that clarifying the source of dividend income through the implementation of option B has on the effective tax rates imposed on shareholders in Australian companies is set out in Tables 4.14, 4.15 and 4.16.

Impact on Australian shareholders

Table 4.14 outlines the effective tax rates imposed on the income of Australian shareholders, expressed in percentage terms, under the current imputation regime and option B. As a result, it indicates how the implementation of Option B would alter the effective tax rates imposed on the income of Australian shareholders in the Australian Corporate Group, the Emerging Australian Multinational, and the Mature Australian Multinational, assuming dividend payout ratios ranging from 25 per cent to 100 per cent.

Table 4.14: Impact of clarifying the source of dividend income on Australian shareholders (ETR%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	19.2	11.4	4.3	1.5	20.5	13.5	8.9	8.5	24.1	20.9	22.6	23.2
Option B	19.2	11.4	4.3	1.5	20.5	13.5	8.9	8.5	24.1	20.9	22.6	23.2

Implementation of option B would not affect the effective tax rates imposed on the income that Australian shareholders derive from Australian Corporate Groups, since those companies are assumed not to earn any foreign source income.

By contrast, implementation of option B does have the potential to reduce the effective tax rates imposed on the income that Australian shareholders derive from both Emerging and Mature Australian Multinationals by reducing the extent to which conduit income flows reduce the amount of imputation credits that can be attached to their dividends that are paid out of Australian source income.

However, the magnitude of that reduction will be small when the volume of conduit income is small. In addition, the effective tax rates imposed the income of Australian shareholders are unlikely to fall if, as is assumed for the purposes of the analysis in this section, that Australian multinational companies are following the practice of deferring payments of dividends from the foreign dividend account until they have exhausted their imputation credits. This is the reason why the results in Table 4.14 indicate that implementation of option B would not alter the effective tax rates imposed on the income of Australian shareholders in Australian multinational companies.

Impact on foreign shareholders in credit countries

Table 4.15 outlines the impact of implementing option B on the effective tax rates imposed on the income of foreign credit country shareholders in the Australian Corporate Group, the Emerging Australian Multinational, and the Mature Australian Multinational, assuming dividend payout ratios ranging from 25 per cent to 100 per cent.

Table 4.15: Impact of clarifying the source of dividend income on foreign shareholders in credit countries (ETR%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	27.2	27.4	28.1	30.9	28.3	28.9	30.0	32.6	31.7	33.4	35.4	38.4
Option B	27.2	27.4	28.1	30.9	28.3	28.9	29.7	31.7	31.7	33.4	35.2	37.9

Implementation of option B would not affect the effective tax rates imposed on the income that foreign credit country shareholders derive from Australian Corporate Groups, since those companies are assumed not to earn any foreign source income.

By contrast, the implementation of option B has the potential to reduce the effective tax rates imposed on the income that foreign shareholders in credit countries derive from Australian multinational companies by ensuring that conduit income flows do not reduce the amount of exempt foreign dividends that can be paid to those shareholders out of the foreign dividend account.

Once again, however, implementation of option B would only reduce the effective tax rates imposed on the income that foreign credit country shareholders derive from Emerging and Mature Australian Multinationals when dividend payout ratios are relatively high (eg 75 per cent and above). This is due to the relatively small volume of conduit income and the practice of exhausting imputation credits before paying dividends out of the foreign dividend account.

Implementation of option B would produce a much greater reduction in the effective tax rates of foreign credit country shareholders when the volume of conduit income is much higher (eg when the value of foreign investments and the numbers of foreign shareholders are much greater than what has been assumed for the purposes of this analysis).

Impact on foreign shareholders in exemption countries

Table 4.16 outlines the impact of implementing option B on the effective tax rates imposed on the income of foreign exemption country shareholders in the Australian Corporate Group, the Emerging Australian Multinational, and the Mature Australian Multinational, assuming dividend payout ratios ranging from 25 per cent to 100 per cent.

It is assumed that the Australian Corporate Group does not have any shareholders located in countries that exempt Australian dividend income from tax. As a result, the impact of implementing option B on this type of foreign shareholder is not applicable to the Australian Corporate Group.

Table 4.16: Impact of clarifying the source of dividend income on foreign shareholders in exemption countries (ETR%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	na	na	na	na	28.3	28.9	30.3	34.1	31.7	33.4	35.8	39.2
Option B	na	na	na	na	28.3	28.9	29.7	31.7	31.7	33.4	35.2	37.9

Once again, implementing option B has the potential to reduce the effective tax rates imposed on the income that foreign exemption country shareholders derive from Australian multinational companies. This is because it would ensure that conduit income flows do not reduce the amount of exempt foreign dividends that can be paid to those shareholders out of the foreign dividend account.

However, this effect only becomes apparent at relatively high payout ratios (75 per cent and above) since the volume of conduit income is relatively small. This reduction in effective tax rates would be much greater for companies with more investments offshore and more foreign shareholders than we have assumed for the purposes of this analysis.

4.5.2 Impact on the cost of capital

Table 4.17 outlines the cost of capital of each of the Australian corporate groups under the current dividend imputation regime and under option B. As a result, it provides an indication of the impact of implementing option B on the cost of capital of the Australian Corporate Group, the Emerging Australian Multinational, and the Mature Australian Multinational under dividend payout ratios ranging from 25 per cent to 100 percent.

Table 4.17: Impact of clarifying the source of dividend income on the cost of capital (%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.8	10.9
Option B	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.8	10.9

In principle, implementation of option B should:

- not affect the cost of capital of the Australian corporate group; and
- reduce the cost of capital for Australian multinational companies that have conduit income flows by reducing the effective tax rates imposed on foreign shareholders.

However, since the magnitude of the conduit income flows are relatively low and we have assumed that companies exhaust their imputation credits before they pay dividends out of their foreign dividend accounts, there is no noticeable impact on the cost of capital. For companies with greater investments offshore and more foreign shareholders, however, the implementation of option B would be expected to reduce the cost of capital.

4.5.3 Impact on shareholder value

Table 4.18 outlines the value of shareholders' initial equity interest in each of the corporate groups under the current dividend imputation regime and under option B. As a result, it provides an indication of the overall impact that the implementation of option B would have on the value of shares held in the Australian Corporate Group, the Emerging Australian Multinational and the Mature Australian Multinational under payout ratios ranging from 25 per cent to 100 per cent.

Table 4.18: Impact of clarifying the source of dividend income on shareholder value ($000)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	1410	2065	2325	1955	1317	1943	2231	1952	1208	1811	2069	1730
Option B	1410	2065	2325	1955	1317	1943	2238	1988	1208	1811	2076	1751

Implementation of option B would not affect the value of shares in the Australian Corporate Group, since it is assumed to have no foreign source income.

However, implementation of option B would increase the value of shares in both the Emerging and Mature Australian Multinationals. The magnitude of that increase in shareholder value would be even greater for those Australian multinational companies with more foreign investment and foreign shareholders that has been assumed for the purposes of the analysis in this section.

4.6 Simplification of the measurement of foreign source income

What are the implications of simplifying the measurement of foreign source income by extending the list of broadly exempted countries to include a currently unlisted country?

4.6.1 Impact on effective tax rates

The impact that expanding the list of exempted countries has on the effective tax rates imposed on shareholders in Australian companies is set out in Tables 4.19, 4.20 and 4.21.

Impact on Australian shareholders

Table 4.19 outlines the effective tax rates imposed on the income of Australian shareholders, expressed in percentage terms, under the current imputation regime and in the case where the country in which the Australian multinational company has its unlisted subsidiary is added to the list of broadly exempted countries. As a result, it indicates how the implementation of this option would alter the effective tax rates imposed on the income of Australian shareholders.

Table 4.19: Impact of simplifying the measurement of foreign source income on Australian shareholders (ETR%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	.25	.5	.75	1	.25	.5	.75	1	.25	.5	.75	1
Current imputation	19.2	11.4	4.3	1.5	20.5	13.5	8.9	8.5	24.1	20.9	22.6	23.2
Expand exemption to unlisted country	19.2	11.4	4.3	1.5	20.4	13.6	9.1	9.2	22.2	19.6	21.8	22.7

Implementation of this option would not affect the effective tax rates imposed on the income that Australian shareholders earn from Australian Corporate Groups, since it is assumed that those companies do not earn any foreign source income.

However, implementation of this option does have the potential to reduce the effective marginal tax rates of tax on the income Australian shareholders derive from Australian multinational companies with investments in unlisted countries.

The magnitude of that potential reduction in effective tax rates will be greater the lower the tax rate prevailing in the unlisted country, the greater the amount of foreign source income earned from the unlisted country, and the greater the amount of time that income remains in the unlisted country. As a result, increases in the dividend payout ratio will tend to reduce the value of this benefit.

However, the magnitude of that reduction will be reduced, and may even be more than offset, by reductions in the amount of imputation credits payable to Australian shareholders. This is the reason why this option increases the effective tax rates imposed on Australian shareholders in Emerging Australian Multinational companies. For these companies, the loss in imputation credits more than offsets any gains due to lower tax rates on the small amount of foreign source income from the listed country.

By contrast, the implementation of this option would reduce the effective tax rates imposed on the income Australian shareholders derive from Mature Australian Multinationals.

Impact on foreign shareholders in credit countries

Table 4.20 outlines the impact of implementing option B on the effective tax rates imposed on the income of foreign credit country shareholders.

Implementation of this option would not affect the effective tax rates imposed on the income that foreign shareholders earn from Australian Corporate Groups, since it is assumed that those companies do not earn any foreign source income.

Table 4.20: Impact of simplifying the measurement of foreign source income on foreign shareholders in credit countries (ETR%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	.25	.5	.75	1	.25	.5	.75	1	.25	.5	.75	1
Current imputation	27.2	27.4	28.1	30.9	28.3	28.9	30.0	32.6	31.7	33.4	35.4	38.4
Expand exemption to unlisted country	27.2	27.4	28.1	30.9	28.4	29.4	30.7	33.7	30.1	32.1	34.5	38.0

However, implementation of this option would affect the effective tax rates imposed on the income that foreign credit country shareholders derive from Australian multinational companies.

Once again, such an option would:

- increase the effective tax rates imposed on the income those shareholders derive from Emerging Australian Multinationals, since the benefits to the company of reducing the rate of tax on the small amount of foreign source income from the unlisted country would be more than offset by the loss in imputation credits; and
- reduce the effective tax rates imposed on the income those shareholders would derive from Mature Australian Multinationals.

Impact on foreign shareholders in exemption countries

Table 4.21 outlines the impact that expanding the broad exemption list to include the unlisted country has on the effective tax rates imposed on the income of foreign exemption country shareholders.

