Tax Harmonisation

Research Topic: Harmonisation of Australia and New Zealand tax systems under a single economic market

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A dissertation submitted to
Auckland University of Technology
In partial fulfilment of the requirements for the degree of
Master of Business (MBus)

2011
School of Business and Law
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Attestation of Authorship

“I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person (except where explicitly defined in the acknowledgements), nor material which to a substantial extent has been submitted for the award of any other degree or diploma of a university or other institution of higher learning.”

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Wanshan Yang
Acknowledgements

The author would like to thank professor Chris Ohms for the support and assistance with this research. His inspiration, constant direction and encouragement motivated me to enter this research deeply. In particular, he shared his knowledge and opinions on tax harmonisation.

Thank you to Ken Hyde and Bill Doolin for introducing the techniques and philosophical issues in research to me. To Melanie Shepherd, thank you for guiding me in using databases for research.

Also, I acknowledge the assistance of Julie McMeikan who proofread the final draft of this dissertation for spelling and grammar.
Abstract

Australia and New Zealand have an ambitious intention of driving towards a trans-Tasman Single Economic Market (SEM) based on common regulatory frameworks. Tax harmonisation is a key part in the process of becoming a SEM. The Australian and New Zealand tax systems share a common culture in many ways. This dissertation examines the possibilities and difficulties for Australia and New Zealand in putting aside tax competition to harmonise their current tax systems under a SEM. The researcher carried out a secondary analysis and quantitative data analysis to gain insight into the influences on tax harmonisation. The data resources were mostly retrieved from the official statistics websites of both countries.

This research took an economics approach in analysing tax incentive and tax administration. It gives insight into the income tax model and current tax system in New Zealand and Australia. Based on the principles of a good tax system, and the differences in both tax systems, the researcher provides a range of suggestions for tax harmonisation of the tax base, tax entities, tax rates and tax rules. In terms of tax policy innovation, the study concerns the effects of reforming existing tax policies instead of adopting streamlined agreement. For reasons of length, this dissertation focuses only on the structure of the tax systems rather than the wording of the tax legislation.
**Introduction**

Australia and New Zealand have the closest and broadest economic and trading relationships in the Pacific. They share many similarities -- there is strong historical connection with collective social, political and cultural values. The Australia New Zealand Closer Economic Relations Trade Agreement (CER) provides the foundation for the current extensive trading relationship. Compared with other small OECD countries,\(^1\) New Zealand has a high corporate tax rate. New Zealand also has a high personal tax rate compared to Australia. Highly skilled labour has been flowing from New Zealand to Australia in recent years. The variability of tax rates influences peoples’ behaviour, and this is driving investment into areas where a lower tax rate applies (OECD tax policy studies No.17, 2007). International competition for capital and labour has an impact on the sustainability of tax. Deadweight costs arise in the way taxes influence how people act and in the costs to taxpayers in complying with the tax system.

Collecting tax is the true intention and spirit of tax legislation. International competition for labour and capital means that the tax system should not be considered in isolation within an economy. Under such intensive competition for capital and labour, especially in the context of a worldwide economic recession, most countries are concerned with reviewing their current tax system in order to boost their national economies (OECD Economic Survey, 2007). Considering the close relationship between Australia and New Zealand, it is essential that both tax systems are harmonised in order to create a SEM in the Pacific. Obstacles to trans-Tasman investment and trade should be removed to allow the free flow of labour, capital, goods and services across the Tasman.

It is necessary to simplify the current tax system and increase its efficiency with lower revenue collection costs. The figure from New Zealand Inland Revenue indicates that individuals use companies and trusts to shelter personal income from higher rates of personal tax. Many people receive more in tax credits than they pay in tax because of a large transfer system. Only a fair and efficient tax system can help to boost national economies with strong competition in the labour and capital market (Head & Krever, 2009).

\(^1\) The average company tax rate of OECD countries was 26 per cent in 2008.
Creating a SEM is a precondition for tax harmonisation in New Zealand and Australia. Both governments have reached this view on creating a common economic market.\(^2\) Some business legislation is in the process of being harmonised. Tax reforms are under review by the Tax Working Group (TWG) in New Zealand. Tax harmonisation between Australia and New Zealand will be possible in the near future.

It is inevitable that an economic approach to tax reform is taken, due to the special characteristics of taxation law. In Part I, the researcher discusses the economic efficiencies and compliance costs of the tax system in order to demonstrate the need for a change of tax system under a SEM. Part II compares the differences in the Australia and New Zealand tax systems. Section 3.0 provides an overview of the broad-based low-rate tax system which is currently adopted in Australia and New Zealand. Section 4.0 introduces McIntyre’s income tax model. Sections 5.0 and 6.0 compare the current changes in the tax systems in Australia and New Zealand. Both tax systems have experienced modification and innovation in the last two decades. Because of the limitation on the length of this dissertation, these sections capture only the key features of the current tax systems in order to contrast the differences between these two systems.

Part III analyses the principles of a good tax system and options for tax harmonisation. In the last two decades, tax experts have put great effort into improving and completing the current tax system to better serve Government budgeting. However, there are difficulties harmonising tax with another country because the tax systems must work well for both countries. Tax experts have to consider future tax reforms in relation to both countries, as each government has a different tax strategy for boosting its economic growth and tax revenue. Part III illustrates the possibilities and difficulties of tax harmonisation in Australia and New Zealand. Based on these analyses, the author makes some suggestions on future tax reform needed to achieve tax harmonisation under a SEM.

Part I: Tax Economic Efficiency and Compliance Costs

Overview

Collecting tax revenue is the main purpose of imposing a range of legislation on taxation. The Government has to fund enough money for public services and welfare. Generally, taxpayers are only liable for paying tax in their resident country. In these days, capital and labour are more mobile because of international trade. People are required to pay tax on the income which is derived in other countries. In some countries, travellers are also required to pay the same consumption tax as the local residents. The development of globalisation brings new challenges in taxation coordination and tax administration.

In order to enhance the competitiveness of international trade and investment, Australia and New Zealand have the ambitious intention of creating a SEM which is similar to the European Economic Community. Both countries have adopted the International Accounting Standards for financial statements. Some business and investment legislation is in the process of being harmonised. The first section will review what has improved in tax coordination and foresees the need for changes in the tax system under a SEM. The second section focuses on the economic features of tax policy and the tax system. Tax harmonisation is the solution for improving economic efficiency and reducing tax compliance costs of creating a SEM.

1.0 The Need for a Change of Tax System under a SEM

Australia and New Zealand share many similarities in economic, social, political and cultural values. Because of the geographical closeness and common features in the tax systems, they have introduced notable tax changes to reduce or eliminate double taxation. One of the reasons for tax cooperation is to reduce the opportunity for tax evasion across the Tasman. Both countries have increased their coordination and harmonisation of tax policies in order to assess their residents’ tax activities effectively.

There are three stages involved in achieving tax coordination and harmonisation between Australia and New Zealand. The first stage was when both countries entered into a double tax agreement to eliminate double taxation on trans-Tasman investment. In the second stage, Australia and New Zealand expressed the intention to create a SEM
in the Pacific. This new economic union changes their roles from competitors to trading partners. The third stage is harmonising tax policies to ensure taxpayers have similar tax treatment in their investing activities in both countries. At present, the Australia and New Zealand governments are working toward the last stage – tax coordination and harmonisation. The following sections will demonstrate the key features of the different stages.

- Double tax agreement

The current international income tax system includes unilateral rules and bilateral double tax treaties. Unilateral rules deal with cross-border investment and income flows, while bilateral double tax treaties deal with broader double taxation problems arising from overlapping source or residence rules. Double tax treaties are based on models that were developed by the Organisation for Economic Cooperation and Development (OECD) and the United Nations (UN) in the 1920s and 1940s (Rigby, 1991). Double tax treaties are concerned with avoiding double taxation occurring when two tax systems overlap. New Zealand has double tax treaties or agreements with 35 countries.3

In 1983, New Zealand and Australia signed a comprehensive free trade agreement and set a model for both countries in the negotiation of newer free trade agreements.4 In 1995, both countries entered a double taxation agreement, which was designed to share the cost of eliminating double taxation. It was aimed at reducing tax impediments to cross-border trade and investment, and assisting with tax administration.

