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Australian Taxation of Companies and Shareholders: Imputation Arrives Down Under

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The recognition which has historically been afforded to the company, unlike the trust or partnership, as an entity separate in law from its proprietors has often complicated the taxation of companies and their shareholders through the imposition of income tax upon both the company and its shareholders regardless of their economic interrelationship. This double taxation of company income has increasingly been subject to academic criticism due to the distortion which such a system (the classical system of company taxation) causes. While alternatives to this system of taxation of companies have been adopted in several European countries and Canada, the Australian system of company taxation used until 1985, like that in the United States, was one based upon the recognition of the company as a taxable entity separate from its shareholders. Although there was a logical consistency to this classical system of company taxation, in order to rectify its shortcomings in achieving tax neutrality and equity, an increasingly complex tax statute was required. In proposals advanced in 1985, the Australian government has indicated that starting in 1987 the taxation of companies and shareholders in Australia will be accomplished through a full imputation system with features similar to that of the United Kingdom's partial imputation system.

The acceptance of full imputation as the basis for the taxation of companies and shareholders in Australia was necessitated by the shortcomings of the classical system, particularly as it operated in Australia. A review of the alternatives considered by the Australian government and an examination of the system to be instituted in Australia after 1987

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2 See C. Nessen, Imputation Systems in the EEC in Comparative Tax Systems: Essays in Honour of Richard Goode (1983). Imputation systems are currently in place in Belgium, France, the United Kingdom, Ireland, West Germany, Denmark, and Italy. Other mechanisms are used in Sweden, Norway, Finland (dividend deduction), Austria, Portugal (split rate), Greece and the Netherlands (partial exemption).

3 Prior to 1942, some recognition of the connection between companies and shareholders was accorded through various credit mechanisms designed to relieve the double taxation problem.
provide a useful insight into the strengths and weaknesses of the various alternatives to the classical system. Additionally, the abandonment by Australia of the former taxation regime highlights another dilemma faced by each country which has attempted to coordinate company and shareholder taxation. That dilemma is the acceptance of a loss of revenue as a result of a reduction of total tax imposed on dividends paid to foreign shareholders or the confrontation of the international implications of treating foreign shareholders, particularly United States nationals, in a discriminatory fashion. The consideration of these matters in the Australian experience may contribute to the continued academic debate concerning viable alternatives to the classical system of taxation of companies and shareholders and, concurrently, inform those in the United States of the potential tax consequences which may result from equity investment in Australia.

THE CLASSICAL SYSTEM IN AUSTRALIA

The taxation regime in Australia under which companies have operated for over four decades\(^4\) is based upon the fundamental principal of taxation of both the company and its shareholders. The income of the company, calculated similarly to that of an individual, was taxed in the hands of the company as a separate legal, and consequently a separate taxable, entity.\(^5\) In addition, a distribution of income from a company to its shareholders by way of dividend was taxable in the hands of the shareholders as part of their individual income.\(^6\) Despite the apparent simplicity of the classical system, it proved to be deceptively complex in application. This was due at least in part to the absence of a tax on capital gains prior to September 15, 1985.

Several practical problems were caused by the strict separation for tax purposes of the company and the shareholder. In particular, the difficulty with maintaining consistency in the treatment of capital profits was never adequately resolved in Australia.\(^7\) Distributions from a company to a shareholder from proceeds of a company's capital profits were taxa-

\(^4\) The system is scheduled to be phased out during a transition period ending in 1987.


\(^7\) Id. § 44(1). Profit, as used in ITAA § 44(1) is a commercial concept different from income and includes both capital and ordinary receipts which exceed the cost of the item sold. Dividends paid from capital profits, though such profits were not assessable to the company, would be assessable to the shareholder. See Dickson v. Federal Commissioner of Taxation, 62 C.L.R. 687 (1939). In F.C.T. v. Slater Holdings Ltd. (No. 2), 84 A.T.C. 4883 (1984), the inconsistency of the classical system in this regard was displayed clearly when the High Court of Australia ruled that an increase
ble to a shareholder if paid in cash, but could be received tax-free if transferred by way of a bonus share issuance. Likewise, redemption of shares, which might be thought to give rise to a tax-free capital gain, was treated as an income distribution despite the fact that the share ceased to exist and the proceeds could not accurately be regarded as a dividend under corporate law. Similar difficulties were faced upon the liquidation of the company. Although both redemption of shares and payment upon liquidation of a company could easily be regarded as a return of capital, and despite the inconsistency of such an approach, the possible manipulation of the artificial entity of the company necessitated that the amount of the gains attributable to retained accumulated earnings be treated as taxable to the shareholder.

The classical system which operated in Australia presented numerous theoretical problems common to most systems which rely upon the double taxation of companies and shareholders. Attempts to rectify in the company's funds by virtue of a gift to the company should be considered as capital profits with the result that distributions therefrom were assessable to the shareholders.

It should be noted further that capital gains under the proposed Australian capital gains tax differ from the concept of capital profits in that capital gains will not include that portion of the capital profits allocable to the inflation-caused increase in value of the item sold.

8 See ITAA, supra note 6, § 44(1)(a), which states, with regard to shareholders:
   The assessable income of a shareholder in a company (whether the company is a resident or non-resident shall, subject to this section and selection 128D [concerning the withholding tax] -
   (a) if he is a resident - income dividends paid to him by the company out of profits derived by it from any source; and
   (b) if he is non-resident - include dividends paid to him by the company to the extent to which they are paid out of profits derived by it from sources in Australia.

9 The issuance of bonus shares not representing a capitalization of profits were not assessable if issued pursuant to the provisions of Id., § 444 (2) (substituted by No. 165 § 8, 1973), which allowed such issuances from non-taxable capital profits or revaluation of capital assets.

10 See id. §§ 6(4) and 44(B) (Inserted by 85 § 8, 1967). The First section expanded the definition of a dividend to include any return of capital on a share in excess of its paid-up value whether the share continued to exist or not. Section 44(B) deemed moneys or property paid by a company in such circumstances (and also in circumstances where such payments were made from share premium accounts) to be paid out of profits.

11 F.C.T. v. Uther, 112 CLR 630 (1965). Such a payment was not considered a dividend due to the statutory definition of dividend then in force, which reflected the substantive company law concept.

12 ITAA, supra note 6, § 47 indicates that distributions to shareholders in winding up shall be deemed to be dividends to the extent to which they represent income derived by the company not applied to replace loss of paid-up capital. The difficulty of applying this section are illustrated in Gibb v. F.C.T., 118 C.L.R. 628 (1966), 118 C.L.R. 628 concerning a § 47 distribution made from a company which had received a bonus share issuance pursuant to § 44(2), and Harrowell v. F.C.T., 116 C.L.R. 607 (1967), dealing with a company making a § 47 distribution after having itself received such a distribution from a subsidiary. These decisions concentrated on whether the term "income" in § 47 meant income by ordinary concepts or income as defined and expanded by virtue of the provisions of the Income Tax Assessment Act.
these shortcomings often resulted in solutions which displayed undesirable levels of complexity. For example, the policies which were served by the progressive taxation of individuals were generally not served by the use of progressive rates for companies (often made up of numerous small investors). Likewise, the use of several companies in varying combinations and structures not only made the use of progressive rates inappropriate, but also presented difficulties from multiple taxation of companies as dividends flowed from one company to another before arriving ultimately in the hands of an individual shareholder. As a result, double taxation and progressivity were maintained in Australia by assessment of a non-progressive tax at the company level, while the progressive rate structure was maintained for individual taxation. A dividend rebate mechanism insured that dividends could pass between Australian companies without the imposition of additional taxation, thus maintaining the principle that tax should be imposed at most twice on income originally earned by a company and ultimately distributed to an individual.

The maintenance of a single rate for company tax in conjunction with progressive rates for individuals resulted in the use of companies as tax shelters for taxpayers in higher marginal tax rates than those imposed upon companies. In 1985, for example, the highest rate individual taxpayer who chose to operate through a company could reduce the immediate tax imposed on the income so earned from the highest personal rate (60%) to the company tax rate (46%), an immediate saving of 14% of income earned. The income earned by the company would potentially be subject to the additional personal tax upon distribution to the shareholder, but the benefit of the initial tax savings was maximized when the additional tax which would be incurred upon distribution of company dividends to the individual could be deferred for significant periods (for example where the company needed to accumulate working capital) or incurred when the recipient was in a low income year. Due to the lack of capital gains tax, the use of companies as tax shelters for high rate individual taxpayers proved particularly advantageous in Australia especially since this potential liability was often avoidable through realization upon

13 This was discovered in Australia when, as in the United States, increasing tax rates were imposed in increments on company income. Tax avoidance was facilitated through the use of numerous companies for income splitting.

