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AFTS Secretariat
The Treasury
Langton Crescent
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Australia

17 October 2008

Dear Sir

Mutual recognition of franking credits

This submission is made on behalf of PricewaterhouseCoopers Australia and New Zealand, and the following companies:

- ANZ Banking Group
- APN News & Media Limited
- AXA New Zealand
- Commonwealth Bank of Australia
- Fairfax Media Limited
- Fletcher Building Limited
- Fonterra Cooperative Group Limited
- Lion Nathan
- Macquarie Group Holdings New Zealand Limited
- National Australia Bank
- SKYCITY Entertainment Group
- Woolworths

The submission deals only with the question of mutual recognition of franking credits between Australia and New Zealand. PricewaterhouseCoopers, and some of the other parties to the submission, will be making separate submissions to the AFTS on other matters.

SUBMISSION SUMMARY

- Consistent with the experience following the adoption of the Australia New Zealand Closer Economic Relations Trade Agreement ("CER") in 1983, mutual recognition should provide significant economic benefits to Australia and New Zealand.

- The current double taxation of trans-Tasman profits is inconsistent with the concept of a single economic market ("SEM"). Both governments have expressed strong support for a SEM.

- Current policy settings impede the free flow of investment between Australia and New Zealand.

  – Foreign direct investment ("FDI") faces a significantly higher tax rate on a trans-Tasman basis relative to domestic investment. As a consequence investment decisions have an inbuilt inefficiency.

  – Portfolio investment by individual investors, particularly those seeking a higher dividend yield, is discouraged due to the absence of franking credits on trans-Tasman investment.

  – Portfolio investment by Australian and New Zealand institutions is restricted as a result of the tax inefficiency arising from the absence of franking credits.

- Tax distorts the form trans-Tasman investment takes, causing debt to be preferred over equity with consequential inefficiencies.

- Under mutual recognition:

  – The cost of raising new equity capital would be reduced.

  – The pool of investors from which to source capital would be expanded.

  – The allocation of investment between the two countries would be more efficient.

  – Trans-Tasman businesses would be better placed to exploit economies of scope and scale.

  – The capital markets of Australia and New Zealand would become more integrated and competitive. The bias toward debt financing of trans-Tasman investment would be reduced.

  – Decisions on issues such as the location of a company's head office would better reflect commercial factors rather than tax bias.

- Mutual recognition will come at a fiscal cost to both Australia and New Zealand. It is acknowledged that this cost will need to be estimated and justified on the basis of the broader benefits arising. However, on the experience of the signatories to this submission it is considered that the benefits would materially outweigh the costs.

- It is important that mutual recognition not be seen as a substitute for broader reforms that Australia may make on the taxation of offshore investment. The case for mutual recognition is based on the special economic and political relationship between the two countries. There is no reason however for this initiative to impede or undermine progress being made on a broader front. Equally mutual recognition could be implemented irrespective of broader reforms in Australia.
- A number of senior politicians[1] and officials have expressed concern over the absence of an investment protocol to CER. It is difficult to see how an investment protocol of substance could proceed without the introduction of mutual recognition.
- Tax is currently one of the few remaining significant issues that impede the free flow of investment between the two countries. The AFTS provides an ideal opportunity to address it at a time when there is strong political will on both sides of the Tasman to make tangible progress on the formation of a SEM.
- The Australian Treasurer, Hon Wayne Swan, and the New Zealand Minister of Finance, Hon Dr Michael Cullen, have stated that their respective governments are open to the idea of moving towards mutual recognition of imputation and franking credits.[2]

STRUCTURE OF THE SUBMISSION

The submission is structured under the following headings:

- Explaining mutual recognition
- Economic implications
- Fiscal cost
- Commercial implications
- Design features
- Conclusion

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1 For example, Hon. Simon Crean at the June 2008 meeting of the Australia New Zealand Leadership Forum.
2 Media statement issued by Hon Dr Michael Cullen, Minister of Finance and Hon Peter Dunne, Minister of Revenue, 17 July 2008.