In the early stages, the Trans-Tasman Mutual Recognition Arrangement (TTMRA) focused on eliminating tariff barriers to trade and investment by legislative means. In July 2005, New Zealand and Australia made progress in establishing the Joint Therapeutic Product Agency. Also, the effectiveness of the TTMRA is a driver in achieving a single economic market. Both countries share a common goal of reducing trade-distorting subsidies and improving market access.

On 22 March 2010 an updated double tax agreement (DTA) between Australia and New Zealand replaced the agreement entered into in 1995. It reduced withholding tax rates

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3 They include Australia, Austria, Belgium, Canada, Chile, China, Czech Republic, Denmark, Fiji, Finland, France, Germany, India, Indonesia, Ireland, Italy, Japan, Malaysia, Mexico, Netherlands, Norway, Philippines, Poland, Russia, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland, Taiwan, Thailand, United Arab Emirates, United Kingdom and United States (Source: New Zealand Ministry of Foreign Affairs and Trade).

4 Australia and New Zealand Closer Economic Relations (CER) Ministerial Communiqué, retrieved from Australian Department of Foreign Affairs and Trade website.
on certain non-portfolio dividends and cut the tax rate on royalties. It also includes a provision for the trans-Tasman mobility of pensions. Under s BH 1(4) of *Income Tax Act 2007* the DTA is paramount over other taxation law. The DTA is a vital step in building up a tariff alliance between Australia and New Zealand.

- Trans-Tasman SEM

The idea of a SEM comes from the European Economic Community. A SEM is defined as “an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured” (*Single European Act 1987*). There should be no discrimination in regional markets for goods, services or factors, i.e., no obstacle for the movement of goods and people within the Community. Lloyd (2005) noted that national treatment is not enough to ensure a SEM. In other words, it requires more than a fair trade agreement between the countries within SEM. Political decision-makers and bureaucrats must fully understand the meaning of a single market, and the measures required to implement it, otherwise it is difficult to achieve the goal of a single market.

Australia and New Zealand share many similarities -- there is a strong historical connection with collective social, political and cultural values. Both countries are constantly working towards further growth and prosperity through trade, boosting favourable business environments and attractive markets. The TTMRA, which entered into force in 1998, is a central instrument in regulatory coordination and a key foundation in both governments’ efforts to create a seamless trans-Tasman SEM.

In January 2004, the Australian and New Zealand Prime Ministers announced an intention of creating a seamless trans-Tasman business environment. This required providing a seamless regulatory environment for business, consumers and investors across the Tasman. There is a broad range of initiatives within the SEM work programme, which can be grouped in four themes: reducing the impact of borders; improving the business environment through regulatory coordination; improving regulatory effectiveness; and supporting business opportunities through industry and innovation policy cooperation.⁵

The process of forming a SEM occurs across a range of areas including banking regulation, business law co-ordination, competition and consumer policy and taxation. Australia and New Zealand have already identified a range of shared outcomes in the

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areas of insolvency law, financial reporting policy, financial services policy, competition policy, business reporting, corporation law, personal property securities law, intellectual property law, and consumer policy. On 14 January 2010, the New Zealand Ministry of Foreign Affairs and Trade announced that the focus of work in taxation would be around the coordination of tax systems.

- Tax harmonisation under a SEM

Tax harmonisation is different from achieving a DTA between countries. It presents a higher level of government policy coordination and harmonisation. The TWG believes that “for New Zealand to have a world-class tax system and to ensure that the system is sustainable in the medium-term, significant changes are required to the current tax mix and base. Small changes at the margin are unlikely to achieve this” (TWG, 2010). In order to harmonise the tax systems between Australia and New Zealand, both countries have to make further progress on tax reform.

In 2003, the Australian and New Zealand governments enacted legislation to permit trans-Tasman companies to allocate their shareholders’ franking credits and imputation credits. This legislation was a major improvement in trans-Tasman taxation. Dunbar (2005) explains that a triangular investment occurs when a shareholder resident in Australia or New Zealand invests in a company resident in the other jurisdiction that earns income and pays tax in the shareholder’s home jurisdiction. There were some loopholes in the current imputation system. The recent Westpac and BNZ cases raise a caution on tax avoidance using triangular investments.

Another example of a loophole is the different tax requirements of foreign trusts in the two countries, which also gives investors the opportunity to directly or indirectly avoid, reduce, alter, relieve or postpone their tax liability. Sharing the same information system for tax residents in Australia and New Zealand is the ideal solution for detecting tax avoidance issues. New Zealand and Australia recently entered an information exchange agreement. This improves the efficiency in identifying and investigating tax avoidance and evasion issues. In Part III, this research will discuss the improvements in the current imputation and tax administration systems in Australia and New Zealand.

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One of the most important tax harmonisation issues is reforming the tax administration process. Creating a fair administration system could release the tension between taxpayers and tax authorities. Ryan (1999) points out there is a growing sense of unfairness when the tax authorities are forced to push every margin to its limit to extract more from the tax base, and some taxpayers are able to get around the more stringent rules while others are not. From the point of taxpayers’ view, people are concerned about the disputes procedure and the tax authority. It will be a big challenge for governments and taxpayers to keep compliance and administration costs to a minimum.

The above paragraphs outline the development of the trade relationship between Australia and New Zealand in the last three decades and indicate the necessary changes for the tax system under a SEM in the near future. The double tax agreement helps to avoid double tax on residents’ income. Tax harmonisation encourages foreign investors to contribute capital to businesses which are located in Australia or New Zealand. The following section will further discuss the economic efficiency and compliance costs in the tax system. Those economic factors influence individual behaviours and trading patterns.
2.0 Economic Efficiency and the Administration Cost of the Tax System

The modern microeconomic approach to measuring economic efficiency and tax incentives is based on Adam Smith’s observations. In Wealth of Nations, Smith recognised that tax levies may change the behaviour of taxpayers. He wrote:

> It may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and unemployment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds which might enable them more easily to do so.\(^8\)

Smith believed that if the tax system was simple and easy to administer the economic effect of taxes would be minimised. Some economists might argue about his observation because it was put forward in 1776. The following paragraphs will discuss the effect of taxes on taxpayers’ behaviour and the costs of administering today’s modern tax systems.

2.1 Economic efficiency and tax incentives

To ensure fair competition, economists suggest that the same laws that apply domestically should be extended internationally. Australia and New Zealand have applied the same laws to trade between themselves that they apply domestically. Stiglitz (2008) states that the demand for any asset depends on its average return, risk, tax treatment and liquidity. The “efficient market” theory perfectly reflects the characteristics of assets. Meanwhile, people make economic decisions, whether as consumers, workers or investors, based on the real costs and benefits of their choice rather than the tax preferences attached to them (Coyne, 2009).

Going by the experience in the creation of a single European market, taxation was one of the most sensitive issues, and the most difficult proposal for the European Commission to enact (Watson, 1988). For example, the tax on petrol, alcohol and tobacco was significantly lower in Luxembourg than it was in Belgium in 1988. These differences were compounded by the VAT rates: it was 19 per cent in Belgium but only 12 per cent in Luxembourg. The price differential justified travelling some distances to buy petrol and drink in Luxembourg. At that time, not only were the rates of VAT

different within the Community, a number of rates on operating goods also applied in each country. In order to reach the completion of the internal market by 1992, the Commission proposed that there should only be a standard rate and a reduced rate. An increased GST or corporate tax rate is going to pass from the business to the final consumer. Generally, decreased GST or corporate tax might result in a reduced selling price for the goods.