Table 4.21: Impact of simplifying the measurement of foreign source income on foreign shareholders in exemption countries (ETR%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	na	na	na	na	28.3	28.9	30.3	34.1	31.7	33.4	35.8	39.2
Expand exemption to unlisted country	na	na	na	na	28.4	29.4	30.7	34.4	30.1	32.1	34.5	38.2

Since the Australian Corporate Group does not have any shareholders located in countries that exempt Australian dividend income from tax,, the impact of implementing this option this type of foreign shareholder is not applicable to the Australian Corporate Group.

However, implementation of this option would affect the effective tax rates imposed on the income that foreign credit country shareholders derive from Australian multinational companies.

Once again, such an option would:

- increase the effective tax rates imposed on the income those shareholders derive from Emerging Australian Multinationals, since the benefits to the company of reducing the rate of tax on the small amount of foreign source income from the unlisted country would be more than offset by the loss in imputation credits; and
- reduce the effective tax rates imposed on the income those shareholders would derive from Mature Australian Multinationals.

4.6.2 Impact on the cost of capital

Table 4.22 outlines the cost of capital of each of the Australian corporate groups under the current dividend imputation regime and in the case where the unlisted country has been added to the list of broadly exempted countries. As a result, it provides an indication of the impact of implementing this option on the cost of capital of the Australian Corporate Group, the Emerging Australian Multinational, and the Mature Australian Multinational under dividend payout ratios ranging from 25 per cent to 100 percent.

Table 4.22: Impact of simplifying the measurement of foreign source income on the cost of capital (%)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.8	10.9
Expand exemption to unlisted country	10.6	11.0	11.4	11.6	10.6	10.9	11.2	11.3	10.6	10.8	10.8	10.9

In principle, implementation of this option should:

- not affect the cost of capital of the Australian corporate group; and
- reduce the cost of capital for Australian multinational companies that derive significant amounts of income from investments in the unlisted country that is added to the list of broadly exempted countries.

However, since it is assumed that the amount of income that Australian multinationals derive from investments in unlisted countries is relatively small, there is no noticeable impact of this option on the cost of capital of either the Emerging or Mature Australian Multinationals. It is important to note, however, that the implementation of this option could reduce the cost of capital for a company that was deriving significant amounts of foreign source income from the unlisted country that is added to the list of broadly exempted countries.

4.6.3 Impact on shareholder value

Table 4.23 outlines the value of shareholders' initial equity interest in each of the corporate groups under the current dividend imputation regime and in the case where the unlisted country has been added to the list of broadly exempted countries. As a result, it provides an indication of the impact of implementing this option on the value of shares in the Australian Corporate Group, the Emerging Australian Multinational, and the Mature Australian Multinational under dividend payout ratios ranging from 25 per cent to 100 percent.

Table 4.23: Impact of simplifying the measurement of foreign source income on shareholder value ($000)

Initiative	Australian Corporate Group				Emerging Australian Multinational				Mature Australian Multinational			
	Dividend payout ratio				Dividend payout ratio				Dividend payout ratio			
	25%	50%	75%	100%	25%	50%	75%	100%	25%	50%	75%	100%
Current imputation	1410	2065	2325	1955	1317	1943	2231	1952	1208	1811	2069	1730
Expand exemption to unlisted country	1410	2065	2325	1955	1362	1997	2282	1909	1300	1932	2175	1742

Since it is assumed that the Australian Corporate Group does not have any foreign source income, implementation of this option would not affect the value of shares in this company.

By contrast, implementation of this option would increase the value of shares in both the Emerging and Mature Australian Multinationals, regardless of the dividend payout ratio.

5. Implications for Australian Tax Policy

Section 4 analysed the implications of the key international trends in dividend taxation for Australian companies and their shareholders under the simplifying assumption that those tax changes would have no impact on their real investment decisions.

In reality, however, such an assumption is highly unrealistic. It is inevitable that such significant changes in tax policy will alter the real investment decisions of Australian companies and their shareholders. For example, significant reductions in company tax rates in other jurisdictions may encourage Australian companies to consider increasing their investment in those jurisdictions or moving their head offices offshore in order to take advantage of those lower rates of tax.

Indeed, these international changes in tax policy are actually intended to alter real investment decisions. In particular, they are the result of countries trying to reduce the extent to which their income tax systems deter saving, raise the domestic cost of capital, discourage investment, distort patterns of investment, and reduce their international competitiveness.

As a result, in this section we relax that simplifying assumption and examine the implications of these key trends in dividend taxation for the real investment decisions of Australian companies and their shareholders and Australian tax policy.

Once again, our analysis is not intended to be comprehensive. Rather, we focus attention on the same key trends in dividend taxation that were analysed in section 4.

Our approach to analysing the implications of these trends is outlined in section 5.1. In brief, it is a similar approach to that used in section 4, but it involves the use of a different set of analytical tools and is more qualitative in nature due to constraints on available data. Specifically, we discuss the implications of each of the key trends in dividend taxation for:

- effective marginal rates of tax imposed on the income of shareholders in Australian companies;
- the cost of capital for Australian companies; and
- national welfare.

5.1 Approach adopted

What impact do these key international trends in dividend taxation have for the real investment decisions of Australian companies and their shareholders and Australian tax policy?

In order to answer this question, we have adopted an approach broadly similar to that used in section 4. In section 4, we sought to determine the impact of those tax changes on Australian companies and their shareholders under the simplifying assumption that there was no change in real investment. This involved analysing the impact of those changes on:

- effective tax rates imposed on the income of Australian companies and their shareholders;
- the cost of capital; and
- shareholder value.

By contrast, in section 5 we are seeking to determine the implications of those changes for real investment decisions and Australian tax policy. This involves a similar approach to that used in section 4, but the use of a different set of analytical tools. In particular, as discussed further below, it involves analysing the impact of those changes on:

- the effective marginal rates of tax on investment, which is a different concept of effective tax rate than that used for the purposes of section 4;
- the cost of capital; and
- national welfare as opposed to shareholder value.

5.1.1 Determining the impact on effective marginal tax rates

In order to determine the impact of changes in dividend taxation on real investment decisions, we need to measure the extent to which those changes alter the relative returns to alternative investments.

This requires the measurement of the **effective marginal tax rates** (EMTRs) applying to the income from alternative **investments**, which is a different effective tax rate concept than the one used for the purpose of the analysis in section 4.

The effective tax rate concept used in section 4 provided a measure of the net impact of changes in dividend taxation on the **total amount of tax** (ie Australian plus foreign taxes) payable by Australian companies and their shareholders under the assumption that there was no change in the real investment decisions. That is, those effective tax rates provided an indication of the average rates of tax applying to the income of companies and their shareholders.

By contrast, for the purposes of section 5, we employ an **effective marginal tax rate concept** which measures the extent to which the alters the rates of return that would have existed **in the absence of Australian taxes**.

Specifically, the effective marginal tax rates calculated in this section measure the percentage difference between the minimum required rate of return for an investment to proceed in the presence of Australian taxes and the minimum required rate of return for the investment to proceed in the absence of Australian taxes.

That is, these EMTRs on investment indicate the extent to which rates of return are distorted in relation to the rates of return that would have existed in the absence of Australian taxes. As a result, they provide an indication of the extent to which the **Australian** tax system:

- deters investment – the higher the EMTR, the greater the disincentive to invest; and
- distorts patterns of investment – the greater the differences in EMTRs across different companies and forms of investment the more the Australian tax system distorts the relative rates of return available from alternative investments.

As discussed in Appendix 2, the calculation of these EMTRs on investment is based on the assumption that Australia is a small, open, net capital importing nation. This means that the appropriate 'benchmark' for determining the extent to which the tax system deters and distorts investment is the level and pattern of investment that would exist in the absence of **Australia taxes**, not the one that would exist in the absence of world taxes.

A detailed analysis of effective marginal tax rates in Australia and overseas can be found in the information paper *An International Perspective* which was released by the Review of Business Taxation in December 1998. That analysis indicates that effective marginal tax rates in Australia vary considerably across investments in plant, buildings, land, inventory, research and development and mining due to differences in the manner in which Australia taxes the income from those investments.

In this section of the report we are not seeking to estimate the impact of Australia's overall tax system on the effective marginal tax rates applying to those particular forms of real investment. Rather, our focus is on how specific aspects of the company tax, dividend imputation, and international tax regimes, affect the effective marginal tax rates imposed on the income earned by different types of Australian companies with different patterns of investment and different sources of finance. That is, we are primarily interested in the extent to which these key features of the Australian tax system distort decisions to invest in different types of Australian companies and the extent to which various options for reform would reduce those distortions.

The assumptions regarding the investment patterns of these three different types of Australian companies are similar to those employed for the purposes of the analysis in section 5. Specifically, it is assumed that:

- the Australian Corporate Group does not earn any foreign source income;
- the Emerging Australian Multinational:
  - earns 10 per cent of its total income from foreign sources;
  - 90 per cent of that foreign source income is derived from listed countries and is subject to a 15 per cent foreign dividend withholding tax;
  - 10 per cent of that foreign source income is the income of foreign investors (ie conduit income);
- the Mature Australian Multinational earns 20 per cent of its income from foreign sources, and 90 per cent of that income is derived from investments in listed countries and is subject to a 15 per cent foreign dividend withholding tax
  - earns 20 per cent of its total income from foreign sources;
  - 90 per cent of that foreign source income is derived from listed countries and is subject to a 15 per cent foreign dividend withholding tax;
  - 20 per cent of that foreign source income is the income of foreign investors (ie conduit income);

5.1.2 Determining the impact on the cost of capital

Since we are now using effective **marginal** tax rates, rather than effective tax rates, we must also recalculate the cost of capital in a manner that is consistent with the methodology used to calculate those effective marginal tax rates. Once again, in principle, the cost of capital will depend on a number of factors including:

- who determines rates of return on Australian capital markets;
- who is the marginal investor;
- what is the marginal source of equity finance; and
- what is the company's dividend policy.

Who determines rates of return on Australian capital markets?

As was the case in section 4, for the purposes of section 5 we continue to assume that Australia is a small open economy and that the required rates of return that prevail on Australia's capital markets are set by the operation of world capital markets.

However, we also consider the implications of relaxing the assumption that capital markets operate perfectly. In particular, we discuss how the results of our analysis change if some Australian companies have difficulty accessing foreign capital.

If we assume that capital markets operate perfectly, then the required rates of return that prevail in a small, open, capital importing nation like Australia will be set by world markets.

In this case, Australian companies and their Australian shareholders are simply 'price takers'. Australian companies will have to be prepared to pay the world rate of return applying to that particular type of equity investment and Australian shareholders will have to accept that prevailing rate of return on their equity investments.

In particular, Australian companies will have to be prepared to compensate foreign shareholders to some extent for the amount of Australian tax levied on their income. The amount of that compensation will depend on how sensitive that foreign investment is to changes in the rate of return.