EXPLAINING MUTUAL RECOGNITION

Background

Both Australia and New Zealand introduced dividend imputation systems in the late 1980s in place of the former classical systems. The underlying reason for the introduction of a dividend imputation system was to address the double taxation of income derived from equity investments. Under the classical system corporate income was subject to double tax, firstly in the hands of the company and then as dividends in the hands of the shareholders. The double taxation led to investment distortions such as the preference for debt funding over equity funding.

Under the current imputation systems in place in Australia and New Zealand, resident shareholders are subject to tax on the gross dividend income (including franking credits) that is distributed to them. A credit is provided for tax paid at the company level, and this offsets any personal tax due.[3] In the case of Australia the credit is known as a franking credit, and in New Zealand it is called an imputation credit. In this submission, both are referred to as franking credits.

Imputation systems are based on the residence principle. Australian franking credits cannot be used to offset home country tax payable on dividends paid to non-resident shareholders in Australian companies, including those resident in New Zealand. Similarly, New Zealand franking credits cannot be used to offset Australian tax payable by Australian resident shareholders on the dividends paid by New Zealand companies. As a consequence, trans-Tasman investment is subject to a higher effective rate of tax than domestic investment. This constitutes a tariff on imported capital.

This significant raising of the effective rate of tax on trans-Tasman profits creates a bias in favour of domestic investment. Companies try to align the country in which they pay tax with the location of their current and future shareholders. The tax bias thereby influences the location and structure of businesses. Companies are also enticed to use debt to fund trans-Tasman investment. It impedes companies from raising equity to fund trans-Tasman investment by increasing their cost of capital, discouraging investment and materially altering the form of some trans-Tasman investment.

The current position also impacts on the value of trans-Tasman corporates. While, due to the dividend exemption rules, the cash value of franking credits is only realised on distribution to the ultimate shareholders, there is still value in the receipt of franking credits for companies as worth is attributed to franking credits when those companies are valued (typically at 70 cents to the dollar). At present there is therefore a disadvantage for trans-Tasman corporates as when they are valued no value is attributed to franking credits arising in the other jurisdiction. Mutual recognition of franking credits would resolve this issue.

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[3] Australia also allows the refund of franking credits to certain taxpayers.

Trans-Tasman Imputation Regime

Partial relief to the problem outlined above was provided in 2003 with the introduction of the Trans-Tasman Imputation Regime (the "triangular" regime), which focuses on corporates with operations and shareholders in both Australia and New Zealand. However, the collective experience of corporates is that the regime is too narrow and that consequently it has made no material inroads into addressing the double tax problem.

Overview of mutual recognition

Under mutual recognition, Australia and New Zealand would each provide a franking credit for company tax paid in the other country. For example, an Australian shareholder in a New Zealand company would receive a credit for franking credits attached to dividends received from New Zealand in the same way as if those dividends had been received from an Australian domestic company. The same would apply in reverse to a New Zealand investor investing into Australia.

The investor's country of residence would effectively bear the cost of reciprocal recognition of franking credits. This is because under mutual recognition, tax currently collected by the country of residence would be reduced to the extent that underlying company tax has been paid in the country of source.

While in some forums it has been suggested that there could be some form of compensation paid by the source country to mitigate the cost being borne by the resident country, this submission does not contemplate that occurring. It is considered that the upfront fiscal cost for each country will be mitigated by the broader economic benefits to both countries flowing from the resulting increase in trans-Tasman investment. Further, the payment of pro rata compensation between the two Governments would be inconsistent with the broader concept of integrating the two economies into a SEM. We note that when CER was introduced in 1983, there was no pro rata revenue sharing to account for differentials in tariffs forgone, and, in retrospect, the success of that agreement suggests that such a "square up" would have been unnecessary and inappropriate.