New Zealand might be disadvantaged in terms of tax competition if it maintains higher tax rates than Australia. Leach (2003) examined the connection between high taxes and reduced economic growth in the major industrialised economies from 1992 to 2002. He found that those countries with low or reducing tax rates had significantly stronger growth rates than those with high or increasing taxes. New Zealand’s tax rates cannot be set completely independently of other countries’ rates – in particular, Australia. International competition for capital and labour will impact on the sustainability of the corporate and personal tax rate.

From the Government point of view, tax revenue is the main source for funding public spending. The effects of the global crisis were reflected in reduced business profits and investment income which flowed through to a lower company or capital gains tax receipt. In the financial year 2010/11, total tax revenue ($60.3 billion) contributed 29.6 per cent of GDP in New Zealand. It is 1.4 per cent lower than the last financial year. In Australia, total tax revenue ($187.0 billion) was $1.5 billion lower than expected in the 2009/10 financial year. The Government has to budget its spending based on tax revenue, which is affected by economic performance.

Based on the tax incentive theory, the Government could introduce a new tax policy to influence the taxpayers’ behaviours and investment patterns. Whether a new tax policy could maximise economic efficiency depends on the current financial environment and the tax competition from other countries. Tax harmonisation is the essential step in creating a SEM. Author suggests that it is time to move further toward taxation harmonisation between Australia and New Zealand because of its effect on goods pricing. This will be discussed further in Part II with a comparison of the current tax systems in Australia and New Zealand.
2.2 Tax administration and compliance costs

Generally speaking, a good tax system should be as simple and stable as possible. It could help to reduce the costs for both individuals and businesses in reading the rules, filling out the forms and doing all the other things required to meet the tax laws. It is important for the policy-makers to have an estimate of this compliance cost, because the performance of the economy is affected by tax law. Making compliance as straightforward as possible is a driver of economic efficiency. This section focuses on identifying the relationship between tax administration and compliance costs. The compliance cost model indicates the importance of simplifying the current tax administration process.

- **Tax administration**

In New Zealand, tax administration covers a broad range of activities which are governed by the *Tax Administration Act* 1994 (TAA94). The Inland Revenue Department (IRD) is given the responsibility to collect most of the revenue under the Inland Revenue Acts. The IRD cooperates with a number of government agencies: Accident Compensation Corporation (ACC levies), New Zealand Customs Service (collection of GST), Department of Labour (paid parental leave) and Department of Social Welfare (child support, family assistance and student loans). In order to minimise revenue risks and maximise the opportunities to collect tax, the IRD also cooperates with the Australian Tax Office (ATO) and other foreign tax authorities, such as the OECD.

The IRD has the responsibility of administering the law fairly and impartially, and maintaining the confidentiality of the affairs of taxpayers. Section 16 of TAA94 provides the Commissioner of Inland Revenue (CIR) with broad powers which are not limited to the acquisition of evidence or information that may lead to or support a prosecution for an offence against the tax statues. The CIR has unrestricted access to all properties, books and documents, subject to specific statutory restrictions, secrecy, privilege or other established principles: see *National Bank of NZ Ltd v CIR*. In ER

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9 TAA94, s 5.
10 Ibid, s 6.
Squibb case, the judge was concerned that the CIR must have reasonable grounds for considering the documents to be necessary or relevant.  

The CIR has the statutory power to make assessments and determinations. A dispute may arise when a taxpayer and the IRD have not reached agreement on self-assessment and determinations. Failure to meet tax obligations may result in civil penalties, criminal penalties, or both. On 23 September 2004, the IRD released exposure draft INA0009: Interpretation of s BG 1 and GB 1 of the Income Tax Act 2004. It highlighted the most significant decisions since 1990, including O’Neil, BNZ Investments, Auckland Harbour Board, Westmoreland, and a selection of leading decisions from the High Court of Australia. In addition, the Income Tax Act contains a number of anti-avoidance provisions to protect the tax base from certain types of schemes and arrangements which are designed to reduce the amount of tax payable.

In Australia, the Taxation Administration Act 1953 (TAA) contain provisions dealing with the administration of the tax laws by the ATO. The TAA has become increasingly important. It contains the PAYG withholding and instalment regimes; generic offence and prosecution provisions; generic provisions dealing with objections, reviews and appeals under various tax laws; generic provisions imposing penalties for breaches of various tax laws; generic record-keeping provisions; the payment, ABN and identification verification system; and provisions governing the public, private and oral rulings systems.

The increasing inter-relatedness of the global economies, individuals’ business and investment activities span world widely. Australia and New Zealand have attempted to increase information sharing about income payments across borders. Both countries signed a Tax Information Exchange Agreement. This agreement only applies to specified persons who have evaded taxes providing there are reasonable grounds for suspecting evasion. However, both countries have no jurisdiction to require taxpayers to file information returns in other countries.

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12 ER Squibb & Sons (NZ) Ltd v CIR [1991] 3 NZLR 635.
13 TAA94, Part VI.
14 Ibid, s 149.
16 ITA07, s BG 1.
Compliance costs

Compliance cost in tax is the expenditure of time or money in conforming to government taxation requirements. Individuals and organisations have the extra burden of having to keep detailed tax records to facilitate their tax returns. They might need to pay someone skilled in the tax area. Because of the loss of tax revenue caused by under-reported income and over-reported deductions, the tax department has to increase auditing expenses and apply additional rules and regulations. These expenses are also considered to be compliance costs, which are shared with all tax payers.

Income tax law has been widely criticised for being too difficult to read and understand. The complexity of the law has also increased the costs of taxpayer compliance and government administration. In Australia, the Tax Law Improvement Project (TLIP) was established in 1993 following a report of a Parliamentary Committee recommending the setting up of a Task Force to rewrite the income tax law. The aim of the project was to restructure, renumber and rewrite the income tax law, rather than to reform the tax system or review tax policy. In late 1997, the New Zealand Government released the discussion document “Rewriting the Income Tax Act: Parts C, D and E”. The purpose of rewrite project is providing tax legislation with clear and plain language consistently.

The ATO introduced a compliance model\textsuperscript{17} for understanding and improving taxpayer compliance. This model shows that taxpayer compliance behaviour is influenced by business, industry, sociological, economic and psychological factors. It also indicates a continuum of taxpayer attitudes towards compliance and how different kinds of strategies could affect taxpayer’s attitudes. If the tax system is easy to comply with, taxpayers are more willing to do the right thing. The full force of the law will be used against those taxpayers who have decided not to comply. The model suggests that taxpayer behaviours could be influenced by the different tax strategies.


The New Zealand Inland Revenue Department (IRD) proposed a number of policies to reduce the tax compliance cost. In 2004, the IRD adopted Evans’s and Tran-Nam’s “total compliance costs” as the foundation of the compliance cost definition in its survey. The total compliance costs are calculated as:\(^{18}\)

\[
\text{(Direct monetary outgoings incurred by taxpayers + Imputed costs of time and resources spent by taxpayers) – Managerial benefits to taxpayers + Cash flow benefits to benefits to taxpayers + Tax deductibility benefits to taxpayers + Cash grants from the government)}
\]

In practice, this benchmark quantifying exercise has been simplified as:

\[
\text{Tax compliance costs = internal time + external advisor costs – (cash flow (benchmark) benefits + tax deductibility) + psychological costs [The definition excludes audit costs, computing and other internal non-labour costs, external payroll provider costs]}
\]

where:

- internal time = imputed costs of time spent by owners, staff, family, and friends
- external advisor = direct monetary outgoings to tax advisers (regular and occasional) costs
- cash flow benefits = financial benefits arising from the mismatch in timing between when taxes are collected and when they are remitted to the tax authority
- tax deductibility = for example, costs associated with using a tax advisor
- psychological costs = the level of stress associated with tax activities, including finding the money; measures are not converted to dollars

\(^{18}\) C. Evans and B. Tran-Nam, *The tax compliance costs of small and medium-sized business*, Atax, University of New South Wales, January 2004, p 12. A research report was commissioned by the New Zealand Inland Revenue Department.
In 2005, Colmar Brunton measured the tax compliance costs of small and medium-sized businesses in New Zealand. It showed corporations spend more on tax compliance than the other types of entities. All entities contribute more cost towards complying with income tax and GST.