The sensitivity of foreign investment to Australian taxes will depend on a number of factors including the ability of foreign shareholders to claim credits for Australian tax against their home country tax liabilities, as well as the availability of alternative investments in other countries. If foreign shareholders are not able to claim credits for Australian tax and there are many alternative investments available in other countries, then the supply of foreign investment is likely to be highly sensitive to Australian tax. In such cases, Australian companies would have to be prepared to compensate those foreign shareholders for the full amount of Australian tax levied on their income.

In particular, the sensitivity of foreign investment to Australian tax will vary significantly across different investments. For example, portfolio equity investments are likely to be more sensitive to Australian tax than direct equity investment.

This means that the imposition of Australian company tax and dividend withholding tax on the income of foreign shareholders will raise the cost of capital in Australian to some extent. Conversely, reductions in the rate of Australian company tax and dividend withholding tax is likely to reduce the cost of capital for Australian companies, as has been demonstrated in section 4.

However, the effective marginal rates of tax imposed on Australian shareholders and changes in those effective marginal tax rates will have no effect on the cost of capital of Australian companies. Rather, those changes will simply alter the final after tax rate of return received by the Australian shareholder. They will realise gains when there are reductions in their effective marginal tax rates and losses when their effective marginal tax rates increase.

By contrast, **if we assume that capital markets do not operate perfectly** and some Australian companies have difficulties accessing international capital, then the effective marginal tax rates imposed on the income of Australian shareholders will affect the cost of capital of those Australian companies.

As a result, the assumptions that are made about the efficiency with which capital markets operate have a significant impact on the extent to which changes in the Australian tax system will impact on the domestic cost of capital of Australian companies.

In practice, it is unrealistic to assume that capital markets operate perfectly and that the manner in which Australian shareholders are taxed has no impact on the cost of capital of Australian companies. Although there has been significant deregulation of capital markets over the last two decades, empirical research indicates that there is still a significant 'home country' bias in favour of domestic investment, which arises due to the existence of a number of potential sources of market failure such as asymmetric information.[8] Typically, it is much easier for shareholders to obtain accurate information about local companies than foreign companies. Even relatively large Australian companies still have to rely heavily on Australian shareholders to provide the equity capital needed to finance their expansion offshore since they are not well known to potential foreign investors.

However, it is also unrealistic to assume that Australia is a 'closed economy' and the only determinant of the cost of capital of Australian companies is the manner in which Australia taxes the income of Australian shareholders. For a small, open, net capital importing nation such as Australia, the rate of tax applied to the income of foreign investors clearly has the potential to alter the cost of capital of Australian companies.

Rather, the more realistic approach is to recognise that the truth lies somewhere between these two extreme assumptions and that the existence of capital market imperfections will mean that changing the tax treatment of Australian shareholders is likely to influence the cost of capital for Australian companies to some extent.

Who is the marginal investor?

As noted in section 4, the identity of the marginal investor is a key factor that determines the impact of changes in dividend taxation on the cost of capital of Australian companies.

For the purposes of section 4, it was assumed that the marginal investor was a foreign shareholder. As noted in section 4.2.3, however, in an open economy such as Australia, it is possible for the marginal investor to be either an Australian or a foreign shareholder.

In view of the significance of this assumption to the results of the analysis, section 5 considers the impact of changes in dividend taxation on the cost of capital under the assumption that the marginal investor is either a foreign or an Australian shareholder.

What is the marginal source equity finance?

In section 4, it was assumed that Australian companies financed their activities via a combination of debt, equity and retained earnings.

For the purposes of section 5, however, we need to determine the **marginal** source of equity finance. That is, we need to determine the extent to which the marginal dollar of equity finance comes from retained earnings, new equity or some combination of the two.

The marginal source of funds is probably one of the most contentious areas of corporate finance since it revolves around the core issue as to why companies continue to pay dividends when those dividends are taxed at a higher effective tax rate than capital gains (the 'dividend puzzle').

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8 See, for example, Obstfeld and Roggoff (2000), Feldstein (1994), Gordon and Bovenberg (1994).

There are two main views on this issue:

- the 'traditional view', which argues that the marginal source of equity finance is some combination of retained earnings and new share issues. This view resolves the dividend puzzle by arguing that shareholders place an additional value on dividends over and above their role as a mechanism for distributing profits. As noted by Poterba (1987), companies may choose to pay tax penalised dividends to:
  - signal the company's prospects to shareholders (ie to overcome asymmetric information between the company and its shareholders regarding the company's prospects);
  - reduce the scope for managerial discretion by reducing the free cash flow within the company (ie to alleviate agency problems arising from the inability of shareholders to costlessly monitor managers);
  - aid shareholders plan their consumption.
- the 'new view', which argues that the marginal source of equity finance is retained earnings. This view resolves the dividend puzzle by arguing that companies pay dividends because they have excess cash flows. Since it is assumed that companies cannot repurchase their shares, equity is 'trapped' in the company and can only be distributed as dividends. That is, under this view, dividends are simply regarded as a means of distributing income and have no additional value.

Between these two regimes is a situation where firms pay minimum dividends and issue no new shares.

As noted by Auerbach (2001) and Sinn (1991), it is probably best to view companies as moving through a life cycle in which the company begins in the traditional regime and eventually becomes more reliant on retained equity to finance marginal investment.

As a result, we have calculated the impact that changes in dividend taxation have on the cost of capital under both the traditional and new views. The approach used to calculate the cost of capital in each case is discussed further in Appendix 2.

5.1.3 Determining the impact on national welfare

In section 4, we were interested in determining the impact of changes in dividend taxation on shareholder value.

By contrast, in section 5, we are interested in determining the impact of those changes on national welfare.

In principle, this requires the use of a general equilibrium model that is capable of determining how changes in the relative rates of return will affect national welfare.

In practice, however, existing general equilibrium models of the Australian economy are not sufficiently detailed to capture the complexities of Australia's international tax regime and the impact of the highly specific changes in dividend taxation that are the focus of this report.

As a result, our discussion of the impact of changes in dividend taxation on national welfare is primarily qualitative and is based on:

- the results of our analysis of the impact of those changes on effective marginal tax rates; and
- assumptions about how sensitive levels and patterns of investment are to changes in those effective marginal tax rates.

When examining the impact of a particular change in dividend taxation on national welfare, a key issue is whether that change will reduce the extent to which the tax system deters investment and distorts patterns of investment away from those that would have prevailed in the absence of Australian tax.

As noted above, our effective tax rate estimates provide an indication of the extent to which the Australian tax system deters and distorts investment. In general, changes in dividend taxation that reduce effective marginal tax rates across companies, regardless of their source of finance, are likely to improve economic efficiency in Australia to some extent.

The extent of that improvement in economic efficiency will depend on:

- the amount of investment potentially affected by the change; and
- how responsive that investment is to changes in the effective marginal tax rate. In general, the greatest potential improvements in economic efficiency will be produced by those changes in dividend taxation that:
  - reduce the EMTR on those forms of investment that are the most sensitive to tax (eg foreign portfolio investment in Australia, since foreign investors have a large number of alternative investments to choose from in other countries); and
  - reduce differences in the effective marginal tax rates imposed on closely substitutable investments.

In addition to considering the impact of changes in dividend taxation on EMTRs and economic efficiency, however, we also need to consider the impact of those changes on the amount of tax revenue raised by the government. When considering the impact on national welfare of change in dividend taxation that would result in a significant reduction in tax revenue, it is important to ensure that such revenue can be raised in a more efficient manner. While such a change might improve the overall efficiency of the tax system, it might also require rates of tax to be raised in order to make up any shortfall in revenue, and this increase in tax rates could reduce the overall efficiency of the tax system.

It is also important to determine the extent to which any revenue lost by the government goes to foreigners as opposed to Australian residents. When a change in dividend taxation reduces the amount of tax revenue raised by the Australian government, but all of that lost revenue goes to Australian residents, there is no net cost to Australia as a whole. All that happens is that there is a redistribution of income within the economy from the government back to Australian taxpayers. By contrast, when a change in dividend taxation reduces the amount of tax revenue collected by the Australian government, and that revenue goes to a foreign revenue authority with no offsetting gain to Australia (eg via a reduced cost of capital), then this will reduce national welfare.

5.2 Reductions in tax rates

What are the implications of the international trend towards reducing tax rates for the real investment decisions of Australian companies and their shareholders?

This section analyses the implications of tax reductions brought about by reductions in statutory rates of company tax, both overseas and in Australia.

Once again, the specific tax rate reductions analysed are:

- reductions in the rate of foreign company tax in the listed country from 35 per cent down to 20 per cent;
- reductions in the rate of foreign company tax in the unlisted country from 25 per cent to 20 per cent;
- elimination of the foreign dividend withholding tax (FDWT) imposed on dividend income from the unlisted country; and
- reductions in the rate of Australian company tax from 36 per cent down to 20 per cent.

5.2.1 Impact on effective marginal tax rates

Impact on Australian shareholders

Consider first the impact of changes in foreign tax rates, such as reductions in the rates of foreign company tax and foreign dividend withholding tax, on effective marginal tax rates of Australian shareholders.

Such changes will affect the after-all-taxes rates of return earned by Australian shareholders. For example, the international trend towards reducing rates of foreign company tax and foreign dividend withholding tax will reduce the amount of foreign tax imposed on Australian shareholders' foreign source income when they are unable to fully offset those foreign taxes against their Australian tax liabilities. That is, those reductions in foreign tax have the potential to reduce the extent to which the those foreign taxes currently:

- deter Australians from investing offshore; and
- distort their patterns of offshore investment in relation to what those patterns of investment would have been in the absence of those foreign taxes.

However, such reductions in foreign taxes will not affect the effective marginal tax rates calculated in this section. This is because those effective marginal tax rates measure the extent to which the Australian tax system distorts rates of return to investment in Australia, not the extent to which the combination of Australian and foreign taxes (ie world taxes) distorts investment decisions in Australia.

This is the reason why the analysis in section 5 focuses on the impact of changes in the Australian tax system, such as reductions in rates of Australian company tax, changes to the dividend imputation regime, and changes to the Australian international tax regime as it applies to conduit income and the foreign source income of Australian investors.

Now consider the impact of reductions in the Australian company tax rate on effective marginal tax rates. Table 5.1 outlines the effective marginal tax rates applying to the income that shareholders derive from each of the three corporate groups under different assumptions regarding:

- the rate of Australian company tax;
- the marginal source of funds for the company. For each corporate group, the source of funds can be either retained earnings or new equity;
- the company's dividend payout ratio, which is assumed to range from 25 to 100 per cent.

These effective marginal tax rates provide an indication of the extent to which the Australian income tax system deviates from an 'ideal' comprehensive income tax regime that would tax income from all sources at the same marginal tax rate – the statutory marginal rate of personal tax of the investor.

The magnitude of the effective tax rate provides an indication of the extent to which the Australian tax system may be discouraging investment in Australia. The higher the effective marginal tax rate, the higher the potential disincentive to investment.