14 ITAA, supra note 6, § 46(3) provided a rebate for taxes attributable to inter-company dividends. This rebate on taxes was calculated by multiplying the total dividends received by the average rate of tax paid by the recipient company upon the entirety of its taxable income. Inter-company dividends paid from one private company to another were normally subject to only half of the rebate for reasons related to the avoidance of the minimum distribution requirements of Division 7 of the ITAA. However, where the Federal Commissioner of Taxation concluded that dividends paid to a private company would, during the year, ultimately be distributed to an individual, he could allow the full rebate under ITAA § 46(3).
sale of the company shares of the accumulation of those earnings in a tax-free capital gain.\textsuperscript{15}

\textbf{Constraints on Companies as Tax Shelters}

In order to limit the use of companies as tax shelters, Australia imposed an undistributed profits tax upon private companies\textsuperscript{16} which did not fall under the Australian definition of public companies. Public companies, defined primarily to include companies whose shares are listed on a stock exchange,\textsuperscript{17} were considered less susceptible to use as tax shelters and were consequently not subjected to the tax. The undistributed profits tax prevented private companies from retaining excessive after-tax earnings by establishing an amount of each year's corporate income which could be retained by the company. This amount was calculated by applying a statutory percentage to each designated class of net income (eg. property income, trading income, dividends from private companies, dividends from public companies).\textsuperscript{18} These percentages were set at levels

\textsuperscript{15} The difficulty of detecting indirect benefits conferred by shareholder use of the company assets also added to the potential benefits of the company as a tax shelter. The taxation of companies and shareholders based upon the imposition of tax at both the company and individual level necessitated several protection provisions to assure that the income earned by a company would be taxed twice upon enjoyment by an individual. Of primary concern were methods by which the controllers of small companies could enjoy the benefit of company earnings without the direct declaration of a dividend. In order to assure the integrity of the doubt taxation system, loans to shareholders and payments to directors and shareholders of companies were deemed top be dividend distributions in certain circumstances, thus insuring that tax would be imposed at both the shareholder and company level. These provisions, applying only to private companies, are located in ITAA \textit{Id.} §§ 108(A), \textit{amended by No. 90 § 7, 1962 (substituted by No. 85 § 16, 1989), 1989, 109, \textit{amended by No. 90 § 7, 1982 (substituted by No. 85 § 16, 1989).} Enforcement of these provisions, as might be expected, was somewhat difficult.

\textsuperscript{16} \textit{Id.}, Div. 7.

\textsuperscript{17} \textit{Id.}, § 163A(2) \textit{amended by No. 51 § 22, 1973 (substituted by No. 216 § 3, 1973). Section 103 A(2) includes in its definition of public companies:

(a) companies whose shares, not being shares entitled to a fixed dividend, are listed on a stock exchange;
(b) a cooperative;
(c) a non-profit company; or
(d) companies which are

(1) mutual life assurance companies;
(2) friendly society dispensaries;
(3) registered trade unions, friendly societies, and employee organizations;
(4) a state, commonwealth, or territory organization but which is not a company under the laws of the state, commonwealth or territory;
(5) a company controlled by a Government or by an entity included in (4) above;
(6) a subsidiary of a public company.

Further limitations on the definition of a public company are found in \textit{Id.}, § 103A(3) \textit{amended by No. 51 § 22, 1973, preventing companies with concentration of ownership from being so classified, and \textit{Id.} § 103A(3A), clarifying the applicability of the definition in the case of subsidiaries.

\textsuperscript{18} \textit{Id.} § 105B (\textit{substituted by No. 165 § 23, 1973). The retention allowance in 1986 for trading
intended to make private companies less attractive as tax shelters through required annual dividend distributions. The required distribution for each year was calculated by the amount of income (net of income tax) less permitted retention, with the tax imposed upon insufficient distributions in each year equal to half of the amount which had not been distributed to shareholders within the year as required.

The fear of use of private companies as tax shelters also resulted in special treatment to them through elimination of cumulative taxation of inter-company dividends. In keeping with the policy of allowing maximum flexibility to businesses in their decision as to which form to utilize and how to carry on business, the tax imposed upon inter-company dividends was eliminated. This was accomplished, as previously mentioned through a tax rebate for the amount of income tax paid which was allocable to dividends received from other companies.

Private companies presented certain difficulties because the use of a string of private companies could possibly circumvent the undistributed profits tax by cumulating the periods allowed for making the necessary distributions. Consequently, the dividend rebate allowed for distributions from one private company to another private company was limited to one half of the tax allocable to that income. Furthermore, all dividends between private companies were required to be distributed by the recipient company (as no retention allowance applied) or be subject to the undistributed profits tax.

income was set at 80% of the trading income net of allocable expenses and income tax. Public company dividends and property income were likewise established as 10% of the net income in those categories. No retention allowance was provided for dividends from one private company to another. The retention allowance for trading income increased from 70% to 80% in 1982.

The retention allowance of 70% in force prior to 1982 resulted in a company's being subjected to a total tax liability of 54.1% on trading income fully retained. In addition to the 46% primary company tax, a company retaining all its after-tax profits consisting of trading income would be subject to the excess retention tax of 8.1% of pre-tax profits, equal to half of the amount remaining after payment of primary tax (1 less 46% = 54%) and allowance for retention (54% less 70% of 54% = 16.2%). This effectively reduced the potential benefit of such a shelter; however, with the retention allowance at 80%, the total tax liability for fully retained trading profits was reduced to 51.4%. The total tax incidence on retained property income exceeded 70% under full retention, making distribution desirable when earnings included a substantial amount of this type of income.

The appropriate period during which the distributions were permitted to be made was the period beginning two months before the end of the tax year and ending ten months after the end of the tax year. ITAA, supra note 6, § 103(1).

Id. § 104(1) amended by No. 90 § 17, 1982 (substituted by No. 51 § 22, 1973).

Id., § 46 (substituted by No. 110 § 10, 1964).

By use of such companies in tandem, dividends could be paid at the end of each successive distribution period (which ended ten months after the tax year-end) enabling indefinite postponement of any distribution to an individual.

Id., § 46(2)(a).

TAX AVOIDANCE IN THE CLASSICAL AUSTRALIAN SYSTEM

Despite efforts to eliminate the use of companies as tax shelters, high marginal rate individual taxpayers were effectively able to continue to use companies in Australia to avail themselves of the lower marginal tax rates of companies so long as profits could be accumulated at the company level and the tax upon distribution could be avoided. To these ends, various means of both circumventing the undistributed profits tax and avoiding the taxation of the dividend distribution developed. To avoid the undistributed profits tax, companies were structured to avoid characterization as a private company. Legislative amendments to the definition of public companies effectively eliminated such efforts. Attempts to avoid the tax on dividend distributions, however, provided greater scope for originality and thus proved much more difficult to regulate. Additionally, the absence of a capital gains tax increased the attractiveness of most tax avoidance schemes.

The techniques for avoiding the personal tax upon distribution of company profits in Australia, as elsewhere, relied upon the ability of the shareholder to realize, through the sale of his shares, the value of the retained profits of the company as capital gains. Certain share purchasers, such as those who had incurred, expected to incur, or could artificially generate (by means discussed below) losses during the current year, could distribute the accumulated earnings of purchased companies without concern for the tax liability brought about by such a distribution. These purchasers, by taking advantage of their tax position, could purchase shares at nearly the full value of the asset backing of each share and avoid the substantial discount for the tax liability which might normally be expected. Similarly, purchasers who were not planning a distribution in the foreseeable future had no reason to discount fully the price they were willing to pay for such shares. Because of these possibilities (which would allow a shareholder to realize the full benefit of the earnings retained in their companies through the sale of shares to such purchasers), numerous artificial tax avoidance schemes developed to enable

26 See e.g. F.C.T. v. Cappid Pty. Ltd., 127 C.L.R. 140 (1971), Nadir Pty Ltd. v. F.C.T., 129 C.L.R. 595 (1971), Luceria Investments Pty Ltd v. F.C.T., 6 A.L.R. 116 (1975), and F.C.T. v. Casuarina, 127 C.L.R. 62 (1970). Of the numerous variants of these avoidance techniques, two are noteworthy as examples. The first was to structure a company so that the shareholders, normally nominees of the real parties in interest, were prevented under the company documents from receiving any of the company profits. The real parties in interest were listed as potential objects of the company's generosity. While the company could then be described as not being formed for profit (at least not as usually understood), these schemes, as might be expected, received little judicial support. The second variant was the use of partially owned subsidiaries of public instrumentalities (both being defined as public companies due to the provisions relating to the subsidiaries of public companies). Though initially successful, this second type was eliminated by legislative changes.