**Table 1 New Zealand tax compliance costs – small and medium-sized businesses**

<table>
<thead>
<tr>
<th>Entity type</th>
<th>GST</th>
<th>Income tax</th>
<th>PAYE</th>
<th>FBT</th>
<th>Total costs (internal &amp; external)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporation</td>
<td>$2,296</td>
<td>$2,591</td>
<td>$696</td>
<td>$100</td>
<td>$5,677</td>
</tr>
<tr>
<td>Individual</td>
<td>$818</td>
<td>$1,579</td>
<td>$121</td>
<td>$3</td>
<td>$2,521</td>
</tr>
<tr>
<td>Partnership</td>
<td>$1,873</td>
<td>$2,079</td>
<td>$459</td>
<td>$9</td>
<td>$4,416</td>
</tr>
<tr>
<td>Trust</td>
<td>$1,027</td>
<td>$1,951</td>
<td>$197</td>
<td>$24</td>
<td>$3,202</td>
</tr>
</tbody>
</table>


The Inland Revenue’s policy objective is to make it as easy as possible for taxpayers to comply with their obligations, and as difficult as possible to avoid them. A number of Inland Revenue’s proposed changes aim to reduce the cost burden through easing cash flow and budgeting problems. Some tax experts have doubts about reducing tax compliance costs in increasing the alliance in tax policies between Australia and New Zealand. In Part III, this research will estimate the tax compliance costs of current tax policy harmonisation.

**Summary**

Part I demonstrates the development of a trading partnership between Australia and New Zealand. It focuses on the taxation cooperation history in last three decades. Tax harmonisation becomes the key step in building a closer trans-Tasman trading partnership – a SEM. Section 2.0 highlights the economic efficiency and compliance cost of a tax system. The economic factors of taxation legislation are reflected in its influence on boosting economic growth and balancing wealth redistribution. This research concentrates on the effect of tax harmonisation on boosting economic growth under a SEM.
Part II: Tax System and Current Changes

Overview

Part II compares and contrasts the current tax systems in New Zealand and Australia. Section 3.0 outlines the common broad-based low-rate tax strategies in both tax systems. The broad-based low-rate principle provides the guideline for tax reform in both countries. It also becomes the basis of tax harmonisation under a SEM. Direct and indirect taxes compose the current tax base. Under the pressure of tax competition, new tax must be introduced in order to reduce the tax rate.

Income tax contributes the major part of tax revenue. Section 4.0 introduces McIntyre’s income tax model. This income model is used as the basis for an ideal income tax system design. It provides a formula for an affordable income tax base. The New Zealand government adopted the principle of “affordable tax” in its recent tax changes, reducing the income tax rate and increasing the GST rate. This principle could be applied to tax harmonisation.

Section 5 and 6 outline the similarities and differences in the current Australia and New Zealand tax systems. It focuses on the three major tax categories: income tax, capital tax and GST. The income tax system is divided into three subcategories: income tax base, income tax entities and income tax rate. These two sections provide an overall picture of the two tax systems. It indicates the direction for future tax reform leading to harmonising the current tax base, tax rates and tax rules.

3.0 Broad-based Low-rate Tax System

Comprehensive base-broadening and rate-reduction strategies are considered as the fundamental path to tax reform. Broadening the tax base makes the tax system more neutral in respect of economic decisions, allowing tax rates to be lowered while still increasing total tax revenue (Stephens, 1993). Since the mid 1980s, the New Zealand government has undertaken several tax reforms for broadening the tax base and reducing the tax rate. Smith (2009) considers that the intrinsic complexities of the
income base and progressive rates provide ongoing fertile ground for reform-minded policy attention.\textsuperscript{19}

From 1984 to 1987, the major changes were: reduction in the top personal tax rate; the introduction of a tax mix shift with a comprehensive, single-rate GST; the introduction of a compensatory programme for assisting low-income families; the introduction of a separate tax on fringe benefits; and the abolition of tax concessions. The mid 1980s tax reforms reduced the share of tax revenue from personal income tax from 64 per cent in 1984 to 49 per cent in 1990. In order to retain the same amount of tax revenue, governments must broaden their current tax base if they are forced to reduce tax rates under international economic pressure. In addition, the Government also introduced higher petroleum fuel taxes and an emission trading reduction scheme. The introduction of more indirect taxes is one method of broadening the tax base.

There have been hundreds of proposals regarding tax reform over the last 25 years. In 2001, an expert committee (the McLeod Committee) undertook a general review of the New Zealand tax system. The committee reviewed the proposal of introducing capital gains tax in New Zealand. The committee concluded that New Zealand should not adopt a general realisations-based capital gains tax because it believed that this type of tax

\ldots{} would not necessarily make our tax system fairer and more efficient, would not lower tax avoidance and would not raise substantial revenue that could be used to lower rates. Instead, any such tax would be more likely to increase the complexity and costs of our tax system. The experience of other countries (such as Australia, the UK and the US) supports that conclusion.\textsuperscript{20}

Johansson et al (2010) suggest that the tax on immovable property would be the least harmful tax instruments in terms of its effect on long-run GDP per capita.

Both the New Zealand Tax Working Group\textsuperscript{21} and the Henry Tax Review\textsuperscript{22} noted that the impact of high income taxes on individuals and companies may be harmful. A common international pattern is to set the rate of company tax below the top personal tax rate.

\begin{thebibliography}{9}
\bibitem{TaxWorkingGroup} The Tax Working Group considered the medium-term direction of the current New Zealand tax system of the time and worked through the pros and cons of a variety of policy options. It held a series of regular meetings between June and November 2009, and prepared discussion papers by officials or commissioned from tax experts.
\bibitem{HenryReview} The Australia's Future Tax System Review, informally known as the Henry Tax Review was commissioned by the Rudd Government in 2008 and published in 2010. The review was intended to guide tax system reforms over the next 10 to 20 years.
\end{thebibliography}
tax rate. In order to compensate for the reduction of company tax, the Government needed to broaden the tax base by introducing other new taxes. The introduction of GST marked a significant change in the mix of taxation from direct to indirect tax. GST has relatively low administrative and compliance costs. In general, the new tax on goods and services brought about 11 per cent and 8 per cent GDP in New Zealand and Australia respectively. In 2010, the New Zealand government decided to reduce personal tax rates, increase GST and change the tax rules on property investment.\footnote{See Budget 2010 (20 May 2010).} With international competition pressures, the company tax rate is rapidly falling. Australian taxation of corporate and capital income reduced from 46 per cent to 30 per cent between 1981 and 2010. The New Zealand corporate tax rate has decreased by 15 per cent, i.e. from 45 per cent to 30 per cent.\footnote{Refer to Appendix 1: Taxation of corporate and capital income for OECD countries.} From 1 April 2011, the New Zealand corporate tax rate reduced an extra 2 per cent to 28 per cent. It is similar to the current average corporate tax rate in OECD countries. The data from OECD countries indicates that a 1 per cent cut in the corporate tax rate generates a 2.6 per cent increase in private savings channelled through the corporate sector (Fuest & Weichenrieder, 2002). As discussed in Part I, the statutory tax rate particularly affects marginal decisions and generates issues such as profit shifting.
4.0 Income Tax Model

The merits of a tax provision depend on its contribution to the goals of the tax system. In a model tax system, all provisions of the system have specified functions towards achieving the same goal. McIntyre (1988) introduced an income tax model for specifying how a particular tax provision operates. This income tax model presents an ideal income tax system design. The model divides the provisions of an ideal income tax system into three categories: sorting rules, imposition rules, and tax expenditure rules.