Differences in effective tax rates across the corporate groups in this study provide an indication of the extent to which the tax system may be distorting patterns of investment. For example, differences in effective tax rates across the columns of Table 5.1 indicate the extent to which the Australian tax system may be distorting patterns of investment across different types of Australian companies. This is because all Australian companies will differ depending on whether their marginal source of funds is retained earnings or new equity and will have different dividend payout ratios.

As a result, variations in the effective marginal tax rates across the columns of Table 5.1 provide an indication of the extent to which the Australian tax system may be biasing shareholders' decisions regarding which Australian companies in which to invest. For the purposes of the analysis in this section, we are assuming that all investors are subject to a top marginal tax rate of 47 per cent. As a result, the extent to which the estimated effective marginal tax rates deviate from 47 per cent provides us with an indication of the extent to which the Australian tax system has the potential to distort shareholders investment decisions. If the effective marginal tax rate is in excess of 47 per cent, this suggests the Australian tax system may be discouraging investment in that activity. By contrast, if the effective marginal tax rate below 47 per cent, then this suggests that the tax system may be encouraging investment in that activity.

As noted in Table 5.1, for any given rate of Australian company tax, the effective marginal rates of tax vary across Australian companies depending upon:

- their marginal source of finance (retained earnings or new share issues);
- their dividend payout ratios (assumed to vary between 25 per cent and 100 per cent); and
- the nature and extent of their domestic and foreign investment (which varies across the three different corporate groups being analysed).

For example, consider the pattern of effective marginal tax rates at the current company tax rate of 30 per cent. In this case, Australian shareholders in Australian Corporate Groups face an effective marginal tax rate of 46.5 per cent if the company finances its marginal investment through retained earnings and 46.6 per cent if the company issues new shares to finance its marginal investment and pays out 50 per cent of its income in the form of dividends. Australian shareholders are only taxed at their marginal rate of tax of 47 per cent if the company uses new equity to finance its marginal investment and it fully distributes its income. This illustrates the impact of the lower tax rate on capital gains.

The high and varying pattern of effective tax rates across the three corporate groups provides an indication of the extent to which the current tax system has the potential not only to deter investment by Australian shareholders, but also distort their investment choices across Australian companies.

The magnitude of these effective marginal tax rates and the extent to which they vary across companies reflects the effects of:

- the rates of company tax, personal tax and capital gains tax (assumed to be one half of the top personal tax rate). Higher rates of company and personal income tax impose higher effective marginal tax rates on the income of shareholders in Australian companies. The lower rate of tax applying to capital gains provides an incentive for companies to finance their new investments from retained earnings rather than new equity and not to distribute their profits;

- the dividend imputation regime, which only provides full relief from domestic double taxation of income when a company fully distributes its income; and
- flows of conduit income through the Emerging and Mature Australian Multinationals, which reduce the imputation credits available to Australian shareholders.

For simplicity, it is assumed that there are no investment allowances or accelerated rates of depreciation. That is, the rate of depreciation allowed for tax purposes is assumed to be the economic rate of depreciation, which is assumed to be 10 per cent. This means that the effective rate of company tax is constant across all investments and is equal to the statutory rate of company tax.

As noted above, foreign taxes have no impact on these effective marginal tax rates. As a result, differences in those rates of tax are not a source of potential differences in these effective marginal tax rates. However, the manner in which the Australian tax system treats those foreign taxes is a potential source of difference in these effective marginal tax rates. It is assumed initially that no credits are provided to Australian shareholders for foreign taxes paid by the three corporate groups. That assumption is relaxed in section 5.3 when we examine the implications of a shift away from dividend imputation.

As indicated in Table 5.1, reducing the rate of Australian company tax:

- reduces the effective marginal tax rates imposed on the income of Australian shareholders from all Australian companies, regardless of whether they use retained earnings or new equity to finance their marginal investment, or their dividend payout ratios. This reduces the extent to which the Australian tax system deters Australian shareholders from investing in Australian companies; and
- reduces differences in the effective marginal tax rates applying to the income that Australian shareholders derive from different Australian companies. This reduces the extent to which the Australian tax system distorts patterns of investment across companies.

Impact on foreign shareholders

Foreign shareholders face a different pattern of effective marginal tax rates than do Australian shareholders. Foreign shareholders are potentially subject to two layers of Australian tax on their income – company tax when the income is earned and dividend withholding tax when it is distributed. However, since Australia exempts fully franked dividends from Australian dividend withholding tax, it is effective rate of company tax that primarily determines the effective marginal tax rates imposed on the income of foreign shareholders.

These effective marginal tax rates will vary across different types of investments due to differences in the corporate tax treatment of that income. As noted above, however, for the purposes of this section, it is assumed that there are no investments incentives or accelerated depreciation allowances. As a result, the effective marginal rate of tax imposed on income from Australian investments is assumed to be uniform across all investments and equal to the company tax rate. Reducing the Australian company tax rate on foreign shareholders therefore reduces the effective marginal tax rate imposed on their income.

Table 5.1: Impact of changes in dividend taxation on the effective marginal tax rates of Australian shareholders (EMTR%)

Initiative	Australian corporate group					Emerging Australian multinational					Mature Australian multinational				
	Source of funds					Source of funds					Source of funds				
	Retained earnings	New share issue				Retained earnings	New share issue				Retained earnings	New share issue			
		25%	50%	75%	100%		25%	50%	75%	100%		25%	50%	75%	100%
REDUCTIONS IN TAX RATES:															
Reductions in the Australian company tax rate:															
36%	51.0%	51.0%	50.0%	49.0%	47.0%	51.0%	50.7%	50.4%	50.1%	49.8%	51.0%	51.4%	51.7%	52.0%	52.4%
34%	49.5%	49.5%	48.9%	48.3%	47.0%	49.5%	49.5%	49.6%	49.6%	49.6%	49.5%	50.1%	50.7%	51.3%	52.0%
30%	46.5%	46.5%	46.6%	46.7%	47.0%	46.5%	47.1%	47.8%	48.5%	49.2%	46.5%	47.6%	48.8%	50.0%	51.2%
25%	42.6%	42.6%	43.7%	44.8%	47.0%	42.6%	44.1%	45.7%	47.2%	48.7%	42.6%	44.5%	46.5%	48.4%	50.3%
20%	38.8%	40.9%	42.9%	45.0%	47.0%	38.8%	41.2%	43.5%	45.9%	48.3%	38.8%	41.5%	44.2%	46.8%	49.5%
SHIFT AWAY FROM DIVIDEND IMPUTATION:															
Current dividend imputation regime	46.5%	46.6%	46.7%	46.9%	47.0%	46.5%	47.1%	47.8%	48.5%	49.2%	46.5%	47.6%	48.8%	50.0%	51.2%
Classical tax system	46.5%	50.6%	54.7%	58.8%	62.9%	46.5%	50.6%	54.7%	58.8%	62.9%	46.5%	50.6%	54.7%	58.8%	62.9%
UK style notional tax credit for all dividends															
notional credit of 10% of dividends	46.5%	48.8%	51.2%	53.5%	55.9%	46.5%	48.8%	51.2%	53.5%	55.9%	46.5%	48.8%	51.2%	53.5%	55.9%
notional credit of 20% of dividends	46.5%	47.1%	47.7%	48.3%	48.9%	46.5%	47.1%	47.7%	48.3%	48.9%	46.5%	47.1%	47.7%	48.3%	48.9%
notional credit of 30% of dividends	46.5%	45.3%	44.2%	43.0%	41.9%	46.5%	45.3%	44.2%	43.0%	41.9%	46.5%	45.3%	44.2%	43.0%	41.9%
Option A - Current imputation regime plus notional tax credit for non-franked foreign source dividends															
notional credit of 10% of dividends	46.5%	46.6%	46.7%	46.9%	47.0%	46.5%	47.0%	47.5%	48.0%	48.5%	46.5%	47.3%	48.2%	49.1%	50.0%
notional credit of 20% of dividends	46.5%	46.6%	46.7%	46.9%	47.0%	46.5%	46.8%	47.2%	47.5%	47.9%	46.5%	47.0%	47.6%	48.2%	48.8%
notional credit of 30% of dividends	46.5%	46.6%	46.7%	46.9%	47.0%	46.5%	46.6%	46.8%	47.0%	47.2%	46.5%	46.7%	47.0%	47.2%	47.5%
Option C - Additional franking credit for foreign dividend withholding tax	46.5%	46.6%	46.7%	46.9%	47.0%	46.5%	46.9%	47.3%	47.8%	48.2%	46.5%	47.2%	47.9%	48.7%	49.4%
CLARIFYING THE SOURCE OF DIVIDEND INCOME:															
Option B - Streaming of dividends paid to foreign shareholders out of foreign source income	46.5%	46.6%	46.7%	46.9%	47.0%	46.5%	46.6%	46.7%	46.9%	47.0%	46.5%	46.6%	46.7%	46.9%	47.0%
SIMPLIFYING THE MEASUREMENT OF FOREIGN SOURCE INCOME:															
Extension of exemption to unlisted country	46.5%	46.6%	46.7%	46.9%	47.0%	46.0%	46.7%	47.4%	48.1%	48.8%	45.6%	46.8%	48.0%	49.2%	50.4%

5.2.2 Impact on the cost of capital

Now consider the implications of those changes in effective marginal tax rates for the cost of capital of Australian companies.

As noted in section 5.1.2, if we assume that capital markets are operating efficiently, then the rates of return prevailing on the Australian market will be set by world markets and Australian companies and shareholders will be 'price takers'.

Australian companies will have to compensate foreign investors to some extent for the Australian taxes imposed on their income and this will raise the domestic cost of capital to those companies.

As a result, reducing rates of Australian company tax will reduce the cost of capital in this case.

Now consider the case where capital markets are operating less than perfectly and some Australian companies are experiencing problems accessing foreign capital and are having to rely on Australian shareholders to provide the funds to finance their marginal investments.

As indicated in Table 5.2, in this case, a reduction in the Australian company tax rate will also reduce the cost of capital for all Australian companies, regardless of whether they are financing their marginal investments via retained earnings or new equity and regardless of their dividend payout ratios.

5.2.3 Impact on national welfare

Regardless of the identify of the marginal investor and the marginal source of funds, reductions in Australia's company tax rate tend to improve national welfare by:

- reducing the effective marginal tax rates imposed on shareholders in Australian companies;
- reducing the cost of capital; and
- reducing the disincentive for both Australian and foreign shareholders to invest in Australia.

The magnitude of that increase in national welfare will depend on:

- the extent to which the reduction in the Australian company tax rate reduces the total tax rate imposed on the income of foreign shareholders. The greatest reductions in the domestic cost of capital and improvements in national welfare will occur when the full benefit of the foreign tax reduction is passed on to foreign shareholders and is not offset by an increase in the amount of foreign tax payable; and
- how sensitive foreign investment is to changes in taxes. The greatest reductions in the domestic cost of capital will occur in those cases where foreign investment is highly sensitive to tax.