27 See ITAA § 103A, subsections 3A, 3B, 4, 4A, 4B, 4C, 4D, and 4E.
shareholders of private companies to receive, without great difficulty, the retained earnings of the company as tax-free capital gains rather than as dividends. Unfortunately, the benign response of the Australian courts to these schemes accelerated the growth of their popularity.

In the case of Slutzkin v. FCT, the High Court of Australia considered the primary scheme for the transformation of profits into capital gains known as the dividend strip, and accepted its validity. In the Australian version of the dividend strip, a shareholder would sell his shares to a share trader who would pay for the shares with the proceeds of dividend distributions from the newly purchased company (often accomplished with an artificial transfer of checks). The shares were then sold by the share trader at a loss equivalent to the dividend, and enabled the former shareholder of the private company to obtain the after-tax company earnings from his company without further tax liability for either the selling shareholder or the share trader. In the Australian context, dividend strips were not only used to enable shareholders to receive tax-free earnings upon termination of their shareholding interest in the private company, but they were also used, though less successfully, to avoid the tax on excess retention through the sale of special rights shares.

While the Slutzkin scheme and its various refinements made the use of companies advantageous to individual taxpayers whose marginal indi-

29 The High Court refused to apply s 260, Australia's general anti-avoidance section at the time, in Slutzkin, supra note 28, and Patcorp Investments Ltd. v. F.C.T., 140 C.L.R. 247 (1976). It preferred instead to look at the steps in the dividend stripping scheme in isolation to avoid the conclusion that the purpose of the scheme was the avoidance of tax. Slutzkin concentrated upon the sale of shares while Patcorp centered upon the operations of the share trader in the inquiry as to whether tax avoidance was found. Neither step, in isolation, was indicative of tax avoidance.
30 Indeed, the dividend rebate to a share trading company might also make the transaction extremely attractive by enabling it to generate artificial losses for its own benefit. The elimination of rebates on dividends paid in dividend stripping operations was accomplished through the adoption of ITAA § 46A in 1978.
31 These schemes were similar to a preferred stock bail out, but the necessity to replace the capital so removed often resulted in the entire transaction appearing even more obviously like a sham. See, e.g. Newton v. F.C.T., 98 C.L.R. 1 (1958), in which the Privy Council (to which certain Australian appeals were permitted until 1986) used the general anti-avoidance section of the Australian Income Tax Assessment Act to strike down such a dividend strip in a case originating in New South Wales.

The High Court of Australia, which was an alternative ultimate court of appeal for decisions from State Supreme Courts in Australia (the right of appeal from the High Court to the Privy Council was limited in 1968 and abolished in 1975), began to display a less interventionist approach to the use of the anti-avoidance statute, § 260 of the ITAA, with the advent of Chief Justice Sir Garfield Barwick in 1964. While the jurisprudence of the High Court during this era was the subject of great criticism, this aspect of the tax environment in Australia is beyond the purview of this article. In this regard, however, see Lehmann, The Income Tax Judgments of Sir Garfield Barwick: A Study in the Failure of the New Legalism, 9 MONASH L. REV. 115 (1983).
individual rates were above the company rates by effectively eliminating the personal tax on dividend distributions, later developments were of even more universal appeal. They were targeted to avoid all tax on income earned through companies. After the Slutzkin case, tax avoidance promoters relied upon the High Court of Australia's legal analysis of the basic dividend strip to promote avoidance schemes under which the payment by the company of even primary company tax upon earnings could be avoided. Where the dividend strip occurred prior to the assessment of company tax upon the stripped company, the amount stripped from the company would include all pre-tax earnings for the year. In order for the share trader to realize its loss on the sale of the stripped company's shares and to insulate itself from any liability for the mismanagement of the stripped company (having, as it did after the strip, no assets but a large contingent tax liability), the shares were sold to straw men who deposited the company records at the "bottom of the harbour." Although this scheme culminated in legislation which imposed tax liability equivalent to the lost company tax, directly upon shareholders who sold the shares in such circumstances, companies continued to provide an attractive tax shelter through use of the basic dividend strip.

THEORETICAL INADEQUACY OF THE CLASSICAL SYSTEM

Models for taxation are usually judged on the basis of their accomplishment of certain objectives, such as neutrality, efficiency and equity. The Australian system of company tax used prior to 1985 had several major shortcomings when judged by these criteria.

The first obvious problem with the former company tax was its lack of equity among potential investors. Since a single tax rate was imposed

32 Self-assessment in Australia has been introduced for years subsequent to the 1984-85 tax year, however even 1985-86 is a transitional year due to the administration difficulties involved. Under the prior scheme, the tax liability arose only upon assessment by the tax authorities based upon information reported by the taxpayer.

33 The scheme originally developed in Sydney, where the Sydney Harbour provided a large depository for such company records, at least figuratively. The men of straw were often individuals recruited because their departure from Australia was imminent. Relying upon the view that a shareholder need not be concerned with any transaction which took place after the shares had been sold (from Slutzkin v. F.C.T., supra note 28), both the shareholders and the dividend strippers were able to argue that any liability should not fall upon them. The scheme, originally discovered because of the failure of such companies to comply with requirements under corporate rather than tax law, came to be known as a "wet Slutzkin" as opposed to the normal dividend strip, the "dry Slutzkin."

34 Taxation (Unpaid Company Tax) Assessment Act 1982, Taxation (Unpaid Company Tax-Vendors) Act 1982, and Taxation (Unpaid Company Tax-Promoters) Act 1982. Liability was imposed on a shareholder who sold shares in a company for an amount in excess of the asset backing of the company less any potential tax liability where the tax liability was ultimately not paid by the purchaser.

35 The deficiencies of the Australian company tax are well reported in Krever, Companies, Shareholders and Tax Reform, 20 Taxation in Australia 163 (1985).
upon companies, shareholders with different marginal tax rates faced substantially different consequences from the use of companies as an investment medium. Lower rate taxpayers invariably faced increased taxation as the company tax itself could not be avoided (although the amount of increase might vary upon the treatment of company earnings). High rate taxpayers, on the other hand, faced either an increase or decrease in tax rate depending upon the disposition of the company earnings. The retention of post-company tax earnings at the company level followed by subsequent transformation of these earnings into tax free gains by a sale of shares would result in a decrease in the marginal tax rate to the individual. The distribution of dividends by the company to the individual, however, would result in the imposition of both the company tax and the individual tax which, would in turn, result in an increase of the effective marginal tax rate of the individual.

As a necessary corollary to the above principle, the classical system biased the decision-making processes and resulting resource allocation of the economy in several ways. It inhibited the efficient working of the free market economy by placing artificial incentives or disincentives upon decisions which were best made by reference only to commercial considerations. This bias of the Australian classical system was evidenced in a number of ways, the most obvious of which was in the system's inherent incentive for companies to retain earnings rather than to distribute them. This bias resulted in economic inefficiency through the encouragement of fund retention by less economically productive companies merely because of the tax disincentive to distribute profits.

Due to the double taxation of company profits and distributions, the classical system also greatly affected the choice of investment venue which would more appropriately be made with regard to the economic and legal characteristics of such venue. This particular bias would cause investment through partnerships and trusts in situations where, but for the tax implications, company form would be chosen. As a further consequence, existing companies were at a disadvantage in competing for equity funding with potentially less efficient businesses because of the comparative tax advantage enjoyed through use of the alternative forms.

Finally, the classical system resulted in a bias against equity financing and in favor of debt financing for companies. While interest payments made by a company could properly be deducted from its income (with imposition of a tax at the investor level alone), amounts distributed as dividends had to be made from company after-tax earnings and were also taxable to the shareholder. The imposition of the additional tax upon the income earned through equity financing induced investors to minimize their equity investment by thinly capitalizing companies. The result was that capital committed to companies was determined more by
reference to taxation consequences than by proper financial considerations.