The sorting rules are used for ranking taxpayers in accordance with their economic well-being. It can be subdivided into three subcategories: tax base rules, taxable person rules, and taxable period rules. The term “tax base” is adopted from the Haig-Simons income concept. It refers to “the class of economic benefits with respect to which a taxpayer is made taxable”. Henry Simons provides a formula:

\[ HSI = C + (NW_1 - NW_0) \]

Where:

- \( HSI \) is the taxpayer’s income sources for the taxable period;
- \( C \) is the market value of the taxpayer’s consumption for the period;
- \( NW_1 - NW_0 \) is the change in the market value of the taxpayer’s assets from the start of the taxable period \( NW_0 \) to the end of that period \( NW_1 \).

Base on the Haig-Simons principles, McIntyre looks to the sources of income as the starting point in identifying the tax base. He rewrites the formula as:

\[ HSI_{t,p} = S_{t,p} + (OA_1 - OA_0)_{t,p} + (NA - AC)_{t,p} - E_{t,p} - PD_{t,p} \]

Where:

- \( S \) = total realised income, including wages, investment income, realised capital gains, windfalls, gifts, and any taxable imputed income;
- \( OA_1 - OA_0 \) = the unrealised gains on assets held both at the start and the end of the taxable period, measure by subtracting the market value of those same assets held at the start of the period \( OA_0 \) from the market value of those same assets held at the end of the period \( OA_1 \);
- \( NA - AC \) = the unrealised gain on assets obtained during the taxable period, measured by subtracting the acquisition costs of those assets \( AC \) from the market value as of the end of the period of the newly acquired assets \( NA \);
\[ E = \text{the total of the taxpayer’s profit-seeking expenses (that is, payments that are intended to produce income and that do not either increase the value of an asset already owned by the taxpayer or produce an asset with utility that extends beyond the taxable period);} \]

\[ PD = \text{any personal deductions, such as the deduction for state and local income taxes, that are judged to fall outside of a refined definition of consumption.} \]

In the model tax system, the tax based rules are used for specifying the economic benefits. The tax authorities could apply the above formula to determine each taxpayer’s consumption expenditures. The taxable person rules are used to define the class of the persons or relating items of income to the persons subject to tax. In the model, the imposition rule is presented as the tax rate schedule. The tax expenditure rules are defined as specific rules to favour a particular industry, activity, or class of persons.

The following sections apply the income tax model to identify the tax base, tax entities and tax rate schedules in New Zealand and Australia. The result of the analysis shows the similarities and differences between both income tax systems. It indicates how far away we are from the ideal tax system and what would be improved in the current tax systems under a SEM.
5.0 Current Tax System in New Zealand

In New Zealand, the main taxes are income tax and goods & services tax (GST). As a result of major tax reforms undertaken since the mid 1980s, these taxes are applied at low rates to broad bases. This tax system has long been regarded as one of the most efficient tax system within the OECD. However, this system is facing challenges such as increasingly mobile capital and labour. The OECD has suggested a higher GST rate could help to reduce the risk in long-term fiscal sustainability.28

New Zealand-resident companies are subject to tax on all income derived locally and from abroad. The Income Tax Act 2007 uses the same procedure as the Income Tax Act 2004 to calculate taxable income for accounting purposes. It has provided tax cuts of NZ$1.1billion for businesses phased in over a four-year period. It has also changed the tax depreciation rules to encourage more productive use of capital.29

The global economy is shrinking because of the international financial crisis. The annual budget forecasts for growth show the economy in New Zealand as being nearly $50 billion smaller over the next three years compared to last year’s forecast.30 A shrinking economy means less tax revenue for government and mounting debt because of deficits. New Zealand is facing a critical need to raise tax revenue in the context of intense international capital and labour competition.

The following table shows New Zealand tax revenue as a percentage of gross domestic products (GDP) between 2005 and 2009. Total tax revenue contributes a lower percentage toward GDP because of the tax cuts on corporate income and personal income. The tax on goods and services remains at a similar level due to there being no change in the GST rate in that time frame.

Table 2 New Zealand tax revenue as a percentage of GDP

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total tax revenue</td>
<td>36.7</td>
<td>36.1</td>
<td>35.1</td>
<td>33.7</td>
<td>31.0</td>
</tr>
<tr>
<td>Tax on corporate income</td>
<td>6.2</td>
<td>5.7</td>
<td>5.0</td>
<td>4.4</td>
<td>3.3</td>
</tr>
<tr>
<td>Tax on personal income</td>
<td>15.1</td>
<td>14.7</td>
<td>14.8</td>
<td>13.7</td>
<td>12.7</td>
</tr>
<tr>
<td>Tax on goods and services</td>
<td>11.8</td>
<td>11.8</td>
<td>11.1</td>
<td>11.4</td>
<td>11.4</td>
</tr>
<tr>
<td>Tax on property</td>
<td>1.8</td>
<td>1.9</td>
<td>1.9</td>
<td>1.9</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Source: OECD Tax Statistics (2010), Revenue statistics: Comparative tables, (database)

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30 Budget 2010. Available at the New Zealand Treasury website.
5.1 Income tax


- Income tax base

New Zealand income tax is imposed on all the income of New Zealand residents and the income derived from New Zealand sources by non-residents. Section BC 1 of the *Income Tax Act 2007* provides a method for determining a person’s income liabilities. The following diagram illustrates the process for calculating taxable income.

**Graph 2** New Zealand taxpayer calculation of taxable income (s BC 1)
Income tax is the main source of revenue for the New Zealand’s Government. A reduction in the personal income tax rate caused a loss of revenue (refer to Table 2). The further reduction of the company tax rate is going to tighten up the current taxation of expenses. The loss of revenue from the income tax reduction should be paid for by broadening the income tax base. New Zealand employers are the subject to fringe benefit tax. A tax on capital gains is not included in the current income tax base. According to the McIntyre’s income tax formula, New Zealand’s current income tax base could be presented as:

$$H_{SI_{t,p}} = S_{t,p} - E_{t,p} - PD_{t,p}$$

Where:
- $S$ = total realised income, including wages, property income, business and statutory income;
- $E$ = the total of the taxpayer’s profit-seeking expenses (that is, payments that are intended to produce income and that do not either increase the value of an asset already owned by the taxpayer or produce an asset with utility that extends beyond the taxable period);
- $PD$ = any personal deductions, such as the deduction for state and local income taxes, that are judged to fall outside of a refined definition of consumption.

- Income tax entities

In the late 1980s New Zealand was ahead of international trends in introducing a broad-based consumption tax and reducing the rate of personal and corporate taxes. However, current New Zealand personal and corporate tax rates have become less internationally competitive. The mobility of labour and capital is putting pressure on the corporate tax system as well. This section focuses on the changes in tax rates and policies for individuals, partnerships, corporations and trusts.

(a) Tax on individuals

The tax rates for individuals changed on 1 April 2009 and again on 1 October 2010. As at 1 April 2009, the effective personal tax scales applying to personal income was as follows: 12.5 per cent on income up to NZ$14,000 per annum; 21 per cent on income between NZ$14,000 and NZ$48,000; 33 per cent on income between NZ$48,001 and NZ$70,000 and 38 per cent on income above NZ$70,001. A new tax credit was introduced for some earners who were not entitled to government assistance.

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Due to the heavy effect of the global economic recession and the increase in the GST rate in 2010, the individual tax rate changed just six months later. The new rates applicable from 1 October 2010 are as follows: 10.5 per cent on income up to NZ$14,000 per annum; 17.5 per cent on income between NZ$14,001 and NZ$48,000; 30 per cent on income between NZ$48,001 and NZ$70,000 and 33 per cent on income above NZ$70,001.