There are a significant number of design issues that will need to be worked through before determining the optimal model for mutual recognition. These are considered in a later section in the submission.

ECONOMIC RATIONALE FOR MUTUAL RECOGNITION

The Trans-Tasman Relationship

The Australian and New Zealand economies have become increasingly integrated following the adoption of CER in 1983.[4] Free trade in goods produced in the two countries was achieved by 1990, five years ahead of the initial schedule. Free trade in almost all services was attained in January 1989. Since then the list of exclusions has been reduced to a few items.

CER has led to significant increases in the volume of trade between the two countries, strengthening the importance of the relationship to both countries. Australia is the largest recipient of New Zealand exports, taking 20% in the year to June 2007[5] and New Zealand is Australia's 6th largest export market.

The freedom of movement of residents between the countries is a key element in the trans-Tasman relationship. There is a long history of arrangements, collectively known as the Trans-Tasman Travel Arrangement, which allow Australians and New Zealanders to visit, reside and work in each other's country without restriction. A person registered to practise an occupation in one jurisdiction is entitled to do so in the other. These arrangements mean that Australia and New Zealand share a common labour market.

CER is underpinned by a strong bilateral relationship. This is based on shared values, interests and strong historical, cultural, geographical and political ties. Both countries have moved progressively towards much deeper cooperation on policies, laws and regulatory regimes through processes involving coordination, mutual recognition and harmonisation. Australia and New Zealand now share a common goal of a seamless business environment, or a SEM.[6] The concept of a SEM envisages a free flow of capital, people, goods and services between the two countries.

There is currently no formal agreement between Australia and New Zealand on investment. This is an unusual omission from an otherwise comprehensive and outward-looking set of arrangements. Both countries are however committed to concluding an investment protocol.[7]

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4 Background information on the trans-Tasman relationship draws on Ministry of Foreign Affairs and Trade (2005), *The Australia - New Zealand Closer Economic Relationship,* www.mfat.govt.nz/Foreign-Relations/Australia/1-CER/index.php.

5 The New Zealand Institute *The State of the Trans-Tasman economic relationship* (Background material prepared for the Australia-New Zealand Leadership Forum, Wellington, June 2008).

6 Goff, Phil and Truss, Warren (2007), "Joint statement for the 2007 CER Ministerial Forum, by the Hon Phil Goff MP, NZ Minister for Trade and for Trade Negotiations, and the Hon Warren Truss MP, Australian Minister for Trade", http://www.beehive.govt.nz.

7 Goff and Truss (2007), *op cit*.

Investment flows between the trans-Tasman partners are significant. New Zealand is the third largest destination for Australian investment abroad while Australia is New Zealand's principal investment partner.[8] Australian total investment in New Zealand was NZ$79 billion as at 31 March 2007 and New Zealand total investment in Australia was NZ$30 billion.[9]

Freer investment would lead to a more efficient allocation of investment between the two countries, just as openness between the states and territories of Australia is more efficient than previous policy that led to the balkanisation of Australian domestic investment.

Current regulatory rules also discourage trans-Tasman investment. An Australian firm wishing to invest in New Zealand may, for instance, require the sanction of New Zealand's Overseas Investment Commission. Similarly, a New Zealand firm wishing to invest in Australia may require the approval of the Australian Foreign Investment Review Board. Residents investing in their own country do not require such approvals.

While a persuasive argument can be made to reduce regulatory impediments to trans-Tasman investment, the matter is beyond the AFTS's terms of reference and is not discussed further. Progress in this area however is feasible, would be beneficial for both countries and would be a commendable step toward the realisation of the goal of a SEM.

Economic impact of mutual recognition

The mutual recognition of franking credits would provide a comprehensive answer to the tax-induced distortion of trans-Tasman investment (explained earlier in this submission). At a high level, each country would extend its imputation regime by providing a franking credit for company tax paid in the other country.