The biases of the Australian tax system for companies and shareholders were quite apparent by 1985. In its “Draft White Paper,” (Reform of the Australian Tax System) the Australian Federal Government recognized that the classical system utilized in Australia caused an equity problem not because of the double taxation but because the taxation system was dependent upon the dividend payout policy of each company. As a direct result of taxation being dependent upon company dividend policy, companies could tailor their dividend policies (and consequently minimize tax) according to the taxation position of the proprietors. The inefficiency costs were reflected in corporate structures and financing decisions based primarily upon taxation consequences were apparent.

In response to this system, companies with minimal capital (usually two dollars) became commonplace. Likewise, the use of trading trusts (usually a trust which has a corporate trustee so as to maintain limited liability for the beneficiaries) proliferated and so enabled investors to reap the benefits of the company form without the attendant increased tax liability. Even large businesses were organized as unit trusts to avoid the double taxation imposed upon companies.

Possible alternatives to the classical system of taxation of companies and shareholders have twice been proposed recently in Australia. In 1975, the report of the Taxation Review Committee (the Asprey Report) had included proposals that a split rate or imputation system replace the classical system. These proposals were not implemented due to a change in government in November, 1975. In 1981, the report of the Committee of Enquiry into the Australian Financial System (the Campbell Report) had proposed that full integration of the personal and corporate tax rates be accomplished and that companies should be allowed, in certain circumstances, to be taxed as partnerships. The 1985 Draft White Paper, incorporating many of the findings and proposals of both the Asprey and Campbell Committees, indicated that in 1985 the Australian Federal Government was considering full integration, a split rate

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37 Id. at ¶ 17.4.
38 Id. at ¶ 17.5.
39 Id. at ¶ 17.6.
40 All of this was acknowledged in the “Draft White Paper” at ¶¶ 16.5, 17.7 and 17.8.
system, or an imputation system as possible options for the reform of the system for taxation of companies and shareholders in Australia.

ALTERNATIVES

Most of the techniques developed and implemented by other nations to improve upon the classical system of taxation of companies and shareholders were considered by the Australian law reformers. Unfortunately, many of the methods considered, most of which provided for the elimination of either the tax upon the shareholder or the tax upon the company profits, were nevertheless considered inappropriate for Australia because of the loss of revenues which would result from their implementation or because they retained certain of the imperfections of the classical system. Both the Asprey and Campbell Committees made reform proposals which drew heavily upon overseas experience in the elimination of the double taxation of the classical system. Although numerous variants of each general proposal considered for Australia have emerged in academic discussion and in practice worldwide, a review of the specific reforms which were considered indicates the broad nature of the Australian enquiries which culminated in the reforms of 1985.

Split Rate (Dividend Deduction)

One simple means of eliminating the double taxation of distributions from companies is to allow a deduction from company income for dividends distributed to individual taxpayers. This system, similar to the tax system imposed upon trusts in Australia, would result in only one level of taxation upon company income depending upon whether it was retained by the company or distributed to shareholders. A less successful method of correlating the tax on companies and shareholders is to provide different tax rates for company income retained by the company and income distributed to shareholders. This concept was tried in West Germany prior to 1977, that is, before that country's introduction of an imputation system in that year. As discussed by the Asprey Committee, either method would reduce the bias against corporate equity investment where income was distributed (completely eliminating such

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44 This system would be equivalent to allowing only a partial deduction for dividends distributed and would be exposed to the same criticisms as the dividend deduction system while retaining certain of the shortcomings of the classical system. It may best be considered as a compromise between the classical and dividend deduction system, probably proposed to limit the loss of revenues which would occur by elimination entirely of one level of tax upon corporate earnings.

45 Asprey Report, supra note 41, at ¶ 16.33.
bias under the dividend deduction). However, both variants retain the imperfection of the classical system due to the ability of a company, to alter the tax incidence through appropriate dividend distribution policy. Conflict among shareholders who are in different tax brackets might also result because high income individual shareholders could be benefited by the retention of income by the company whereas low income individuals might prefer distribution (depending upon the tax rates and the differential between the tax on undistributed and distributed income). Overall, this underlying lack of neutrality between different level individual taxpayers in respect of dividend policy reduces the attractiveness of this alternative.

Dividend Exemption

By exempting the dividend from the income of the individual taxpayer, several of the negative effects of double taxation may be avoided. Like most alternatives to the classical system, this proposal would eliminate one of the two levels of taxation; in this case it is the tax at the shareholder level. Such a proposal would reduce the tax bias against company investment by lowering the tax incidence of company investment caused by double taxation and would eliminate the inducement for shareholders to retain earnings in the company. Although this system might result in a slight bias toward distribution because of the lack of any tax at the shareholder level, the greater fault with such a taxation regime is its obvious advantage to high level taxpayers. Under this system, investment in companies would be attractive only to individuals with tax rates in excess of the company-imposed rate. Low rate taxpayers would continue to be inhibited from entering the share markets, and biases in the proper business structure to be utilized would be retained.

Although attempts to rectify the lack of progressiveness of this alternative have been attempted through the provision of partial exemptions, these attempts have been ineffective in situations where the company tax rate remains higher than the lower individual rates. In Australia, a partial rebate, rather than an exemption, was used between 1982 and 1983, thereby limiting the advantage enjoyed by shareholders in higher marginal tax rates.46 Either a limited rebate of the kind used in Australia between 1982 and 1983, or a partial exemption system provides greater neutrality among taxpayers in different marginal rates than does a total exemption of dividends in the shareholders’ hands. Unfortunately, a partial exemption or limited rebate system accomplishes this with certain imprecision and is consequently only marginally more attractive in the-

46 ITAA § 46C. The rebate (approximately 30%) applied to the first $1,000 of eligible dividends. The taxpayer was entitled to a reduction of his tax liability (which was based upon income inclusive of dividends) by the amount of the rebate.
ory than the total exemption system.\textsuperscript{47}

**Conduit**

Perhaps the simplest means of eliminating the distortions caused by the classical company tax system is to eliminate the company tax altogether and to impose a tax upon the individual shareholder regardless of whether company earnings have been distributed to the shareholders or not. This method is similar to the tax treatment afforded to partnerships in Australia and is available as an alternative taxation system for small corporations in the United States.\textsuperscript{48} Although this method of taxation would eliminate the relative disadvantage of company investment in relation to other investment structures due to the double tax upon companies and would also assure that company investment would be equally attractive to high and low level individual taxpayers, it does suffer from one rather important deficiency. Under a conduit system, the incentive to distribute company earnings is great as each shareholder is faced with a tax liability upon company earnings whether the company has made distributions or not. This leads to a bias against earnings retention despite any underlying economic justification. Finally, the administrative difficulties which a conduit system might necessitate (particularly where numerous individual returns include a portion of the company’s income) make this method of taxation appropriate, as in the United States, only for companies with a limited number of shareholders. Both the Asprey and Campbell Committees supported the provision of this option for private companies with fewer than ten shareholders and only one class of shares\textsuperscript{49}; however, this proposal was never implemented due to a desire for a more comprehensive reform.

\textsuperscript{47} Another alternative integration method based upon the deduction of capital investments has been proposed by economic theorists upon the assumption that allowing such a deduction to a taxpayer and taxing the taxpayer on all receipts from the investment and upon gains realised upon disinvestment is the same, so long as tax rates remain constant, as an exemption on after-tax investment income. This method, while eliminating the double tax bias against companies, would be the same as eliminating the individual tax level if the deduction were permitted to be taken by the individual shareholder in his share investment. Consequently, this system would suffer from the same drawbacks which were explored under the dividend exemption proposals. A refinement of the approach is to allow the capital investment deduction to the company on its capital investments. This would eliminate the double taxation at the company level with the resultant incentive toward retention even greater than under the classical system due to the imposition of tax for the first time only upon receipt in the shareholders' hands. Andrews, \textit{A Consumption-Type or Cash Flow Personal Income Tax}, 87 Harv. L. Rev. 1113 (1974) and Warren, Jr., \textit{Fairness and a Consumption-type or Cash Flow Personal Income Tax}, 88 Harv. L. Rev. 931 (1975).

\textsuperscript{48} I.R.C. § 1201.