However, it is also important to note that reducing the effective marginal tax rate on the income of foreign investors also increases the effective marginal tax rate on the returns to saving. This is the reason why many countries have combined their reductions in the company tax rate with reductions in the rates of personal tax they impose on income from capital, particularly dividend income.

Given the high statutory rates of personal tax applying in Australia to most resident shareholders and Australia's relatively low rates of tax on the income of foreign shareholders, consideration needs to be given to reducing personal tax rates in order to reduce the disincentive for Australians to save and invest.

If Australia wants to reduce disincentives to save and invest, improve the quality of investment, increase its ability to attract and retain skilled labour, and enhance its prospects for increased growth and employment, the preferable approach it to implement lower and more uniform rates of personal income tax.

In order to achieve the greatest possible improvement in the efficiency of the income tax system, a reduction in personal tax rates is best achieved by **reducing the top personal rate of income tax** since:

- the deadweight costs of raising tax revenue rise more than proportionately as the rate of tax increases; and
- most saving and investment in Australia is undertaken by individuals subject to that top marginal tax rate.

If further reductions in the top personal tax rate are not possible due to either revenue concerns, or concerns about the perceived equity of the tax system, then consideration should also be given to **implementing a dual income tax regime**. This would subject income from capital to a low flat rate of tax, but would continue to tax all income from labour at current statutory marginal rates of tax.

The main advantages of such an approach are that it would reduce the disincentive to save and invest while lowering the fiscal cost of such a reduction and preserving the perceived equity of the tax system.

These advantages would be offset to some extent, however, by the potential efficiency losses from applying different rates of tax to income from capital and income from labour. This would encourage tax planning and distort individuals' decisions regarding the manner in which to organise their business activities (eg it would provide an incentive for individuals to incorporate and recharacterise their labour income as income from capital).

Alternatively, personal tax rate reductions could be restricted to dividend income by **implementing a split rate tax system**. This would apply a lower rate of personal tax to income from capital when it is distributed. The main advantage of such an approach is that it would potentially reduce the disincentive for individuals to save and invest in shares at lower revenue cost that the options outlined above. Once again, however, those advantages would be offset to some extent by the potential efficiency losses from taxing distributions of income at a rate lower than retained earnings, which could distort companies finance decisions and dividend policy.

As discussed further in section 5.3.3, these options for reducing rates of personal tax also need to be considered in conjunction with options for reforming the current dividend imputation regime.

Table 5.2: Impact of changes in dividend taxation on the cost of capital assuming the marginal investor is an Australian shareholder (%)

Initiative	Australian corporate group					Emerging Australian multinational					Mature Australian multinational				
	Source of funds					Source of funds					Source of funds				
	Retained	New share issue				Retained	New share issue				Retained	New share issue			
	earnings	25%	50%	75%	100%	earnings	25%	50%	75%	100%	earnings	25%	50%	75%	100%
REDUCTIONS IN TAX RATES:															
Reductions in the Australian company tax rate:															
36%	15.4%	15.3%	15.2%	15.1%	15.0%	15.4%	15.4%	15.3%	15.3%	15.3%	15.4%	15.4%	15.5%	15.5%	15.6%
34%	15.2%	15.2%	15.1%	15.1%	15.0%	15.2%	15.3%	15.3%	15.3%	15.3%	15.2%	15.3%	15.4%	15.4%	15.5%
30%	14.9%	15.0%	15.0%	15.0%	15.0%	14.9%	15.0%	15.1%	15.1%	15.2%	14.9%	15.1%	15.2%	15.3%	15.4%
25%	14.6%	14.7%	14.8%	14.9%	15.0%	14.6%	14.7%	14.9%	15.0%	15.2%	14.6%	14.8%	15.0%	15.1%	15.3%
20%	14.3%	14.5%	14.6%	14.8%	15.0%	14.3%	14.5%	14.7%	14.9%	15.1%	14.3%	14.5%	14.7%	15.0%	15.3%
SHIFT AWAY FROM DIVIDEND IMPUTATION:															
Current dividend imputation regime	14.9%	15.0%	15.0%	15.0%	15.0%	14.9%	15.0%	15.1%	15.1%	15.2%	14.9%	15.1%	15.2%	15.3%	15.4%
Classical tax system	14.9%	15.4%	15.8%	16.4%	17.1%	14.9%	15.4%	15.8%	16.4%	17.1%	14.9%	15.4%	15.8%	16.4%	17.1%
UK style notional tax credit for all dividends															
notional credit of 10% of dividends	14.9%	15.2%	15.4%	15.7%	16.0%	14.9%	15.2%	15.4%	15.7%	16.0%	14.9%	15.2%	15.4%	15.7%	16.0%
notional credit of 20% of dividends	14.9%	15.0%	15.1%	15.1%	15.2%	14.9%	15.0%	15.1%	15.1%	15.2%	14.9%	15.0%	15.1%	15.1%	15.2%
notional credit of 30% of dividends	14.9%	14.8%	14.7%	14.7%	14.6%	14.9%	14.8%	14.7%	14.7%	14.6%	14.9%	14.8%	14.7%	14.7%	14.6%
Option A - Current imputation regime plus notional tax credit for non-franked foreign source dividends															
notional credit of 10% of dividends	14.9%	15.0%	15.0%	15.0%	15.0%	14.9%	15.0%	15.0%	15.1%	15.2%	14.9%	15.0%	15.1%	15.2%	15.3%
notional credit of 20% of dividends	14.9%	15.0%	15.0%	15.0%	15.0%	14.9%	15.0%	15.0%	15.1%	15.1%	14.9%	15.0%	15.1%	15.1%	15.2%
notional credit of 30% of dividends	14.9%	15.0%	15.0%	15.0%	15.0%	14.9%	15.0%	15.0%	15.0%	15.0%	14.9%	15.0%	15.0%	15.0%	15.0%
Option C - Additional franking credit for foreign dividend withholding tax	14.9%	15.0%	15.0%	15.0%	15.0%	14.9%	15.0%	15.0%	15.1%	15.1%	14.9%	15.0%	15.1%	15.2%	15.2%
CLARIFYING THE SOURCE OF DIVIDEND INCOME:															
Option B - Streaming of dividends paid to foreign shareholders out of foreign source income	14.9%	15.0%	15.0%	15.0%	15.0%	14.9%	15.0%	15.0%	15.0%	15.0%	14.9%	15.0%	15.0%	15.0%	15.0%
SIMPLIFYING THE MEASUREMENT OF FOREIGN SOURCE INCOME:															
Extension of exemption to unlisted country	14.9%	15.0%	15.0%	15.0%	15.0%	14.9%	15.0%	15.0%	15.1%	15.2%	14.9%	15.0%	15.1%	15.2%	15.3%

5.3 Shift away from dividend imputation

Now consider the impact on investment decisions if Australia:

- replaced its dividend imputation regime with a classical tax system that has the same personal and company rates of tax;
- replaced its dividend imputation regime with a UK style notional tax credit regime that provides Australian shareholders with a tax credit equal to some proportion (10 to 30 per cent) of the value of the dividend paid, regardless of the amount of company tax paid on that income or whether the income comes from Australian or foreign sources;
- retained the current dividend imputation regime, but provided Australian shareholders with a UK style notional tax credit regime to foreign source income from listed countries (Option A); or
- retained the current dividend imputation regime, but provided a franking credit for the amount of foreign dividend withholding tax (FDWT) levied on that income (Option C).

5.3.1 Impact on effective marginal tax rates

Impact on Australian shareholders

Table 5.1 outlines the implications of these changes to the dividend imputation regime on the effective marginal rates of tax imposed on the income Australian shareholders derive from the Australian Corporate Group, the Emerging Australian Multinational and the Mature Australian Multinational.

In particular, it indicates that:

- a **return to a classical tax system** would:
  - not alter the effective marginal tax rates imposed on the income that Australian shareholders derive from Australian companies that finance their marginal investments via retained earnings;
  - significantly increase effective marginal tax rates for shareholders in Australian companies that finance their marginal investments via new equity, particularly those companies with high dividend payout ratios. The higher the dividend payout ratio the greater the extent of double taxation of shareholder income and the higher the effective marginal tax rate imposed on that income;
- a **UK style notional tax credit regime** would have much the same effect as returning to a classical tax system, except the notional tax credit would reduce the rate of personal tax on dividend income. In particular:
  - if the rate of notional tax credit was zero, the UK style regime would have the same effects as a classical tax regime. It would not affect the effective marginal tax rates imposed on Australian shareholders in Australian companies that finance their marginal investments via retained earnings. However, it would significantly increase the effective marginal tax rates imposed on the income from Australian companies that use new equity;
  - as the rate of notional tax credit is raised, the effective marginal tax rates imposed on the income of shareholders in Australian companies that finance their investment through new equity decrease;

  - a notional tax credit of around 30 per cent would be required to reduce effective marginal tax rates below the levels prevailing under the current dividend imputation regime;

- **Option A** in effect retains the current imputation regime and reduces the rates of personal tax imposed on Australians holding shares in companies that earn foreign source income from listed countries. As a result, it would:
  - not affect the effective marginal tax rates imposed on the income of Australian shareholders in the Australian corporate group, since that corporate group is assumed not to earn any foreign source income;
  - not affect the effective marginal tax rates imposed on Australian companies that use retained earnings as the marginal source of funds;
  - reduce the effective marginal tax rates imposed on Australian shareholders in the Emerging and Mature Australian Multinational companies, since those companies earn foreign source income from listed countries;
  - provide the greatest reduction in effective marginal tax rates to Australian shareholders in companies earning the most foreign source income from listed countries (the Mature Australian Multinational in this case) with the highest dividend payout ratios;
  - offset to some extent the current tax bias against investing offshore through Australian multinational companies, since it would provide a notional credit that would reduce the impact of any foreign company or dividend withholding taxes imposed on that income.

- **Option C** is similar in its effect to option A in that it involves retaining the dividend imputation regime and reducing the rates of personal tax on Australians holding shares in companies earning foreign source income from countries that levy withholding tax on dividends paid to Australia. As a result, it would:
  - not affect the effective marginal tax rates imposed on the income of Australian shareholders in the Australian corporate group, since that corporate group is assumed not to earn any foreign source income;
  - not affect the effective marginal tax rates imposed on Australian companies that use retained earnings as the marginal source of funds;
  - reduce the effective marginal tax rates imposed on Australian shareholders in the Emerging and Mature Australian Multinational companies, since those companies earn foreign source income that is subject to foreign dividend withholding tax;
  - provide the greatest reduction in effective marginal tax rates to Australian shareholders in companies earning the most foreign source income from listed countries (the Mature Australian Multinational in this case) with the highest dividend payout ratios;
  - offset to some extent the current tax bias against investing offshore through Australian multinational companies, since it would provide a credit for the amount of FDWT actually paid. However, it would not provide a credit for any underlying foreign company tax paid on that income.