A reduction in the tax costs associated with international recruitment aims to improve access to skilled expatriate New Zealanders and foreigners. A four-year tax exemption on foreign income is available to new migrants or returning New Zealanders who have been non-resident for tax purposes for at least ten years. It was applicable from 1 April 2006.

(b) Tax on partnerships

Partnerships are not legal entities. But only partnerships can pass through net tax losses, while companies and trusts cannot. Although a partnership is not a taxpayer in its own right, it has to file a return of income showing the income jointly derived from the business, and how the income and deductions are allocated to the partners. A partnership is liable to deduct Resident Withholding Tax (RWT) from a payment of interest. When a partnership receives a dividend with an imputation credit or a dividend withholding payment credit, an imputation credit or RWT will pass through the partnership to the individual partners.

In order to encourage foreign venture capital into New Zealand, the Government announced a new limited partnership regime on 29 April 2005. The Limited Partnerships Act 2008 came into force on 2 May 2008. A limited partnership is a separate legal person and a flow-through entity for income tax purposes. It is utilised as an investment vehicle for foreign venture capital investors. Foreign investors are allowed to recognise their gains or losses in their home country. The Taxation (Limited Partnerships) Act 2008 imposed new tax provisions for partnerships and clarified the tax treatment of general and limited partnerships.

In subpart HG of the Income Tax Act 2007, a specific anti-avoidance rule applies for partnerships. It requires a partner of a partnership to enter into a transaction for consideration at market value. Special rules apply to non-resident partnerships.
Imputation and foreign dividend payment credits (excluding any supplementary dividends) pass through the partnership to the individual partners. Although an Australian limited partnership is treated as a company under Australian law, it retains partnership treatment for New Zealand tax purposes.  

(c) Tax on companies

New Zealand integrates its personal and business tax systems through full dividend imputation. The imputation system was introduced in 1988. A dividend-imputation system operates for dividends paid by resident companies out of after-tax income to resident shareholders. Under this system, dividend recipients receive an attached credit for taxes paid by the dividend issuer. The credit is normally 30 per cent, but it may be lower where a company has a lower tax liability. Dividends received by New Zealand resident companies from non-resident companies are subject to a special withholding tax of 30 per cent.

In August 2000, the Australian and New Zealand governments announced they would examine the tax treatment of trans-Tasman investments. In order to allow the New Zealand shareholders in an Australian company operating in New Zealand to access New Zealand-sourced imputation credits, the Australian and New Zealand governments released a joint discussion document on 6 March 2002. Under this trans-Tasman imputation system, Australian and New Zealand shareholders of trans-Tasman companies could allocate franking credits representing Australian tax paid and imputation credits representing New Zealand tax paid.

New Zealand companies distributing imputed dividends to shareholders must deduct any further RWT that brings the total tax component up to 33 per cent of the gross dividend amount. However, Australian companies have no responsibility to deduct

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32 See BR Pub 10/01, “Australian source income earned by Australian limited partnership and foreign tax credits”; BR Pub 10/02, “Distributions made by Australian limited partnership and foreign tax credits”; BR Pub 10/03, “Distributions made by Australian unit trusts to Australian limited partnerships and foreign tax credits”; BR Pub 10/04, “Franked dividends received by Australian limited partnerships and foreign tax credits”; and BR Pub 10/05, “Tax paid by an Australian limited partnership as a ‘head company’ and foreign tax credits”.

33 ITA07, s OZ 8.

34 Decreased from 33 per cent to 30 per cent from 1 April 2008.

RWT from dividends to New Zealand shareholders. The New Zealand shareholder is liable for the remaining tax due on that income.  

Interest payments to non-residents are subjected either to non-resident withholding tax or to a 2 per cent levy. In order to attract inward capital flows, New Zealand is considering whether to remove the 2 per cent levy on certain bond issues. The Government is renegotiating the current double tax agreement to reduce non-resident withholding tax on dividends to zero for shareholdings in excess of 80 per cent and 5 per cent for shareholdings of 10 per cent or more.

To take account of the reduction in the company tax rate from 33 per cent to 30 per cent from the beginning of the 2008/09 income year, the maximum imputation ratio for the 2008/09 income year and subsequent income years was reduced to 30:70 at the period ending on 31 March 2010. The Labour-led government announced a business tax reform package in the 2007/08 budget. Aligning with the Australian tax rate, the New Zealand government made a cut in the corporate tax rate from 33 per cent to 30 per cent which took effect on 1 April 2008. The corporate tax rate was reduced further to 28 per cent in 1 April 2011.

(d) Tax on trust

The current regime for trusts is defined in s YA 1. It took effect from the commencement of the 1988/89 income year (under the Income Tax Act 1976). It introduced some changes in the treatment of income derived by non-resident trustees. New Zealand resident settlors are liable for tax on trustee income derived during an income year. A foreign-sourced amount derived by a New Zealand resident trustee is deemed not to be income of the trustee. The tax treatment of trustee income, beneficiary income and taxable distributions is listed below.

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36 See Imputation and the company tax rate change fact sheet (IR237) for more details.
37 ITA07, s HC 29.
38 ITA07, s HC 26.
Table 3 Tax treatment of trustee income, beneficiary income and taxable distributions

<table>
<thead>
<tr>
<th>Distribution</th>
<th>Complying trust</th>
<th>Foreign trust</th>
<th>Non-complying trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-1/4/88 accumulated funds</td>
<td>Not taxable</td>
<td>Not taxable</td>
<td>Not taxable</td>
</tr>
<tr>
<td>Corpus</td>
<td>Not taxable</td>
<td>Not taxable</td>
<td>Not taxable</td>
</tr>
<tr>
<td>Arm’s length capital profits</td>
<td>Not taxable</td>
<td>Not taxable</td>
<td>Taxed at 45 per cent</td>
</tr>
<tr>
<td>Non-arm’s length capital profits</td>
<td>Not taxable</td>
<td>Taxed at beneficiary’s marginal tax rate</td>
<td>Taxed at 45 per cent</td>
</tr>
<tr>
<td>Post-1/4/88 accumulated funds</td>
<td>Not taxable</td>
<td>Taxed at beneficiary’s marginal tax rate</td>
<td>Taxed at 45 per cent</td>
</tr>
<tr>
<td>Trustee income</td>
<td>Taxed at 33 per cent.</td>
<td>Trustee income derived from New Zealand taxed at 33 per cent. Liable as beneficiary’s agent.</td>
<td>Trustee income derived from New Zealand taxed at 33 per cent. Liable as beneficiary’s agent.</td>
</tr>
<tr>
<td>beneficiary’s agent.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Beneficiary income</td>
<td>Taxed at beneficiary’s marginal tax rate in all cases except for beneficiary income derived by minor beneficiaries in certain circumstances.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: CCH, New Zealand Master Tax Guide39

- **Income tax rate schedule**

The following table summarises the current tax rates on income applying to individual, companies and trusts.

Table 4 New Zealand resident income tax rate schedule for 2011/12

<table>
<thead>
<tr>
<th>Tax entities</th>
<th>Income Bracket / Income type</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual</td>
<td>$0 - $14,000</td>
<td>10.5%</td>
</tr>
<tr>
<td></td>
<td>$14,001 - $48,000</td>
<td>17.5%</td>
</tr>
<tr>
<td></td>
<td>$48,001 - $70,000</td>
<td>30%</td>
</tr>
<tr>
<td></td>
<td>$70,001 and higher</td>
<td>33%</td>
</tr>
<tr>
<td>Company</td>
<td>All taxable income</td>
<td>28%</td>
</tr>
<tr>
<td>Trust</td>
<td>Trustee income</td>
<td>33%</td>
</tr>
<tr>
<td></td>
<td>Minor beneficiary income</td>
<td>33%</td>
</tr>
<tr>
<td></td>
<td>Beneficiary income</td>
<td>Taxpayer’s marginal rate</td>
</tr>
<tr>
<td></td>
<td>Distribution from a non-complying trust</td>
<td>45%</td>
</tr>
<tr>
<td></td>
<td>Income of Maori authorities</td>
<td>17.5%</td>
</tr>
</tbody>
</table>

Note: Currency is in New Zealand dollars.