\textsuperscript{49} Asprey Report, \textit{supra} note 41, at ¶ 16.79; Campbell Report, \textit{supra} note 42, at ¶ 307.
Full Integration

Full integration, the preferred alternative of the Campbell Committee in 1981,\textsuperscript{50} entirely eliminates the double taxation of company and shareholders. Under this system, as with the conduit system, the income of each shareholder includes a portion of the income earned by the company regardless of whether it is in fact distributed; however, unlike the conduit system, the company pays tax upon the company income. This tax payment by the company is considered as a prepayment or withholding, taken by the company on behalf of the shareholders, who must pay tax upon their proportionate share of company income in the year in which it is earned by the company whether or not it has been distributed. While many of the administrative difficulties of the conduit system remain, they are somewhat reduced by the prepayment aspect of full integration. Despite the theoretical benefits of full integration outlined by the Campbell Committee, the Australian government concluded in 1984 that such a system would not be feasible primarily due to the loss of revenue which such a scheme would entail. Furthermore, the Australian government pointed to the administrative difficulties which such a system would present as grounds for refusing to implement full integration of company and shareholder taxation for all companies.\textsuperscript{51}

Imputation Systems

The final taxation system which eliminates the double taxation of company earnings is the imputation system. This system, of which the post-1986 Australian company tax is an example, imposes a tax upon company earnings alone. Distributions to shareholders of after-tax company profits give rise to income to the shareholders not only to the extent of the net dividend distributions, but also to the extent of the proportionate share of the tax collected at the company level (which also becomes available as a credit against the shareholder's personal tax liability).

Imputation systems fall into two categories: partial imputation systems and full imputation systems. A full imputation system treats the distribution to the shareholder as consisting of the dividend actually received plus the entire company tax already paid on the profits from which the dividend distribution was made, which is also to be used by the shareholder and applied against his own individual tax liability. Thus,

\textsuperscript{50} Campbell Report, \textit{supra} note 42, at ¶ 308.
\textsuperscript{51} In its White Paper, \textit{Reform of the Australian Tax System}, \textit{supra} note 36, the Australian government mentioned, at ¶ 17.32, in addition to lost revenue:

1. Delay in filing of individual returns where company income was relevant;
2. Difficulties where final assessment of a company return necessitated amendment of numerous shareholder returns; and
3. Difficulties where more than one class of shares was involved.
the tax paid by the company is fully imputed to the shareholders upon distribution.

By way of example, if the company tax rate is set at 30%, the amount of post-company tax income available to be paid by the company (assuming no difference between financial and assessable income) would be 70% of pre-tax income. Should this amount be entirely distributed, the total assessable distributions to the company's shareholders under a full imputation system would equal the entire pre-tax income of the company. The latter is made up of the dividend distributions plus imputed income equal to the total tax paid by the company and allocable to the income distributed. Where companies earn income which is not subject to full taxation, however, adjustment mechanisms are required to prevent super-imputation. Super-imputation is the allowance of a greater credit than is warranted from the tax paid by the company on income which is either exempt or taxed at lower rates. The problem of super-imputation is discussed below.

The advantages of the full imputation system are fairly obvious. The system eliminates the double taxation of earnings which are received by the individual taxpayer by giving a credit for all taxes paid upon the income to the company when the income is received, by way of dividend distribution, to the individual shareholder. The system maintains taxation of the earnings irrespective of whether distribution has taken place. Neutrality between high and low level taxpayers is achieved for distributed earnings; however, undistributed earnings enable high marginal rate shareholders to postpone tax where company rates are below the highest individual rates. Likewise there is a tax inducement for individual taxpayers in marginal rates under the company rate to seek distributions of company earnings because they are faced with excessive tax prepayment while the earnings are retained by the company.

An alternative to the full imputation system is the partial imputation system. Under this system only a certain portion of the tax paid at the company level is attributed to the shareholders upon dividend distribution. Thus the partial imputation system, like the split rate system, is a compromise between full imputation and the classical system. Yet the partial imputation system retains taxation at the company level despite the amount of distributions made by the company. The basic disadvantages of distortion against company investment in relation to other investment venues and the bias toward debt investment, though reduced, nonetheless remain. Despite this, the Asprey Committee recommended

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52 In order to determine any shareholder's assessable income as a result of a dividend distribution, the dividend received need merely be divided by 70% in this example (1 less the tax rate). Likewise, to get the additional amount to be imputed to any shareholder, one need only multiply the dividend received by the ratio of 30/70 (the tax rate over the remainder).
in 1981 that Australia move to a partial imputation system. This recommendation was motivated largely by the introduction of such systems in Canada and the United Kingdom.\textsuperscript{53}

1987 Australian Company/Shareholder Taxation

In proposals advanced by the Treasurer, Mr. Keating, in September, 1985, the Australian government committed itself to the elimination of the double taxation of company earnings. While certain portions of the tax package, particularly the new capital gains tax,\textsuperscript{54} met with strong objections from the opposition parties, the general thrust of the company tax reforms were warmly received. While the exact details of the reform of the company tax have been altered several times since the government committed itself to an imputation system in 1985, the basic components of the system, introduced into the Commonwealth Parliament on April 2, 1987, as the Taxation Laws Amendment (Company Distributions) Bill 1987, have remained unchanged.

The cornerstone of the new Australian company tax will be the elimination of the double tax upon companies by the adoption of a full imputation system. Taxation will be imposed upon companies at a flat 49\% company tax rate upon the taxable earnings (and taxable capital gains) of the company. When a company distributes dividends to its shareholders from income which has been subject to company tax, the shareholder will recognize as income both the income represented by the net dividend distribution as well as the allocable company tax paid upon the portion of the company earnings which that dividend represents. To offset this additional non-cash imputed income, the shareholder will be allowed a credit against his tax liability to the extent of the imputed income. In effect, the company tax which is paid is considered to be a prepayment made by the company for its shareholders on the income which is distributed to them.\textsuperscript{55} Thus, the income received by the shareholder includes both the dividend actually received and the appropriate

\textsuperscript{53} Asprey Report, \textit{supra} note 41, at \textsection 16.52.

\textsuperscript{54} The new capital gains tax, found in the Income Tax Assessment Act, part 3A, operates upon capital assets acquired after Sept. 19, 1985. The gain on each item is calculated by reducing its sales price by the cost adjusted for inflation where the asset has been held for more than one year. Net gains on all assets are included in income for the year with a provision for averaging. Losses on each item are calculated on an adjusted cost basis without reference to inflation, but must be used only to reduce capital gains in the year incurred or in following years. Personal use assets are not grouped with other assets, but gains on these assets (net of losses which may be allowed in certain circumstances) are likewise included in assessable income.


\textsuperscript{55} See Taxation Laws Amendment (Company Distributions) Bill 1987 [hereinafter "Company Distributions Bill"] \textsection 14, proposed ITAA \textsection 160 AQT. This differs from full integration in that the
portion of the prepayment which can be used as a credit against the individual shareholder's tax liability.

Another proposed modification of the tax system, independent of the imputation changes but clearly related to the overall scheme is the alignment of the company tax rate with the top personal rate. This relationship is discussed below. The company tax rate to be imposed represents a rise of 3% from the 46% rate of tax upon company assessable income imposed under the classical system, with the new 49% rate to be initially imposed upon company income for the 1986-87 tax year. The individual marginal rates have been reduced so that the highest individual tax rate shall be only 49% in the period 1987-88, thereby bringing the company tax rate into line with the top individual tax rate. The imputation of credit and income to the individual taxpayer shall apply for the period 1987-88 as well, with the result that the full imputation system will be in place in its entirety from that date.

The operation of the Australian imputation system can be explained through an example which uses income earned by a company (after full implementation of the new system) of $100. Assuming this amount is subject to full taxation, the company tax imposed upon this income would be $49 (49% of $100), leaving $51 available to be distributed by the company. Should the company distribute all of this to its sole shareholder, an individual in the highest tax bracket, then that individual would have $100 of assessable income from the receipt of the cash dividend (dividend of $51 plus imputed income of $49); however the individual would have no further income tax liability because the credit available from the dividend would offset the marginal tax upon the distribution. A shareholder in a personal marginal rate below the company tax rate would have a credit available which would reduce his tax liability on income attributable to other sources during the year because the tax liability upon the dividend distribution and imputed income would be less than the tax paid by the company attributable to the distribution. The proposals to date have indicated that such a credit would not be available for cash refund by the Treasury, nor could it be carried forward if unused during the year received.