Impact on foreign shareholders

None of the options outlined above would affect the effective marginal tax rates imposed on the income that foreign shareholders derive from Australian companies, since they are already subject to classical tax treatment and would not receive any imputation or notional tax credits under those options.

5.3.2 Impact on the cost of capital

Since these potential changes to Australia's imputation regime alter effective marginal tax rates for Australian shareholders, but not for foreign shareholders, the impact of those changes in effective marginal tax rate on the cost of capital will depend on:

- the efficiency of the capital market. In particular, if:
  - capital markets are assumed to operate perfectly, then these changes to Australia's dividend imputation regime would have no impact on the cost of capital. However, they would alter the after-tax rates of return earned by Australian shareholders;
  - imperfections in the operation of capital markets are restricting the access of Australian companies to foreign equity, then these changes in the effective marginal tax rates imposed on the income of Australian shareholders have the potential to alter the cost of capital for those companies;
- the marginal source of funds used by the company to finance investment.

Table 5.2 provides an indication of how these changes to the dividend imputation regime could affect Australian companies that are not able to access foreign capital due to imperfections in the operation of the capital markets.

In particular, Table 5.2 indicates that:

- a **return to a classical tax system** would:
  - not alter the cost of capital for Australian companies that finance their marginal investments via retained earnings;
  - significantly increase the cost of capital for Australian companies that finance their marginal investments via new equity, particularly those companies with high dividend payout ratios;
- a **UK style notional tax credit regime** would:
  - have the same effects as a classical tax regime if the notional tax credit rate was set at a low rate. It would not affect the cost of capital for Australian companies that finance their marginal investments via retained earnings. However, it would increase the cost of capital for Australian companies that use new equity;
  - as the rate of notional tax credit is raised, the cost of capital decreases for all companies that use new equity to finance their investments;
  - a notional tax credit of around 30 per cent would be required to reduce the cost of capital below the levels prevailing under the current dividend imputation regime;
- **Option A** would:
  - not affect the cost of capital of the Australian corporate group, since that corporate group is assumed not to earn any foreign source income;
  - not affect the cost of capital for Australian companies that use retained earnings as the marginal source of funds;
  - reduce the cost of capital for the Emerging and Mature Australian Multinational companies, since those companies earn foreign source income from listed countries;
  - provide the greatest reduction in the cost of capital for those companies earning the most foreign source income from listed countries (the Mature Australian Multinational in this case) with the highest dividend payout ratios;

- **Option C** is similar in its effect to option A in that would:
  - not affect the cost of capital for the Australian corporate group, since that corporate group is assumed not to earn any foreign source income;
  - not affect the cost of capital for Australian companies that use retained earnings as the marginal source of funds;
  - reduce the cost of capital for the Emerging and Mature Australian Multinational companies, since those companies earn foreign source income that is subject to foreign dividend withholding tax;
  - provide the greatest reduction in the cost of capital for Australian shareholders in companies earning the most foreign source income from listed countries (the Mature Australian Multinational in this case) with the highest dividend payout ratios.

5.3.3 Impact on national welfare

Returning to a classical tax system, while retaining rates of personal tax at their current levels, is not a feasible solution to reducing the current bias against Australian shareholders investing offshore through Australian multinational companies.

Although it would reduce the extent of that bias, in so doing, it would also reintroduce all of the distortions the imputation regime was implemented to address. These include distortions in the choice of organisational form, financing decisions and dividend policy the regime was implemented to address. In addition, it would significantly increase in the effective marginal tax rates imposed on the income that Australian shareholders, reducing their investment.

However, Australia should give more serious consideration to:

- reducing rates of personal tax on income from capital; and
- using those personal tax rate reductions as a means of simplifying the dividend imputation regime and reducing the bias against investment offshore through Australian multinational companies.

The options identified in chapter 3 of the consultation paper need to be considered alongside other options for reducing personal rates and evaluated from the point of view of their impact on both:

- the domestic cost of capital; and
- the extent to which they are likely to reduce personal tax rates and the disincentive for Australians to save and invest.

In particular, options for reform that do not result in a reduction in the cost of capital should not be dismissed on the grounds that they would only provide a 'windfall gain' for Australian companies and their shareholders. Rather, their ability to reduce the disincentive for Australians to save and invest also needs to be considered.

Given the international trend towards providing relief from double taxation at the shareholder level through reductions in personal tax rates on dividend income, consideration should be given to implementing a **UK style notional credit regime** as a means of achieving those objectives.

The Treasury consultation paper appears to have rejected this approach on the grounds that it would:

- have a significant negative impact on company tax revenues;

- provide taxpayers on low marginal rates of tax with less benefits than are currently available under the current imputation regime;
- involve significant transitional issues (eg whether to allow companies with excess franking credits time to distribute those credits to shareholders).

However, such an approach would not only be consistent with international trends, but it would also:

- reduce the disincentive for Australians to save and invest if the notional credit rate was set at a rate sufficiently high to reduce the effective marginal rates of tax on shareholder's income below their current levels;
- reduce the current disincentive for Australian shareholders to invest offshore through Australian multinational companies by providing those shareholders with a notional credit for the amount of foreign company tax imposed on their foreign source income;
- reduce the cost of capital where capital market imperfections restrict Australian companies from accessing foreign capital; and
- reduce administrative and compliance costs by simplifying the imputation regime.

If the government is reluctant to consider replacing the dividend imputation regime with a UK style notional tax credit regime, then it should consider **implementing option A** instead. In effect, this would restrict the personal tax rate reductions to dividend income from listed countries. Such a reform would:

- enable the current dividend imputation regime to be retained for those companies that have no foreign source income;
- reduce the effective marginal tax rate imposed on that foreign source income, thereby reducing the disincentive for Australian investors to invest offshore through Australian multinational companies;
- reduce the cost of capital for those Australian companies with restricted access to international capital markets; and
- involve a lower revenue cost than replacing the current dividend imputation regime with a UK style notion credit regime.

However, such a reform:

- would not reduce the overall level of personal tax imposed on income from capital. It would only reduce the effective marginal tax rate on foreign source income from listed countries. This is the main reason why it would be less costly to implement than a move to a UK style regime; and
- may be perceived as being inequitable to the extent that it provides the same amount of tax relief regardless of the amount of foreign tax paid. Although this would favour those companies that pay little foreign tax on that foreign source income, it would also reduce the compliance costs associated with having to determine the amount of underlying foreign tax paid.

If fiscal constraints also preclude the implementation of option A, then consideration should be given to **implementing option C**. Such an approach has the potential to:

- reduce the effective marginal tax rate imposed on that foreign source income, thereby reducing the disincentive for Australian investors to invest offshore through Australian multinational companies;

- reduce the cost of capital for those Australian companies with restricted access to international capital markets;
- encourage the repatriation of profits back to Australia; and
- potentially involve a lower revenue cost than option A, since no credit would be provided for the underlying company tax paid

However, such an approach would:

- not provide credits for any underlying foreign company tax paid;
- be largely redundant for many companies with investments in the US, UK and New Zealand once the new US protocol takes effect. However, it would still be of considerable assistance to those Australian multinationals with significant investments in countries that continue to apply relatively high rates of withholding tax on dividends paid to Australia.

Consideration also needs to be given to **pursuing a more strategic approach to negotiating Australia's double tax treaties**. In addition to considering whether the recently negotiated protocol to the Australia-United States tax treaty provides an appropriate basis for future treaty negotiations (option 3.5 of the Treasury consultation paper), the Government should be seeking to develop, and maintain, much more detailed information on:

- the nature and extent of Australian investments in the treaty country and treaty country investments in Australia; and
- the sensitivity of those investments to changes in the taxes governed by the treaty.

5.4 Clarification of the source of dividend income

What would be the impact on investment decisions of clarifying the source of dividend income so that the foreign source income of foreign shareholders in Australian multinational companies can flow through those companies without any adverse tax consequences for Australian or foreign shareholders?

This section analyses the implications of **implementing Option B**, which would allow Australian multinationals to stream the foreign source income derived from listed countries to foreign shareholders, without reducing either the imputation credits available to Australian shareholders or the amount of exempt foreign dividends that can be paid to foreign shareholders.

5.4.1 Impact on effective marginal tax rates

Impact on Australian shareholders

Table 5.1 outlines the implications of implementing option B on the effective marginal rates of tax imposed on the income Australian shareholders derive from the Australian Corporate Group, the Emerging Australian Multinational and the Mature Australian Multinational.

Such a reform would not alter the effective marginal tax rates imposed on the income of shareholders in the Australian corporate group, since it is assumed not to derive any foreign source income.

However, it would reduce the effective marginal tax rates imposed on the income that Australian shareholders derive from the Emerging and Mature Australian Multinational companies. This is because it would ensure that flows of conduit income through those multinational companies do not reduce the amount of imputation credits payable to Australian shareholders for Australian company tax paid on their income from Australian investments.

Indeed, in the simple model used for the purposes of the analysis in section 5, such a reform would impose the same effective marginal tax rates on shareholders in Australian multinational companies as are imposed on the Australian Corporate Group under the current dividend imputation regime.

Impact on foreign shareholders

In addition to reducing the effective marginal tax rate imposed on the income of Australian shareholders, implementation of option B also has the potential to reduce the effective marginal tax rate imposed on foreign shareholders in Australian multinational companies. This is because it would ensure that conduit income would be able to flow through Australian companies without reducing the value of exempt dividends that can be paid out of the foreign dividend account to foreign shareholders.

5.4.2 Impact on the cost of capital

Since the implementation of option B has the potential to reduce the effective marginal tax rate imposed on the income of both Australian and foreign shareholders, it has the potential to reduce the cost of capital for Australian companies regardless of the identity of the marginal shareholder.

Table 5.2 provides an indication of the extent to which option B would reduce the cost of capital for Australian companies that are constrained from accessing international capital markets.

In particular, it indicates that such a reform would:

- not affect the cost of capital for the Australian Corporate Group, since that corporate group is assumed not to derive any foreign source income;
- not affect the cost of capital for Australian companies that use retained earnings as the marginal source of funds;
- reduce the cost of capital for Australian multinational companies with flows of conduit income, since it would reduce the effective marginal tax rates imposed on the marginal Australian investor; and
- produce the greatest reductions in the cost of capital for those Australian companies that have the largest flows of conduit income (assumed to be the Mature Australian Multinational in this case) and the highest dividend payout ratios.

5.4.3 Impact on national welfare

Implementation of option B would improve national welfare by enabling conduit income to flow through Australian multinational companies without adverse tax consequences for either Australian or foreign shareholders.