Mutual recognition of franking credits would give rise to the following economic benefits for both Australia and New Zealand:

- The cost of raising new equity capital to fund trans-Tasman investment would be reduced. In our experience, the cost of double taxation on trans-Tasman investment routinely impedes investment decisions that might otherwise proceed. A reduction in this cost would lead to higher investment than otherwise, and would tend to boost output and incomes in both countries.

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8 Goff and Truss (2007), *op cit*.

9 Statistics New Zealand *Balance of Payments and International Investment Position: Year Ended 31 March 2007*. "Total investment" is made up of direct investment, portfolio investment, other investment (including trade credits, loans, currency and deposits), financial derivatives and reserve assets.

- The allocation of trans-Tasman investment between the two countries would be more efficient.

- Trans-Tasman businesses would be better placed to exploit economies of scope and scale by producing for both markets where it is economic to do so. This would in turn boost output and incomes.

- The bias toward debt financing of trans-Tasman investment would be reduced.

- The capital markets of Australia and New Zealand would become more integrated. This would reduce costs incurred in raising capital.

- A larger, more integrated, investment market would tend to boost competition amongst Australasian businesses. Australia and New Zealand have relatively small domestic markets. Competition fosters continuous improvements in economic efficiency. It encourages firms to lower their costs by adopting better methods of production and economising on inputs. It also encourages innovation as businesses strive to respond to the preferences of customers.

- Business decisions on issues such as the location of head offices would better reflect commercial factors rather than a tax bias. While other tax issues would still have some impact on these types of decisions, an important tax distortion would be taken off the table.

- Trans-Tasman portfolio investment would increase. The disincentive to direct investment on a trans-Tasman basis is currently magnified for some classes of portfolio investors. The income of Australian superannuation funds, for example, is generally subject to a 15% domestic rate of tax.[10] The funds may also obtain a refund for excess franking credits.[11] Mutual recognition of franking credits would open up new investment opportunities in New Zealand for Australian superannuation funds. Similarly, New Zealand investment funds are likely to increase their investment in Australian entities. The overall result would be an increase in trans-Tasman portfolio investment by institutional investors.

In addition to these economic benefits, freer trans-Tasman investment would be a significant step toward a SEM and would assist in furthering the close economic and political relations that underlie the trans-Tasman relationship.

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[10] Income earned on fund accounts that are in the pension phase is tax free, provided that a pension is paid at the minimum rate (around 5%) of the 1 July balance in the pension account. Contributions from untaxed income are also taxed at the rate of 15%. Superannuation funds also collect this tax.

[11] Australia allows certain taxpayers, including individuals and superannuation funds, a refund for excess franking credits. In contrast, New Zealand only allows excess credits to be carried forward.

The benefits of closer integration of both economies in the area of trade have been larger than expected when CER was signed. CER helped to make it possible for both countries to lower their barriers to trade with the rest of the world. Thus an initial concern that the costs of trade diversion would unduly detract from the benefits of trade creation proved to be unfounded. Similarly, lower tax impediments to trans-Tasman investment would be likely to be followed, over time, by a reduction in barriers to direct investment from third countries, consistent with broader trends in trade and investment.

Economic impact - conclusions

The key conclusions from an economic perspective in respect of mutual recognition are:

- The furtherance of the trans-Tasman relationship is of special importance to Australia and New Zealand. The relationship confers major benefits on both countries.
- The current double taxation of trans-Tasman investment impedes the free flow of investment between the two countries. The free flow of investment would improve the efficiency of investment and boost output and income in affected countries.
- The mutual recognition of franking credits would address this problem. It would help to free up trans-Tasman investment and would be a step toward the achievement of the goal of Australia and New Zealand to form a SEM.

FISCAL COST

The immediate fiscal cost arising from mutual recognition would be tax forgone on imputed dividends received in Australia from New Zealand and vice versa. We understand that a preliminary estimate by New Zealand officials indicates that the fiscal cost of the proposal to New Zealand could be in the order of NZ$300 million, with the cost to Australia being three to four times higher.