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56 A shareholder in a personal marginal rate below the company tax rate would have a credit available which would reduce his tax liability on income attributable to other sources during the year because the tax liability upon the dividend distribution and imputed income would be less than the tax paid by the company attributable to the distribution. The proposals to date have indicated that such a credit would not be available for cash refund by the Treasury, nor could it be carried forward if unused during the year received.

Dividend $51
Imputed income 49
Assessable Income 100
Tax (at 49%) 49
Less: Credit 49
Net tax payable 0

See Company Distribution Bill supra, note 55 at § 14, proposed ITAA § 160 AQU.
The imputation system devised in Australia, when taken in conjunction with the reduction of the highest level of individual tax rates, accomplishes most of the desired goals of taxation policy with respect to reform of the company tax. The changes minimize the distortion caused by different tax treatment of company and non-company investments by (1) elimination of double taxation, (2) restoration of neutrality between income from debt and equity investment, (3) maintenance of the progressive tax structure for individuals without distortion for income earned through companies, and (4) correction of the bias toward the retention of corporate earnings. While a certain bias does remain toward the distribution of company earnings in order to lower rate taxpayers (to enable them to use credits available for the difference between their individual rates and the company rate), this should certainly be recognized as a minor imperfection with none of the tax avoidance implications which are caused by many of the eliminated tax distortions.

As a result of the above changes, several statutory provisions were no longer necessary. Most obviously, the current tax on excess retention of profits was no longer required because of the elimination of double taxation and the sheltering advantage to high rate individuals. The dividend rebate on intercompany distributions was retained due to the distortions which would be caused by the channeling of dividends through loss companies. A system of "franked dividends" was introduced to integrate the continued dividend rebate with the imputation system.

The end of the retention tax and alteration of the dividend rebate resulted in the further elimination of any need to distinguish, for tax purposes, between public and private companies. Although there may continue to be some difficulty with the tax treatment of both direct and indirect distributions to shareholders, these problems may also be greatly discounted since dividend distributions will no longer be a critical step in tax collection, will instead be a largely inconsequential event for income tax reasons (except for the net credit effect for distributions to low rate individuals). The simplification of the tax system which this change encompasses should consequently be welcomed.

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57 Intercompany dividends which would have carried the imputation credit had they been received by individuals would constitute franked dividends. The recipient company would not be able to avail itself of the credit (the dividend being subject to the dividend rebate); however, dividends paid to individuals from this source would carry the imputation credit. In this regard, see the discussion of the qualifying dividend account, and see Company Distribution Bill supra, note 55 at § 14, proposed ITAA § 160 AQF.

58 Despite the diminishment of the importance of the dividend distribution for income tax reasons under the imputation system, the problems in the classical system with the determination of whether a distribution is an assessable dividend (see supra, text accompanying note 7) may not be totally irrelevant. The importance of this concept may continue due both to the imposition of tax upon distributions from non-qualifying funds under the proposed imputation system (as discussed later) and to the introduction of a capital gains tax which does not tax fully capital profits.
Despite the overall simplification afforded by the new full imputation system, there are several complexities to the model. The first problem arises from the possibility that distributions from the company to its shareholders may come from income which has not been taxed at the full company tax rate. Should this be the case, the imputation of income and credit to the individual shareholder would overcompensate as the company tax incurred would in fact be exceeded by the credit given to all shareholders. This problem, known as super-imputation, is handled in various imputation systems throughout the world in a number of ways. The Australian government initially indicated that the approach of the United Kingdom to this problem, the advance company tax, would be utilized. This solution, though somewhat complex in application, would nonetheless have been much simpler in Australia than in the United Kingdom due to Australia’s alignment of the company tax and top individual marginal tax rate and due to the full imputation used in Australia (as opposed to the partial imputation system used in the United Kingdom).

Under the advance company tax and the proposed Australian compensatory tax, the distribution of dividends by a company to its shareholders would have resulted in a tax liability in the company equal to the imputed credit or income which was to be passed along to the shareholder. This compensatory tax was to be allowed, however, as a credit against the company’s income tax liability incurred in the same tax year. Thus, where a company had distributed its net earnings in the same year as the company tax liability on that earnings become due, the company’s total tax liability will not be increased so long as the income earned by the company was fully taxed. However, where the company had income taxed at below the full tax rate, the imposition of the compensatory tax resulted in an additional liability offsetting the amount of any super-imputation benefit. Where the compensatory tax imposed upon distributions made in a given year exceeded the company tax liability in that year (where distributions were from prior years’ earnings or where the company had lower taxable income than financial income due to tax preferences such as accelerated depreciation, for example), the credit allowed for the compensatory tax paid was, as under the United Kingdom system, to be available to be carried back for a limited period and forward indefinitely to be offset against the company’s income tax liability in

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59 Thus in the example where a company has earned $100 and has paid its company tax of $49, a distribution of $51 will cause the company to be faced with an additional tax liability, for compensatory tax, of $49.


61 The United Kingdom allowed only a two year carryback on excess advance company tax until 1984, when a six year carryback was introduced. *Finance Act (U.K. 1984) § 52.*
those periods. 62

While the imposition of the compensatory tax prevents super-imputation, unfortunately it also eliminates the benefit of tax preferences given to companies upon distribution. Consequently it provides a disincentive to distribution of income earned by the company even though taxed at rates below the normal company tax. For these reasons, the Australian government announced in December, 1986, that it would not proceed with a compensatory tax upon companies but would instead introduce a bifurcated system. Under this system imputation would only apply to distributions from income taxed at the full rates at the company level and distributions from income would be taxed at less than the full company rates assessed to shareholders upon distribution in a manner similar to the classical system.

The Qualifying Dividend Account

The imputation system initially proposed by the Australian government met with opposition from the Australian commercial sector in only one area of major importance, that of the compensatory tax. Where income earned by a company has not been fully taxed in the hands of the company, allowance of the imputation credit to shareholders would result in super-imputation, as mentioned earlier, with the result that there would be a loss of revenue without an adjustment mechanism on each distribution of less than fully taxed earnings. While the compensatory tax eliminated this superimputation by assuring that full tax would be paid upon all distributions, it had the effect of eliminating preferences given to companies upon distribution of such income to the shareholders. The difficulty of the compensatory tax adjustment would be most noticeable in two areas, foreign sourced income (subject to lower Australian income tax because of credits given for foreign tax paid) and mining income (subject to lower rates than normally applicable to companies). In both circumstances, distribution to a shareholder of profits from such sources of income would have resulted in an additional compensatory tax liability which would raise the effective Australian company tax rate on that income to 49%. 63

On December 10, 1986, the Australian government announced that the compensatory tax would be abandoned. In order to prevent super-
imputation, the government announced that only such company earnings as had been subject to a full 49% company tax will carry the imputation credit to shareholders. Company earnings upon which no company tax had been paid would be subject to tax to the shareholders at face value with no imputation component (thus eliminating super-imputation and assuring that earnings are taxed at either the company or shareholder level). In order to implement this proposal, each Australian company will be required, after June 30, 1987, to maintain a qualifying dividends account. This account will record the amount of income retained in the company which has borne the full company tax, such figure to be calculated by reference to the company tax paid. Additionally, intercompany dividends paid to a shareholding company from the declaring company’s qualifying dividends account (known as “franked” dividends) are to be added to the recipient company’s qualifying dividends account.

A company declaring dividends from its qualifying dividends account must reduce the account accordingly. Any non-corporate shareholder receiving such dividend will be entitled to the benefit of the imputation credit on such dividend received, thus effectively allowing the company tax paid to be considered as a prepayment for the shareholder’s tax liability on the distribution. After a company distributes its entire

Neither the exact timing of the compensatory tax liability nor the mechanisms for refund had been finalized prior to the abandonment of the compensatory tax.

Interestingly, companies with offshore earnings may have been subjected to total tax in excess of even 49%. Although the Australian company income tax now provides for a credit for foreign income taxes paid, the compensatory tax would have been capable of offset against only the Australian company tax actually paid. Thus, the benefit of the foreign tax credit would have been lost upon distribution, raising the total Australian tax incidence to 49% in addition to the offshore tax.