In particular, it would:

- reduce the effective tax rates imposed on the dividend income of Australian shareholders in Australian multinational companies with significant foreign investments and foreign shareholders, thereby reducing the current bias against investing offshore through Australian multinational companies;
- potentially reduce the cost of capital for those companies by reducing the effective tax rate imposed on the dividend income of foreign shareholders in Australian multinational companies;
- reduce the incentive for Australian companies to shift their operations offshore;
- reduce the need for Australian companies to set up complex dual listed company structures to stream foreign source income to foreign shareholders and Australian source income to Australian shareholders; and
- reduce the disincentive for foreign multinational companies to set up their regional headquarters in Australia.

As a result, regardless of the government's decision in relation to options A and C, consideration should be given to the implementation of option B. Option B should not be regarded as an alternative to options A and C. Rather, it should be considered along with the other options for conduit reform outlined in Chapter 3 of the Treasury consultation paper.

In addition to implementing option B, it is also important for the Government to **implement the proposed trans-Tasman triangular tax reforms**. Implementation of those reforms would ensure that Australian shareholders in New Zealand multinational companies with investments in Australia could in effect receive franking credits for any Australian tax paid on that Australian source income. Similarly, it would ensure that New Zealand shareholders in Australian multinational companies with investments in New Zealand could obtain the benefits of New Zealand imputation credits.

In addition to implementing the proposed trans-Tasman triangular tax reforms, the Government also needs to **explore the scope for mutual imputation credit recognition**. That is, allowing Australian franking credits to flow to the New Zealand shareholders of Australian multinational companies, and New Zealand imputation credits to flow to the Australian shareholders of New Zealand multinational companies.

5.5 Simplification of the measurement of foreign source income

What are the implications for investment decisions of simplifying the measurement of foreign source income by extending the list of broadly exempted countries to include a currently unlisted country?

5.5.1 Impact on effective tax rates

Impact on Australian shareholders

Table 5.1 outlines the manner in which the implementation of this option would affect the effective marginal tax rates imposed on the income Australian shareholders derive from the Australian Corporate Group, the Emerging Australian Multinational and the Mature Australian Multinational.

Such a reform would not alter the effective marginal tax rates imposed on the income of shareholders in the Australian corporate group, since it is assumed not to derive any foreign source income.

However, it would reduce the effective marginal tax rates imposed on the income that Australian shareholders derive from the Emerging and Mature Australian Multinational companies.

Such a reform would reduce the amount of Australian tax payable on the income that Australian multinational companies accumulate offshore in the unlisted country. The magnitude of that reduction in effective marginal tax rates will be greater the greater the amount of attributed income that these companies have to include in their assessable income. That is, the magnitude of the reduction will be greater:

- the greater the amount of foreign source income the company derives from the unlisted country that is to be added to the list of broadly exempted countries; and
- the longer that income is retained in the unlisted country. That is, the magnitude of the reduction in effective marginal tax rates will reduce with increases in the dividend payout ratio.

Impact on foreign shareholders

Such a reform would not alter the effective marginal rates of Australian tax payable by foreign shareholders in Australian companies.

5.5.2 Impact on the cost of capital

Since such a reform has the potential to alter the effective marginal tax rates applying to Australian shareholders, but not foreign shareholders, the impact of this option on the cost of capital will depend on the identity of the marginal investor and the assumptions made about capital market efficiency.

If the marginal investor in the Australian company is a foreign shareholder, then the reform will not alter the cost of capital of the company, since the effective marginal tax rate of the foreign shareholder has not changed.

Similarly, if it assumed that capital markets operate perfectly and the marginal investor in the company is an Australian shareholder, such a reform would not alter the cost of capital.

By contrast, if the marginal investor is an Australian shareholder and the company is not able to access international capital markets, then such a reform has the potential to reduce the cost of capital.

Table 5.2 provides an indication of the extent to which such a reform would reduce the cost of capital for Australian companies that are constrained from accessing international capital markets.

In particular, it indicates that such a reform would:

- not affect the cost of capital for the Australian Corporate Group, since that corporate group is assumed not to derive any foreign source income;
- not affect the cost of capital for Australian companies that use retained earnings as the marginal source of funds;
- reduce the cost of capital for Australian multinational companies with investments in the unlisted country, since it would reduce the effective marginal tax rates imposed on the marginal Australian investor; and
- produce the greatest reductions in the cost of capital for those Australian companies that earn the largest amounts of income from the unlisted country (the Mature Australian Multinational in this case) and have the lowest dividend payout ratios.

5.5.3 Impact on national welfare

Implementation of this option has the potential to improve national welfare to some extent by reducing the domestic cost of capital for those Australian companies with significant investments in unlisted countries where imperfections in the capital market prevent those companies from accessing international capital markets.

More importantly, however, such a reform is likely to benefit Australia by significantly reducing the compliance costs incurred by those companies that have significant investments in unlisted countries.

Rather than introduce further piecemeal reforms to the current CFC and FIF regimes, however, it would be preferable to undertake a comprehensive review of those regimes. An important function of that review would be to clarify the policy objectives of those regimes and explore alternative options for reducing the compliance costs while ensuring that Australian shareholders are not able to defer tax by accumulating profits offshore in low tax jurisdictions.

Appendix 1: Tax Impact Model

Introduction

Section 4 of this report uses Ernst & Young's *Tax Impact Model* to analyse the effects of key international trends in dividend taxation on Australian companies and their shareholders.

This annex provides a brief description of that model.

Model Description

The model consists of a stylised corporate group comprising an Australian resident parent entity and three wholly owned subsidiary entities resident in, respectively, Australia, a listed jurisdiction and an unlisted jurisdiction. The model assumes that income of the unlisted subsidiary is attributable back to Australia for Australian tax purposes. Users of the model have considerable flexibility to vary financial parameters, the group's shareholding profile, its capital structure and intra-group financing arrangements, its sources of earnings and its distribution policy.

The statistics calculated by the model rely on estimates of future taxes and earnings and distributions to shareholders and between companies in the group. The model uses the following procedure to construct forecast income statements, balance sheets, and cash-flow statements for each of the four companies in the group:

- Initial total group fixed and intangible assets are specified, along with the allocation of these assets among the four group companies. The user then specifies the ratios of sales to assets, costs to sales, current assets to sales, cash to sales and current liabilities to sales, accounting depreciation rates and interest rates and other cost of capital parameters. The model assumes these variables remain constant over the forecast period.
- The user specifies how the group's assets are to be financed, by entering the ratio of group debt to market value, the ratio of debt to assets for each of the subsidiary companies, and specifying the extent to which subsidiary debt is obtained externally or from the parent company. Based on this data, the model calculates the amount of equity finance required to finance the group's initial assets, holding the ratio of debt to market value constant for each year.
- The user specifies the parent company's distribution policy. Any earnings which are not distributed are reinvested in fixed and intangible assets, holding proportionate investment in each type of asset constant.
- The model generates forecast financial statements for 14 years. To determine the market value of equity in each year, the model calculates the terminal values of cash-flows on the assumption that the long-run growth rate of cash-flows will equal the average growth rate prevailing over the 14 year forecast period (which in turn is based on the group's distribution policy).

Capturing the Effects of Tax Rules

The model has been designed to capture the effects of current and prospective tax rules on both cash-flows and on the cost of capital. To measure the impact of current tax rules on cash flows, the model incorporates all features of the tax system which will potentially have a material impact on the stylised group, including:

- current tax depreciation rates and the tax rules applying to intangible assets;
- current rules applying to tax losses;
- international tax rules, including the rules applying to attributed income, foreign tax credits and to foreign dividends; and
- the main features of rules applying to distributions, including the imputation rules, foreign dividends account rules and the dividend withholding tax.

To measure the impact of changes in tax rules on cash flows, the model calculates after-tax cash flows under a variety of tax reform options, on the assumption that non-tax-related variables remain unchanged. Tax reform options contained in the model include:

- a facility to apply different tax depreciation rates to fixed or intangible assets acquired by either of the Australian resident entities in or after a year specified by the user (eg, to assets acquired in or after 2001); and
- a range of rules applying to distributions, including a deferred company tax (with and without carry-forward of top-up tax), a resident withholding tax, provision for Foreign Dividend Account dividends to be paid just to non-resident shareholders, and a Non-Resident Investor Tax Credit.

The Model's Outputs

The model calculates several different measures of the effects of taxes:

- The 'effective tax rate' is a present value measure of all taxes forecast to be paid by the company relative to the present value of forecast earnings, adjusted for 'benefits' to shareholders. Effective Tax rates are calculated as

$$\frac{\text{Present value(Firm - level taxes) - Present value(Benefits to shareholders)}}{\text{Present value(Earnings before tax)}}$$

  The model calculates both the overall effective tax rate for the firm and effective tax rates for four different categories of shareholder (Australian residents on the top marginal tax rate, Australian super funds, non-residents able to credit dividend withholding taxes against their home country tax liabilities, and non-residents located in countries that exempt Australian dividends from tax).

- The 'net tax cost' is a present value estimate of the net cost (ie, less benefits to shareholders) of worldwide taxes which will be paid by the group if its forecast earnings eventuate. A $1 reduction (increases) in the net tax cost translates directly into a $1 increase (decrease) in the present value of shareholder wealth.

- The model calculates the effects of tax changes on the cost of equity capital and the weighted average cost of capital, and uses these estimates to show how the total value of equity in the firm might respond either to changes in the group's tax strategy or to changes in tax rules.

The approach taken to estimating the effects of taxes on equity values and on the weighted average cost of capital is based on Monkhouse (1996), who examines the impact of Australia's dividend imputation system on the cost of capital.[9] Under this approach, equity values are determined by adding benefits to shareholders back into after-tax, before interest, cash flows, and, in calculating the WACC, reducing the before-tax cost of debt finance by the effective tax rate. In addition, the effective tax rate on non-resident shareholders is accounted for in estimating the cost of equity capital.

Appendix 2: Effective Marginal Tax Rates and the Cost of Capital

Introduction

Section 5 of this report examined the impact of key international trends in dividend taxation on real investment decisions. That analysis used a different concept of effective tax rate than that used for the purposes of section 4 – the **effective marginal tax rate on investment**. In addition, it also estimated the cost of capital using a methodology consistent with that concept of effective marginal tax rates.

This annex outlines the approach used to calculate those effective marginal tax rates on investment and the cost of capital for the purposes of the analysis in section 5.

Calculation of Effective Marginal Tax Rates on Investment

Effective marginal tax rates and effective marginal tax rates on investment

In order to illustrate the concepts of an **effective marginal tax rate** and **an effective marginal tax rate on investment**, it is useful to consider the impact that the imposition of an income tax has on a small, open, capital importing nation as depicted in Figure A2.1.