5.2 Capital gains tax

Capital taxation refers to levies applied to income from capital: business profits, interest, individuals, capital gains, royalties and income from real property. It may help to enhance capital productivity and overall economic growth. This section mainly focuses on capital gains. Investors will only hold capital in New Zealand if the rate of return net of corporate taxes is the same as in other countries. They might shift their savings to jurisdictions where the after-tax return on capital is higher. It would be interesting to indentify how far the taxation of capital gains income would alter the distribution of taxable income.

New Zealand does not have a specific capital gains tax. It has a very limited capital gains tax. Regular corporate tax applies to gains from either (1) the sale of property purchased with the intention to resell at a profit, or profits from the sale of land arising from a scheme of development or subdivision if the work was of more than a minor nature and commenced within ten years of the date of acquisition; or (2) the trading of debt securities. Gains on debt securities are taxed on an accruals basis. The tax is calculated on the anticipated gain. There may be an adjustment at the end of the life of the instrument if there have been unexpected gains or losses. Capital gains on the profits of share trading are potentially taxable. As New Zealand does not currently have a general capital gains tax, it does not have an information collection mechanism in respect of capital gains.

In 2000, the OECD recommended introducing a realisation-based capital gain tax into New Zealand’s tax system. In 2009, the Tax Working Group suggested that a land tax should be introduced as part of a package of reforms to the New Zealand tax system.

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40 ITA07, s CB 6.
41 ITA07, s EW 46.
5.3 Goods and services tax

New Zealand imposes GST as a broad-based consumption tax under the *Goods and Services Tax Act 1985* (GST Act) on the supply of goods and services in New Zealand. The tax is generally levied at the standard rate.\(^{44}\) A distinguishing feature of New Zealand GST is the full inclusion of food and income taxation of retirement savings.

After GST increased from 12.5 per cent to 15 per cent, the Consumer Price Index (CPI) rose 2.3 per cent for the December 2010 quarter.\(^ {45}\) Retail prices could rise by 2.22 per cent if retailers passed all the added tax onto consumers. Consequently, CPI increased 4.0 per cent for the year to the December 2010 quarter.\(^ {46}\)

A Retail Trade Survey reported that in October total retail sales fell 2.5 per cent ($137 million) following a 1.7 per cent ($94 million) increase in September; core retail sales fell 1.6 per cent ($71 million), reversing the 1.7 per cent ($72 million) increase in September; supermarket and grocery stores recorded the largest increase, up 4.2 per cent ($58 million).\(^ {47}\) The latest Retail Trade Survey reported that November total retail sales rose 1.5 per cent ($82 million); core retail sales decreased 0.2 per cent ($7 million); and supermarket and grocery stores recorded the largest decrease, down 2.8 per cent ($40 million).\(^ {48}\)

Based on the analysis, the behaviour of consumers is influenced by tax rate changes. Although the New Zealand government expected that the income tax cuts would compensate by increase in GST, the retail survey indicates that consumers cut down their shopping lists when goods and services became more expensive with the extra tax add-on.

Further, tourists might choose a cheaper place for a holiday. The GST rate in New Zealand is 5 per cent higher than that in Australia. New Zealand could lose competitiveness in the tourism industry even if the New Zealand currency exchange rate is 20 percent lower than for Australian currency. The following graph shows that taxes on goods and services reached the highest level (measured in US dollars at US$14,916,790,000) in 2007, and then reduced slightly during the economic recession.

\(^{44}\) GST Act, s 8(1). The standard rate increased from 12.5 per cent to 15 per cent after 1 October 2010.
\(^ {46}\) Statistics NZ visited 3,000 shops around New Zealand to collect prices for the CPI. The CPI measures the rate of price change of goods and services purchased by households.
Graph 3 Taxes on goods and services in New Zealand

Source: OECD Statistics
6.0 Current Tax System in Australia

From 1923 to 1926, vital cooperation occurred between the Commonwealth and state governments on the collection of state and federal income taxes. In 1936, the Commonwealth Income Tax Assessment Act 1936 was adopted as the model for income tax legislation. The state revenue departments collected both their own tax and the federal taxes. The Commonwealth achieved power over the states in income tax matters by passing legislation in 1942.

The states and territories raised additional tax revenue in order to compensate for the states’ and territories’ basic spending requirements. According to s 90 of the Constitution, only the Commonwealth has the power to levy duties of excise. In order to minimise the potentially serious impact on state and territory revenues, goods and service tax (GST) was introduced and collected by the Commonwealth from 1 July 2000. The allocation of GST revenue is based on an equalisation formula which reflects the capabilities and needs of each state.

The following table shows tax in Australia as a percentage of GDP between 2005 and 2009. The total tax revenue contributes a lower percentage toward GDP with the tax cuts on corporate income and personal income. The tax on goods and services remains at a similar level because there has been no change in the GST rate.

Table 5 Australia tax as a percentage of GDP

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total tax revenue</td>
<td>30.1</td>
<td>29.8</td>
<td>29.3</td>
<td>29.5</td>
<td>27.1</td>
</tr>
<tr>
<td>Tax on corporate income</td>
<td>5.5</td>
<td>5.8</td>
<td>6.4</td>
<td>6.8</td>
<td>5.9</td>
</tr>
<tr>
<td>Tax on personal income</td>
<td>12.1</td>
<td>11.8</td>
<td>11.0</td>
<td>10.8</td>
<td>10.2</td>
</tr>
<tr>
<td>Tax on goods and services</td>
<td>8.6</td>
<td>8.3</td>
<td>8.0</td>
<td>7.9</td>
<td>7.4</td>
</tr>
<tr>
<td>Tax on property</td>
<td>2.6</td>
<td>2.6</td>
<td>2.7</td>
<td>2.6</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Source: OECD Tax Statistics (2010)

6.1 Income tax

Income tax was first introduced in Australia by its states, commencing with South Australia in 1884. The states and the Commonwealth established a uniform tax system in 1916. From 1923, federal income tax was collected by state officials in order to minimise the duplication of administrative facilities.

- **Income tax base**

Australia income tax is imposed on all income of Australia residents and the income derived from Australia source by non-residents. *Income Tax Assessment Act* 1997 provides a method for determining a person’s income liabilities. Section 4-10(3) gives a formula for calculating income tax as: Income tax = (Taxable income x Rate) – Tax offsets. The following diagram illustrates the process for calculate taxable income.

**Graph 4 Australia taxpayer calculation of taxable income**

Compared with the New Zealand income tax base, the Australian income tax base is broader with a general realisation capital gains tax. Capital gains and losses are realised for tax purposes when an asset is sold. The absence of a social security tax means Australia has put a high tax burden on capital income compared with other OECD countries. According to the McIntyre’s income tax formula, Australia’s current income tax base could be presented as:

\[ HSI_{t,p} = S_{t,p} - E_{t,p} - PD_{t,p} \]

*Where:*

- \( S = \) total realised income, including wages, property income, realised capital gains, windfalls, gifts, and business income;
\[ E = \text{the total of the taxpayer's profit-seeking expenses (that is, payments that are intended to produce income and that do not either increase the value of an asset already owned by the taxpayer or produce an asset with utility that extends beyond the taxable period);} \]

\[ PD = \text{any personal deductions, such as the deduction for state and local income taxes, that are judged to fall outside of a refined definition of consumption.} \]

- Income tax entities

This section focuses on the changes in tax rates and policies for individuals, partnerships, companies and trusts in the last ten years.

(a) Tax on individuals

The tax rates for individuals, who are residents of Australia for tax purposes, changed in 2009 and again in 2010. 49 In 2009, the effective personal tax scale applying to personal income was as follows: no tax on income up to AUD$6,000 per annum; 15 per cent on income between AUD$6,001 and AUD$35,000; 30 per cent on income between AUD$35,001 and AUD$80,000; 38 per cent on income between AUD$80,001 and AUD$180,000; and 45 per cent on income above AUD$180,000.