The account would operate prospectively so that income taxed prior to July 1, 1987 would not be included in the qualifying dividend account. The imputation system will effectively apply only to post-July 1, 1987 income earned by the company if fully taxed.

Intercompany dividends will continue to be non-assessable under ITAA § 46. Of course, the recipient company shall receive no imputation benefit other than the inclusion of the dividend received in the qualifying dividends account.
qualifying dividends account, any further distribution (known as "unfranked" dividends) will be taxed to the shareholders without benefit of the imputation credit. The qualifying dividend account may remain in the positive indefinitely; however, should the account be in the negative at the end of the tax year, a tax payment (similar to the compensatory tax) will be required to restore the account to the positive.

**International Tax Implications**

As with most imputation systems in place worldwide, the Australian imputation system proposed in September, 1985 applies only to coordinate the taxation of resident companies and their resident shareholders. While this principle was mentioned briefly in the announcement of the introduction of the Australian imputation system, the complexities of its application have only recently been addressed. Further, the discriminatory treatment of residents, which the Australian system includes, will undoubtedly lead to difficulties of renegotiating tax treaties which currently prohibit discrimination against residents of the signatory states.

With the abandonment of the compensatory tax and the introduction of the qualifying dividend account, many of the international problems caused by the introduction of imputation have been avoided. Retention of the withholding tax for distributions from other than the qualifying dividend account assures that taxation of non-resident shareholders will also be maintained. In adopting the bifurcated approach to

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67 All dividends were to be treated as being paid first out of the qualifying dividends account according to the Keating Announcement, supra note 65. The Company Distributions Bill supra, note 55 at § 14, proposed ITAA § 160 AQF appears to allow greater flexibility in dividend policy. 68 The announcement contemplates a pro-rating of the dividends paid from the qualifying dividend account where the company has an advance and fixed commitment to pay dividends on particular classes of shares (cf. Company Distribution Bill supra, note 55 at § 14, proposed ITAA § 160 AQG). 69 This would occur where, for example, a company distributes excess qualifying dividends to its shareholders than are in its qualifying dividend account. See Company Distribution Bill supra, note 55 at § 14, proposed ITAA § 160 AQI. Presumably, it is easier to require a correction by the company than an amendment altering each shareholder's position as a result of the excess distribution. For this reason, corrections to a company's tax liability for prior years shall not result in alterations or amendments to the shareholders, but may result in a compensating payment at the tax year and if the reduction in the company's tax liability for prior years is greater than its current year's liability (thus leaving it with a negative balance in its qualifying dividend account at year-end). 70 Requiring a company to incur this liability only at the end of the year enables a company to estimate taxable income and dividend receipts for each year from which franked dividends may be paid. Should a payment be required at the end of the year due to miscalculation, the payment will be available as an off-set against company tax, with no addition to the qualifying dividend account on the income to which the off-set applies. Company Distributions Bill, supra note 55 at § 14, proposed ITAA § 160 AQK. 71 In the Keating Announcement, supra note 65, the Australian government partially retracted its July 28, 1986 undertaking to repeal the dividend withholding tax and branch profits tax. The repeal of both of these taxes were offered in conjunction with the imposition of the compensatory tax
imputation in December, 1986, the Australian government has effectively provided a reduction of the total incidence of taxation on corporate investment internally with minimal loss of revenue from non-resident investors. The qualifying dividend account will result in the taxation of international transactions in the following way:

(a) Resident Companies

Resident companies will continue to be taxed on all income, whatever its source, on the basis of its Australian residence. An Australian resident company with ex-Australian source income will, under the newly introduced foreign tax credit, face a lower incidence of Australian income tax due to the credit now allowed for foreign taxes paid. Only that portion of income for which the Australian tax paid would represent a full levy of income tax would be included in the qualifying dividend account.\(^2\) Distribution to resident shareholders would, as previously mentioned, qualify for the imputation credit if the distribution were from the qualifying dividend account but would be taxable in the hands of the shareholder without benefit of the credit if the distribution were not a qualified dividend. This system would limit the benefit of relief from double taxation of company and shareholders only to so much of foreign income as could be determined to be subject to full Australian taxation, with the result that foreign income effectively taxed offshore would still be subject to two levels of tax, foreign tax at the company level and Australian tax at the individual level.\(^3\)

Dividends to non-resident shareholders would likewise be taxed according to whether they came from the qualifying dividend account. Those qualified dividends paid to non-residents would be subject to no further taxation,\(^4\) but any excess imputation credit would not apply in order to maintain the overall tax burden upon those not subject to the imputation system, non-resident shareholders, who would suffer from the increase in the total company taxes upon distributed income from a maximum 46% (less with preferentially taxed income) to 49% (company tax and compensatory tax raising the effective total tax to this percentage on all income distributed). With the abandonment of the compensatory tax, distributions from preferential income items would probably escape the Australian tax net totally without the imposition of the withholding tax. The withholding tax on non-qualifying dividends was thus retained with distributions from income already taxed at 49% avoiding such tax as previously planned (Company Distributions Bill \textit{supra}, note 55 at § 11). The branch profits tax, however, will be completely abolished from July 1, 1987.

\(^2\) According to the Keating Announcement, \textit{supra} note 65, the amount to be included in the qualifying dividend account in each period (other than from franked dividends received) is calculated with regard only to "Australian company tax paid." See Company Distributions Bill § 14, proposed ITAA §§ 160 APK - 160 APV, particularly § 160 APT.

\(^3\) See also Vann and Parsons, \textit{The Foreign Tax Credit and Reform of International Taxation}, 3 Australian Tax Forum 131 (1986).

\(^4\) Keating Announcement, \textit{supra} note 65.
(thereby discriminating in favor of resident shareholders). Dividends to non-resident shareholders which were not from the qualifying dividend account would attract a dividend withholding tax, but then the recipient would not be subject to further assessment by Australian authorities. These proposals allow income subjected to full tax under the Australian company tax to be distributed without further tax at the individual level while assuring that income not fully taxed would not fully escape Australian taxation by subjecting it to the dividend withholding tax prior to payment to non-residents.

(b) Non-Resident Companies

The current proposals for the Australian imputation system do not make allowance for imputation to apply to distributions from non-resident companies. Where Australian source income is earned by a non-resident company, and is thus subject to full Australian taxation, a distribution to a resident shareholder might arguably be one which should be subject to relief from the double taxation by Australian authorities. Unfortunately, however, the obvious administrative difficulties which would be necessitated by provision of such relief makes the application of the imputation system to such transactions impractical. Consequently, all earnings through non-resident Australian companies will be subject to taxation without resort to imputation.

Treaty Complications

The new imputation system will result in a loss of revenue of between Aus $75 and Aus $300 million per annum according to Treasury estimates. It is not surprising then that its benefits are limited to resident taxpayers. Under the classical system in force prior to July 1, 1987, income distributed to a foreign shareholder in an Australian company would have been subjected to a tax at the company level of 46%. Additionally, the distributions from the company to the foreign shareholder would then be subject to a withholding tax of 15% or 30% depending upon whether the shareholder's country has a double tax treaty with Australia. Allowance of the imputation credit to a foreign shareholder

75 No refund based upon the excess imputation credit will be allowed to resident or non-resident shareholders according to Treasury announcements. While this is non-discriminatory on its face, its effect will be to discriminate against non-resident shareholders who would be less likely to have other types of income against which to use the excess imputation credit.


77 According to the September, 1985, announcement by Mr. Keating of the new tax package, the cost was estimated to be Aus$ 75 million. This was increased in the Keating Announcement *supra* note 65, to Aus$ 300 million.

78 See ITAA Division 11A.
would eliminate the company tax for foreign-owned companies, with only the withholding tax imposed upon distributions to non-resident shareholders. Although the administrative difficulties which resulted from a foreign shareholder's accumulation of net tax credits was eliminated by the general prohibition of cash refunds or carryovers of excess imputation credits, the reduction of tax revenue from the current 46% plus 15% of distributions to foreign shareholders (or 30% of distributions where no treaty exists) to a mere 15% or 30% of the amount distributed was undesirable.

Preventing the application of imputation credit to foreign shareholders will assure that income from such investments will be taxed at the applicable Australian company tax rate (normally 49%) or to the dividend withholding tax upon distribution where full company tax has not been imposed, because of preferences, at the company level. However, most of the tax treaties which Australia has with foreign countries require no harsher treatment in the taxation of the nationals of these countries than is afforded Australian residents, and renegotiation of these treaties may be necessary due to the discriminatory treatment of residential shareholders under the imputation system. Of particular concern is the treaty with the United States, which not only is a major capital exporter to Australia, but which has also been a difficult negotiator in its dealings with other countries where an imputation system has been introduced and whose benefits are not extended to United States residents.