This however is not the complete picture as the second and third order effects of mutual recognition should be substantial. By this we mean that while there may be an initial fiscal cost, this should be offset by the economic benefits for each country in allowing investments that would not otherwise have occurred to proceed, and by removing the existing tax distortion from investments that have already been made.

Further, it is reasonable to assume that as a result of mutual recognition, revenue forgone by Australia and New Zealand could be replaced at a lower efficiency cost than the current regimes which significantly distort trade and investment. We understand that this has been the case in respect of the abolition of tariffs as part of the CER Agreement.

We acknowledge that both Australia and New Zealand will wish to undertake further work on the fiscal cost of mutual recognition before supporting the reform. We consider that it is critical in undertaking this work to ensure that the second and third order effects are taken into account in estimating fiscal cost. Fully modelling the fiscal consequences of mutual recognition will require estimates of elasticity of investment and key assumptions as to the behavioural response to the reform initiative.

COMMERCIAL ISSUES

Effect of current policy settings

We recognise that concern is sometimes expressed that proponents of reforms such as mutual recognition base their arguments on theory and lack empirical support and specificity around fiscal costs. To address that concern the submission outlines the practical consequences of the current policy settings and explains why they are resulting in significant distortions and inefficiencies.

The following three examples demonstrate the way in which tax currently influences decisions on issues such as whether to invest trans-Tasman, the structure of trans-Tasman investment and the location of corporate residence. The introduction of mutual recognition of franking credits will go a significant way towards neutralising the influence of tax considerations when making these types of decisions.

Example 1 – Foreign direct investment (FDI) from Australia into New Zealand and vice versa

FDI from Australia into New Zealand has increased significantly in recent years from NZ$17.8 billion in 2002 to NZ$47 billion in 2007 while FDI by New Zealand into Australia has remained fairly steady over recent years (an increase from NZ$8 billion in 2002 to NZ$11 billion in 2007)[12]. While these figures are significant, in our experience the double taxation on trans-Tasman profits routinely impedes additional investment that would otherwise occur.

Under the current regimes, the aggregate tax rate on trans-Tasman investment is extremely high. Appendix 1 contains a table of the comparative tax costs of domestic and trans-Tasman investment. In summary:

- Dividends paid to Australian shareholders on the 46.5 percent tax rate from profits sourced from New Zealand incur an aggregate tax cost of 55.94 percent.

- Australian profits paid by Australian companies to New Zealand shareholders on the 39% rate results in an aggregate tax cost of 57.3 percent.

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[12] Statistics New Zealand *Balance of Payments and International Investment Position: Year Ended 31 March 2007*.

The practical effect of these significantly higher tax imposts is to cause trans-Tasman investment to be subject to a much higher hurdle rate than domestic investment.

By way of example, take a hypothetical company that has been established to deliver a post tax dividend yield to its Australian shareholders of 10%. If that company is domiciled in Australia and is evaluating direct business investment opportunities in both Australia and New Zealand then the pre-tax rates of return that it requires are quite different. Assuming the same business could be carried out in either Australia or New Zealand then, if that business was located in Australia it would require a 18.7% pre-tax return on equity. If that business was to be located in New Zealand, the pre-tax rate of return required would increase to 22.7%. Similarly, a New Zealand company that wishes to deliver a post tax dividend yield to its New Zealand shareholders of 10%, would require a 16.5% pre-tax return on equity if the business was located in New Zealand, and a 23.4% pre-tax rate of return if the business is located in Australia.

The double tax impact does not produce a marginal difference to the hurdle rate, it produces a very significant difference. It requires a 42% higher pre-tax return from Australia before the investment can be compared to New Zealand. In the event that there are non-tax factors that make locating the business in New Zealand unlikely, then the investment may simply not proceed. This is in neither country's best interest.

PricewaterhouseCoopers is aware of a significant number of investment opportunities, both from large, medium and smaller businesses that have not proceeded as a consequence of this tax hurdle.