Assume initially that the country imposes no income taxes on the incomes that either residents or non-resident investors derive from their investments. In this case, non-residents are willing to supply capital at the world interest rate of w. Since we have assumed the country is open to foreign investment, the prevailing domestic interest rate will also be w and at that rate, domestic savers will be willing to supply S of funds, but domestic investors will demand investments funds of I. The shortfall of funds to finance that domestic investment will be made up by I-S of capital imports[10].

Now consider the impact of taxing the income of:

- resident investors at a rate of t_D; and
- non-resident investors at a rate of t_F.

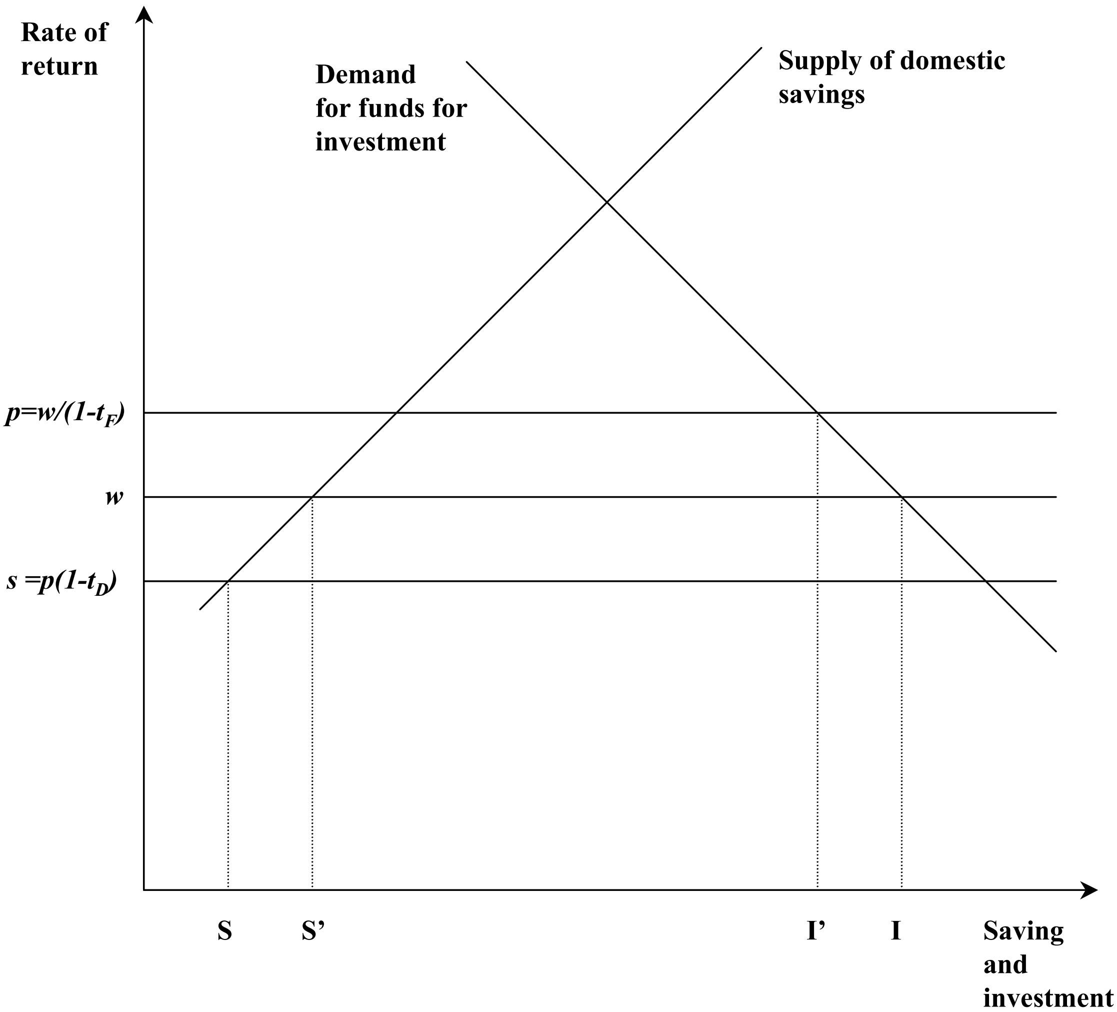
Since non-residents will not provide funds to the country unless they are paid the same after-tax rate of return available from investing elsewhere, they will require a higher before-tax rate of return of $p=w/(1-t_F)$ before they are willing to provide funds to the country. That is, they will 'gross up' the return they require by an amount that is sufficient to offset the amount of tax they have to pay on that income.

10 Note that for the purposes of illustrating the concept of the effective marginal tax rate we are assuming that there is an infinite supply of foreign capital. For the purposes of section 5 of the report, however, it is assumed that some Australian companies have difficulty accessing foreign capital due to the existence of capital market imperfections.

This means that resident investors will only be able to obtain funds if they are prepared to pay the higher pre-tax rate of return p. As a result, the level of domestic investment will fall from I to I'.

Similarly, since resident savers will receive a post-tax rate of return of $s=p(1-t_D)$, the domestic level of savings will fall from S to S'.

Figure A2.1: Effect of taxes on the demand for and supply of investment funds



In summary, the imposition of a tax on the incomes of resident and non-resident investors will drive a tax wedge between the pre-tax rate of return on investment (p) and the post-tax rate of return on savings (s).

The **effective marginal tax rate** (EMTR) estimates the size of that tax wedge. Specifically, it estimates the percentage difference between the minimum pre-tax rate of return to an investor and the post-tax rate of return to a domestic saver who finances that investment.

$$\text{EMTR} = (p - s)/p$$

This effective marginal tax rate is made up of two components:

- the **effective marginal tax rate on investment**; and
- the **effective marginal tax rate on savings.**

In order to analyse the implications of the key trends in dividend taxation for real investment decisions and Australian tax policy, section 5 of this report estimates the impact of those tax changes on the effective marginal tax rates imposed on investment.

The **effective marginal tax rate on investment** measures the percentage difference between the minimum required rate of return to an investment in the presence of taxes and the minimum required rate of return for the investment to proceed in the absence of taxes:

EMTR on investment = $(p-w)/p$

By contrast, the **effective marginal tax rate on savings** measures the percentage difference between the rate of return to savings in the absence of taxes and the rate of return to savings in the presence of taxes:

EMTR on savings = $(w-s)/w$

Calculation of effective marginal tax rates on investment

The effective marginal tax rates on investment presented in Table 5.1 of this report were calculated under the assumption that the marginal investor is an Australian shareholder. As a result, those effective marginal tax rates on investment are potentially affected by any changes in the Australian tax system that alter the tax rates imposed on the income those individuals derive in the form of interest, dividends and capital gains.

The approach used to calculate those effective marginal tax rates on investment (EMTRs) follows that used by Lindhe (2002). In brief, this calculates the effective marginal tax rate on investment as:

$$\text{EMTR} = \delta + \frac{r}{(1-\tau^*_{method})}$$

where:

δ = the economic rate of depreciation, which is assumed to equal the rate permitted for tax purposes (ie it is assumed there are no accelerated depreciation allowances)

r = $\dfrac{(1-\tau_{pi})}{(1-\tau_{pc})} i$

i = the real market rate of interest on bonds (assumed to be 2.5%)

τ_{pi} = the personal rate of tax applying to interest income (assumed to be 47%)

τ_{pc} = the personal tax rate on capital gains (assumed to be 24%)

τ^*_{method} = the adjusted tax rates set out in Table A2.1 below.

Table A2.1: Adjusted tax rates

Method	Adjusted tax rate	Comment
Classical tax system	$\tau + (1-\tau)(1-\theta^{gm})f$	$\theta^{gm} = \dfrac{(1-\tau_{pd})}{(1-\tau_{pc})}$
Dividend imputation	$\tau + (1-\tau)(1-\theta^{is})f$	$\theta^{is} = \dfrac{(1-\tau_{pi})}{(1-\tau_{pc})(1-\phi)}$

Source: Lindhe (2002), Table 1, p20.

Where:

τ = the company tax rate (assumed to be 30% under current imputation regime)

τ_{pd} = the personal rate of tax on dividend income (assumed to be 47%)

f = the dividend payout ratio

The impact on effective marginal tax rates on investment of:

- reducing the rate of Australian company tax is estimated using the formula for an imputation regime and reducing the company tax rate;
- returning to a classical tax system is estimated using the formula for the classical tax system and keeping the company tax rate and personal tax rates at their current levels;
- replacing the Australian dividend imputation regime with a UK style notional tax credit is estimated using the classical tax regime formula and reducing the rate of personal tax on dividend income by the notional tax credit;
- implementing option A is estimated using the formula for the imputation regime and providing additional notional tax credits for the proportion of income from listed countries;
- implementing option C is estimated using the formula for imputation and providing additional franking credits for the proportion of income subject to assumed rate of foreign dividend withholding tax of 15 per cent;
- implementing option B is estimated using the imputation formula and providing Australia shareholders in the Emerging and Mature Australian multinational companies with full imputation credits for company tax rather than the reduced imputation credits that are assumed to arise as a result of flows of conduit income through those companies; and
- simplifying the measurement of foreign source income by adding the unlisted country to the list of broadly exempted countries is estimated by using the imputation formula and reducing the rate of company tax by an amount equal to the proportion of income from the unlisted country adjusted by an assumed deferral advantage of 20 per cent.

Calculation of the Cost of Capital

It is important to note the fundamental relationship between the required real pre-tax rate of return on capital p and the cost of capital. In effect, p is the rate of return that results in an investment having a net present value of zero when all cash flows associated with the investment are discounted at the opportunity cost of capital.

As a result, when estimating the cost of capital, we have used formulae that are consistent with the formulae used to estimate the effective marginal tax rates on investment. Those cost of capital formulae are set out in Table A2.2. Those formulae estimate the net corporate cost of capital. The gross cost of capital, which is set out in Table 5.2, is calculated by adding the economic rate of depreciation (assumed to be 10 per cent) to those net cost of capital figures. Once again, for a comprehensive discussion of the derivation of those formulae refer to Lindhe (2002).

The impact on the cost of capital of returning to a classical tax system is estimated using the general model formula. By contrast, the dividend imputation formula is used to estimate the impact on the cost of capital of all of the other options outlined above.

Table A2.2: Net cost of capital expressed in terms of tax rates

Initiative	Retained earnings	New share issue
General model	$\dfrac{(1-\tau_{pi})i}{(1-\tau)(1-\tau_{pc})}$	$\dfrac{(1-\tau_{pi})i}{(1-\tau)[((1-f)(1-\tau_{pc})+f(1-\tau_{pd})]}$
Dividend imputation(ϕ)	$\dfrac{(1-\tau_{pi})i}{(1-\tau)(1-\tau_{pc})}$	$\dfrac{(1-\tau_{pi})i}{(1-\tau)[(1-f)(1-\tau_{pc})+f\dfrac{(1-\tau_{i})}{(1-\phi)}]}$

Source: Lindhe (2002), Appendix 2, Table C.2.

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