The difficulties which Australia will face in the transition to an imputation system can be seen by examination of the experiences of West Germany, France, the United Kingdom and Canada. Each of these countries encountered international repercussions, particularly with the United States, upon their own abandonment of the classical system of corporate taxation. When corporate income was taxed under classical systems in most countries, income from transnational corporate investment had been effectively allocated by consideration of the company and its shareholders separately. While concessions in the international taxing

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79 But only if such credits could be refunded or applied to other tax liabilities.
82 See Vann, *supra* note 76, at 474-79.
scheme were often allowed for corporate direct investment in the country of the corporate investor's residence, the classical system provided easy demarcation in the ordinary case with company income being subject to tax at the company's residence and distribution to foreign shareholders being subject to tax again by the country of each shareholder's residence. Treaty limitations on the incidence of tax upon distributions to foreign shareholders assured that foreign investors would not suffer a disadvantage through double tax on distributions. This was reinforced by domestic credits for foreign withholding tax and by non-discrimination treaty articles.

With the West German introduction of a split rate system in 1953, the tax imposed by West Germany upon corporations depended upon whether the income was retained or distributed by the corporation. Due to the loss of revenue which the lower rate would cause when such distributions were made to foreign shareholders, the West German government generally negotiated an increase in the dividend withholding to tax at 25% (to offset the 20% differential between distributed and non-distributed income). This increase was not, however, accepted by the United States or Canada, both of which were successful in retaining a 15% withholding tax in their tax treaties.86

In 1977, the West German government introduced an imputation system which retained certain aspects of its former split rate system. Undistributed profits continued to be taxed at a higher rate than distributed profits, but the tax on distributed profits became available as a credit for each shareholder's personal tax liability. This credit on distribution has not been allowed to foreign shareholders and, additionally, the withholding tax of 25% been retained on the grounds that the reduced corporate tax rate for distributed corporate income needs to be offset under the imputation system, as under the former split rate system.87 The West German change from a split rate system to an imputation system, however, had the effect of redressing the advantage obtained by foreign shareholders due to the interaction of the tax treaties with the split rate system. The strength of the West German bargaining position as a capital, self-sufficient country, coupled with prior United States intransigence, enabled West Germany to avoid making the imputation credit available to foreign shareholders.88

In 1965, France introduced an imputation system allowing for a partial credit for corporate tax paid upon distribution of profits to share-

87 See Ault, Germany: The New Corporation Tax System, 8 INTERTAX 262 (1976). This system is also discussed in Kingson, supra note 83, Gourevitch, supra note 83, and in K. LAHEY AND S. SALTER, IMPUTATION ALTERNATIVES FOR AUSTRALIA, supra note 43.
88 See Kingson, supra note 83, at 1210-14.
The benefit of this credit was not extended by statute to foreign shareholders but concessions were made in 1968, under pressure from France's European Community partners, to allow the credit to portfolio investors. United States investors benefited from these concessions as the United States was able to have the same terms given by France to its European partners (particularly West Germany) applied for the benefit of United States residents. The distinction between portfolio and direct investment by companies has been effectively retained through treaty provisions by allowing the credit to shareholders who are taxed on the dividend and do not qualify either for an exemption or for credit relief for foreign corporate taxes under their domestic tax systems.

The United Kingdom, with an imputation system similar to that of France, was the first country to provide the imputation credit directly to United States residents. The United Kingdom allowed the imputation credit to foreign portfolio investors from the onset of their system. In the 1975 United States/United Kingdom treaty, however, the benefit of the imputation credit was extended to all investors. The generosity of the United Kingdom position, which even allows for refunds on the basis of an excess credit, may be attributable as much to the desire for external capital as to the diligence of its trading partners in their tax negotiations.

The difficulties faced by Australia in limiting the benefit of the imputation credit to foreign investors, particularly from the United States, is usefully illustrated by reference to the Canadian experience. As they had successfully done indirectly with France and directly with the United Kingdom, the United States authorities sought to have the benefit of the Canadian imputation credit applied to United States nationals upon the introduction of the Canadian imputation system. The Canadian negotiators were able to successfully prevent the imputation credit from applying to United States nationals by maintaining that their sys-

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90 Portfolio investment, though defined differently in various treaties, usually includes investment by foreign corporate shareholders holding less than ten percent of the shares in a domestic corporation as well as investment by foreign individual shareholders.
91 See Ault, supra note 87, at 473-74.
93 Finance Act (U.K. 1972) § 98.
94 Convention for the Avoidance of Double Taxation, Oct. 9, 1978, United States-United Kingdom, art. 10, T.I.A.S. No. 9580. Only one half of the credit benefit, however, is allowed direct investors. The relationship between the British imputation system and the United States tax laws is discussed in Kingson, supra note 83, at 1214-17.
95 Kingson, supra note 83, at 1207.
96 Krever, supra note 81, at 386.
tem was intended more to promote Canadian share investment than to correlate the corporate and individual tax rates. This argument was strengthened by the lack, in Canada, of any compensating mechanism for super-imputation as found in West Germany, France and the United Kingdom. The United States' compliance with Canada's request in this regard may partially be explained by the special relationship between the two countries; however, academic criticism of the American concessions make the prospect of similar Australian success even less likely.

Differences between the Canadian and Australian systems for company/shareholder taxation accentuate the clear relationship in Australia between the company tax and the shareholder credit which was absent in Canada. The Australian imputation system, as originally proposed, included a compensatory tax which served to distinguish it from the Canadian system. The December, 1986 proposal to allow imputation credits only to distributions from income which has borne full tax makes an assertion that the imputation credit in Australia is a subsidy for Australian investment rather than an attempt to correlate the tax on companies and shareholders even less plausible than the Canadian submission. It is for these reasons that the reduction of both the withholding tax and the branch profits tax on distribution which, for Australian residents, would have carried the imputation credit, must be partially attributed to Australian concern with the position of the United States on the discrimination issue. Whether these concessions will satisfy the Australian treaty partners so as to forego the imputation credit for their resident shareholders remains to be seen. Whatever the outcome, overseas investors nevertheless face a lower total Australian tax burden on corporate income because of the reduction of dividend withholding tax and branch profits tax, even though the full benefit provided Australian shareholders by the imputation system may not be realized.

CONCLUSION

The changes in the Australian tax system instituted on July 1, 1987, will undoubtedly bring direct benefits to foreign investors in Australian companies, and may also, thereby, benefit Australia itself by enticing greater foreign capital investment into the country. Admittedly, each Australian company will now be subject to a 49% company tax and will consequently have less after-tax profits to reinvest should accumulation of earnings be desired; however Australian companies which have policies of high distributions of earnings will be more attractive to foreign

98 See Kingson, supra note 83, at 1255-62.
99 See Vann, supra note 76, at 468-74.
investors, including those from the United States, whatever the outcome of United States/Australia tax negotiations. Income earned through Australian companies will now be subject at most to the 49% company tax for foreign shareholders, representing a tax increase of 3% on company earnings which is more than amply offset by the elimination, in most cases, of the withholding tax on dividend distributions. Likewise, because of the abandonment of the compensatory tax mechanism, Australian companies which benefit from the preferential treatment afforded certain types of income will continue to be attractive notwithstanding the introduction of the new imputation system.

More importantly, the new Australian system for the taxation of companies and shareholders, though perhaps merely a variation on the European theme, provides several useful innovations for the coordination of company and shareholder taxation. The alignment of the highest individual tax rate with the company tax rate, in conjunction with the provision of full imputation benefits on distributions from fully-taxed company income, eliminates, with laudable success, the distorting effects of the Australian tax on company investment. Unfortunately, concessions to erosion of the revenue base have resulted in certain theoretical imperfections in the imputation model employed. Limitations on the use of excess imputation credits, retention of double taxation for certain preferential income items, and the maintenance of the highly favorable treatment of capital gains all provide tax biases which will distort the purely commercial considerations relating to the use of companies. In spite of these compromises, the correlation of the company and shareholder taxation achieved in the Australian model presents new perspectives on the company/shareholder taxation reform debate which warrant consideration.