In contrast, under mutual recognition the aggregate tax rate for trans-Tasman investors would in general fall to the investor's marginal tax rate thus removing the current discrepancy.

Example 2 - Portfolio investment

Trans-Tasman portfolio investment has also increased over the past 10 years although not as significantly as FDI. New Zealand portfolio investment in Australia has increased from NZ$3.6 billion in 2002 to NZ$9.6 billion in 2007 and Australian portfolio investment in New Zealand has increased from NZ$3.6 billion to NZ$8.5 billion.[13] Arguably one reason for the slower growth in portfolio investment is that, unlike the situation with FDI (discussed in example 3 below), it is difficult for portfolio investors to structure around the double tax issue.

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13 Ibid.

Decisions on the location of portfolio investment are based on many factors, which are often particular to the individual investor. Non-tax factors that may influence investment decisions include risk appetite, existing exposures and opportunities for diversification. This explains why there is already trans-Tasman investment despite the double tax issue.

However, it is also clear that tax does currently impact on investment decisions particularly for those seeking a high dividend yield, resulting in investment decisions that are not necessarily the most efficient as they are based on the post rather than the pre tax return.

In the current global financial market high dividend yield is likely to play a larger role in investment decisions as investors seek the security of a regular return, which could therefore have an adverse impact on trans-Tasman portfolio investment.

Take a New Zealand resident individual on the 39% top marginal tax rate seeking a portfolio of dividend yield stocks to fund retirement. That individual may target a long run 7% pre-tax dividend yield. If she buys a New Zealand share, then she only requires the 7% yield (inclusive of imputation credits). However, if she buys an Australian share, she will require a 10% yield (inclusive of franking credits). As a result New Zealand portfolio investors will under invest in Australia (and vice versa). Again, that does not appear to be in the long run best interest of either country.

This issue is exacerbated for some institutional investors such as Australian superannuation funds, which, as discussed, are taxed in Australia at a concessionary rate, heightening the tax distortion on any trans-Tasman investment.

Mutual recognition will have a significant, positive impact on this type of investment opening up additional opportunities for investors, allowing appropriate risk weight and portfolio diversification decisions, and reducing the cost overlay created by complex investment structuring in the financial sector designed to address the double tax distortion.

Example 3 - Impact of tax on structure of trans-Tasman investment

The double taxation problem identified also impacts on the structure of trans-Tasman investment. It creates incentives to drive structures that are complex and not commercially driven.

For example, it creates an incentive for Australians investing into New Zealand and vice versa to invest by way of debt rather than equity. Subject to tax and regulatory limits on the level of debt funding, it enables investors to reallocate taxable profits to their home country (net of any interest withholding tax paid in the source country), where usable franking credits can be generated. Debt funding also minimises tax issues at the time of repatriation as it can generally be repaid without tax impost. This results in balance sheet structures which do not reflect the commercially optimum position, and which are driven significantly by tax considerations.

It also creates a bias towards 100% takeovers rather than strategic or controlling stakes as a 100% acquisition gives the purchaser the ability to leverage debt against the underlying taxable earnings. This has unwelcome impacts on the size and liquidity of capital markets by creating an incentive for outright takeover and delisting rather than the holding of strategic stakes. This also results in investment being more concentrated and less companies benefiting from trans-Tasman strategic minority investment.

In addition to the use of debt funding, trans-Tasman investors have an incentive to shift as many functions as possible to their home jurisdiction, with an arm's length fee charged for those services, thus limiting the tax paid in the other country and maximising the generation of usable franking credits for shareholders.

These factors together also pose threats to Australia and New Zealand's corporate tax bases. As a result, the double tax drives tax policy development into increasingly more complex measures to try and prevent erosion of the corporate tax bases of each country. The complexity and cycle of change creates uncertainty and increases the deadweight costs of each country's tax system on its economy.

Lastly, the current inability to use franking credits generated in the other country is a factor that influences decisions on issues such as location of the head office of a trans-Tasman business as it creates an incentive to locate the head office in the country where the most shareholders reside. Again the drive for relocation is a tax one and does not necessarily align with other commercial drivers that would otherwise dictate the location of the company.

It is submitted that in the context of the SEM objective, it is inappropriate that tax should have such a dominant impact on the scope and structure of investments. Mutual recognition will resolve this issue.

DESIGN ISSUES

If New Zealand and Australia were to implement mutual recognition of franking credits it would make sense to do so via the two countries' existing imputation regimes. Both systems are broadly similar with the payment of corporate tax giving rise to franking credits which are recorded in a company's franking credit account. Those credits can then be attached to shareholder distributions and used to offset tax arising at the shareholder level.

We consider that there are at least two ways in which mutual recognition could be implemented:

- The adoption by both countries of identical franking credit regimes with an interface between the two regimes allowing residents of each country to utilise franking credits received, regardless of which country they originate from.

- The retention of separate franking credit regimes by Australia and New Zealand with a provision in each regime deeming franking credits from the other country to be franking credits for the purpose of that country's franking credit rules.

We consider that the second option above is preferable as it would be simpler to develop and implement and would not require a complete redesign of the existing regimes into one. However, while the two regimes are similar they have some variances the impact of which would need to be considered in the design of any mutual recognition framework. Key differences in the two imputation regimes include:

- ***Continuity rules.*** Australia currently has only limited continuity rules for franking credits, while New Zealand has a comprehensive rule. These rules would potentially need to be aligned to ensure New Zealand companies could not step around the existing rules by generating franking credits in Australia rather than New Zealand.

- ***Streaming rules.*** Both Australia and New Zealand have comprehensive anti-streaming rules which would ideally be aligned to prevent tax planning opportunities to circumvent the rules. We note that the New Zealand Government has recently issued a discussion document *Streaming and refundability of imputation credits* which calls for comment on its existing streaming rules and how they could be enhanced. This document includes discussion of the Australian rules.

- ***Refunds of franking credits***. The Australian regime provides for the refunding of franking credits for certain taxpayers, including Australian residents individuals, superannuation funds and certain tax-exempt organisations. In contrast the New Zealand regime currently allows no refunds. As noted above, this issue is currently being considered in New Zealand, particularly in the context of charities and other tax exempt organisations. We consider that ideally the rules will be aligned so that neither country is disadvantaged in providing refunds for franking credits generated in the other country.

In addition to these differences in the imputation rules, there are a myriad of other issues that would need to be considered to ensure the success of any mutual recognition regime including:

- ***Corporate tax rate.*** From 1 April 2008 the New Zealand and Australian corporate tax rates have come into alignment at 30%. Alignment of the corporate tax rates simplifies the implementation and operation of any mutual recognition regime. However, issues could arise if the rates were to vary in the future. For example, should the Australian corporate tax rate fall to 25% Australia would need to consider whether it would continue to allow recognition of the full 30% franking credit for New Zealand tax paid. We consider that mutual recognition would likely result in New Zealand adopting a partnership approach to its tax reforms in the future. Rather than operating in competition with Australia, post mutual recognition there will be a propensity to design consistent policy reforms to achieve optimal outcomes.

- ***Corporate tax base.*** While New Zealand and Australia have broadly similar tax regimes, there are some key areas of difference the impact of which will need to be considered. One example is the existence of Australian capital gains tax. Two issues come to mind here. Firstly will mutual recognition create an opportunity for Australians to generate tax free capital gains through New Zealand companies? The answer is likely to be no given the comprehensive look through provisions in Australia's controlled foreign company and foreign investment fund rules. Secondly, in the absence of a capital gains tax in New Zealand, should New Zealand allow its residents to utilise franking credits generated from the payment of Australian capital gains tax to offset other tax liabilities arising in New Zealand. Under a simple mutual recognition regime all Australian franking credits should be treated as franking credits for New Zealand tax purposes regardless of the underlying nature of the income for which the credits arose. Any limitation on the types of franking credits that can be recognised would add complexity to the regime and would result in continuing distortions in the tax treatment of trans-Tasman investment.

  A second difference between the corporate tax bases of New Zealand and Australia that will need to be considered is the debt / equity rules. This results in a difference in each country between what is treated as a dividend (to which franking credits can be attached) and what is treated as interest (with no franking credits). We consider that ideally the debt / equity rules would be aligned to minimise the opportunity for arbitrage between the two regimes.

- ***Exchange rates.*** The simplest option would be for all franking credits to be treated as being of equal value regardless of where they are generated. However, given the underlying income will be distributed trans-Tasman and converted to the local currency it will obviously be essential to also convert the franking credits from one currency to the other. Therefore, any mutual recognition regime will need to include aligned foreign currency exchange rules.

- ***Impact on relationships with other jurisdications.*** As Australia and New Zealand are the only countries that we are aware of that still have a comprehensive imputation regime, we consider that the risk of mutual recognition setting a precedent for arrangements with other countries is unlikely. However, as with CER, mutual recognition may be a first step for each country in considering freer investment arrangements with other trading partners.

CONCLUSIONS

The World Trade Organisation has described the CER Agreement as being the world's most comprehensive, effective and multilaterally compatible free trade agreement. It has delivered significant economic benefits to both Australia and New Zealand. In her address to a reception to celebrate the 20th anniversary of CER in March 2003, New Zealand's Prime Minister Rt. Hon. Helen Clark described CER as a "farsighted undertaking" that has produced huge benefits for both countries.

PRICEWATERHOUSECOOPERS

AFTS Secretariat
17 October 2008

The two governments have agreed that the next step in the relationship is the extension of CER to embrace the SEM agenda, the first stage of which is the introduction of an Investment Protocol. Tax is a critical component of any investment protocol, and we believe the opportunity provided by the decision to place mutual recognition on the AFTS agenda provides an ideal opportunity to progress this issue and achieve real gains. We believe that there is a parallel between the decisions taken 25 years ago to abolish tariffs on trans-Tasman trade and the introduction of mutual recognition. This step is clearly bold, comes at a fiscal cost and to some extent results in an erosion of sovereignty. However, it should produce mutual advantage.

We would be pleased to respond to any questions in response to this submission.

Yours faithfully

John Shewan
Chairman
PwC New Zealand

Bruce Morgan
Chairman
PwC Australia

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APPENDIX 1

Comparative tax cost of domestic and trans-Tasman portfolio investment

	NZ company / Aust shareholder	Aust company / Aust shareholder	Aust company / NZ shareholder	NZ company / NZ shareholder
Company	$	$	$	$
Profit	100	100	100	100
Tax[14]	(30)	(30)	(30)	(30)
Supplementary dividend	12.35	-	-	-
Withholding tax[15]	(12.35)	-	-	-
Cash distributed	70	70	70	70
Shareholder				
Dividend received	70	70	70	70
Gross up	12.35	30	-	30
Taxable income	82.35	100	70	100
Gross tax to pay[16]	(38.29)	(46.5)	(27.30)	(39)
Franking credit	-	30	-	(30)
Withholding tax credit	12.35	-	-	-
Net tax to pay	(25.94)	(16.50)	(27.30)	(9)
Dividend after tax	44.06	53.50	42.70	61
Effective tax rate	**55.94%**	**46.5%**	**57.3%**	**39%**

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14 The company tax rate is 30% in Australia and 30% in New Zealand.

15 There is no Australian withholding tax on fully imputed dividends. In New Zealand under the FITC regime the withholding tax is effectively eliminated.

16 Assuming each shareholder is taxed at the top marginal tax rate, 46.5% in Australia (including the Medicare levy) and 39% in New Zealand.