On 1 July 2010, the effective personal tax scale applying to personal income was as follows: no tax on income up to AUD$6,000 per annum; 15 per cent on income between AUD$6,001 and AUD$37,000; 30 per cent on income between AUD$37,001 and AUD$80,000; 37 per cent on income between AUD$80,001 and AUD$180,000; and 45 per cent on income above AUD$180,000.

Resident individuals whose total annual taxable income from all sources exceeds the threshold of AUD$6,000 are required to file a return. A return of income must also be filed by a resident unmarried minor whose total income exceeds AUD$3,000, which is not from employment or personal services rendered. 50 Special lodgement requirements also apply to taxpayers entitled to certain government pensions, allowances and benefits.

An essential element is identifying the residence of a taxpayer. According to the general scheme of tax legislation, an Australian resident’s assessable income includes all ordinary income and all statutory income from all sources, whether in or out of

\[ \text{49 See ATO website, retrieved from } \text{<www.ato.gov.au/individuals/content.asp?doc=/content/12333.htm&mnu=42583&mfp=001/002>}. \]

\[ \text{50 Special rates of tax are applicable under ITAA36 Pt III Div 6AA.} \]
A foreign resident’s assessable income includes only ordinary income and statutory income from all sources in Australia, plus certain other amounts which are not dependent on an Australian source.

The tax rates for individuals, who are non-residents of Australia for tax purposes, changed in 2009 and again in 2010. In 2009, the effective personal tax scale applying to non-resident personal income was as follows: 29 per cent for the income up to AUD$35,000; 30 per cent on income between AUD$35,001 and AUD$80,000; 38 per cent on income between AUD$80,001 and AUD$180,000; and 45 per cent on income above AUD$180,000.

On 1 July 2010, the effective personal tax scale applying to non-resident personal income was as follows: 29 per cent for income up to AUD$37,000; 30 per cent on income between AUD$37,001 and AUD$80,000; 37 per cent on income between AUD$80,001 and AUD$180,000; and 45 per cent on income above AUD$180,000.

(b) Tax on partnerships

For partnership entities, the partners are taxed individually on their share of the net partnership income. A return of partnership income must be lodged even if a partnership is not liable for tax on its income. Limited partnerships are treated as companies for tax purposes under Pt III Div 5A of the ITAA97. But limited partnerships that invest in Australian venture capital companies are treated as ordinary partnerships. Foreign hybrid business entities are treated as partnerships for Australian tax purposes under Div 830 ITAA97.

(c) Tax on companies

When income tax was first introduced in 1915, companies were taxed on their retained profits, i.e. profits after dividends. In 1940, the tax rebate on dividends received by individual shareholders and non-resident companies was removed. 

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51 ITAA97, ss 6-5(2) and 6-10(4).
53 ITAA97, s 91.
54 ITAA36, s 94D.
55 Foreign hybrids include UK limited partnerships (see ID 2006/334) and US limited liability companies (ID 2006/18).
profit tax was imposed on public companies. Since the late 1980s Australia’s overall tax to GDP ratio has been around 30 per cent of GDP. Until 1987, Australia maintained a classical company taxation system. Companies pay a flat rate of tax without a tax-free threshold. The rate has been 30 per cent since 2001.\(^{56}\) In response to the AFTS Report,\(^{57}\) the Government’s revised proposal is to cut the corporate income tax rate to 29 per cent. The corporate tax will be reduced to 29 per cent for the 2013/14 income year and then to 28 per cent from the 2014/15 income year.\(^{58}\)

For tax purposes, a company comes into existence when it is registered and is taxable in its own right.\(^{59}\) Most limited partnerships are taxed as companies.\(^{60}\) Unincorporated clubs, societies, organisations and associations, which cannot be categorised as partnerships, are also regarded as companies. Generally, Australian resident companies are liable to tax on total income from sources both in and out of Australian.\(^{61}\) Foreign resident companies are liable only on Australian sourced income and other taxable income that is specifically defined by the Act.\(^{62}\)

The classical system of company tax was replaced by an imputation system of company tax in 1989. Shareholders receive a credit for tax paid at the company level. When the resident shareholder’s marginal tax rate is below the company tax rate, the excess credit can be used to offset tax payable on other income such as wages and salaries. In 2000, a full refund of excess tax credits for most resident shareholders was introduced into the Australian imputation system.

Under the imputation system, dividends sourced from company profits are assessable to the recipients. Recipients are entitled to claim credits for Australian income tax paid by the company. The attachment of tax credits to distributions paid by corporate tax entities passes on to members the benefit of the tax being paid at the corporate tax entity level. The tax offset equals the franking credit which is attached to the dividend. The imputation system aims to prevent the income being taxed twice. The imputation system applies to companies, corporate unit trusts, corporate limited partnership and public trading trusts.

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\(^{56}\) Income Tax Rates Act 1986, s 23.


\(^{58}\) On 2 May 2010, the Government released its response to the “Australia’s future tax system” report.

\(^{59}\) ITAA97, s 4-1.

\(^{60}\) ITAA36, s 94D.

\(^{61}\) ITAA97, s 6-5.

\(^{62}\) Ibid, s 6-10.
A simplified imputation regime in ITAA97 Pt 3-6 applies from 1 July 2002. A corporate tax entity states the amount of the franking credit on the distribution statement if it intended to allocate the franking credits to a frankable distribution. The maximum franking credit is worked out using the following formula.\(^{63}\)

\[
\text{Amount of the frankable distribution} \times \frac{\text{corporate tax rate}}{100\% - \text{corporate tax rate}}
\]

At current rate, the maximum franking credit would be 30/70 times the amount of the frankable distribution. The benchmark rule requires that a corporate tax entity must frank all frankable distributions made during a franking period.\(^{64}\) The franking percentage for a frankable distribution is calculated using the following formula.\(^{65}\)

\[
\frac{\text{Franking credit allocated to the frankable distribution}}{\text{Maximum franking credit for the distribution}} \times 100
\]

The amount of the over-franking tax or franking debit which arises due to breaching the benchmark rule is calculated using the following formula.\(^{66}\)

\[
\text{franking \% differential} \times \text{amount of the frankable distribution} \times \frac{\text{corporate tax rate}}{100\% - \text{corporate tax rate}}
\]

Under this trans-Tasman imputation system, Australian and New Zealand shareholders of trans-Tasman companies can allocate franking credits representing Australian tax paid and imputation credits representing New Zealand tax paid.\(^{67}\)

(d) Tax on trusts

A trust is not a separate taxable entity. For trusts, the net income of trust estates is taxed to the beneficiaries who are currently entitled to the net income. Any income not taxed to the beneficiaries is taxed to the trustee instead. The Commissioner determines

\(^{63}\) Ibid, s 202-60(2).
\(^{64}\) Ibid, s 203-25.
\(^{65}\) Ibid, s 203-35
\(^{66}\) Ibid, s 203-55.
residency with the trustee rather than the trust. An annual return (Form T) must be lodged for a trust. It is be lodged either by any one of the trustees who is a resident of Australia, the trust’s public office, or the trust’s agent in Australia. A beneficiary is entitled to a share of the net income of a trust.

More and more New Zealand foreign trusts are being utilised as a vehicle for cross-border tax planning. These trusts have been marketed to Australian residents as tax effective offshore trust structures which allow tax-free accumulation of income and capital in an offshore entity. They may be used as a “treaty shopping vehicle” to take advantage of particular features in New Zealand’s double tax treaties. In 27 July 2005, the ATO announced a taxation ruling dealing with the residency status of the trustees of certain New Zealand trusts under the Australia-New Zealand Double Tax Agreement. It concerns New Zealand foreign trusts being used as offshore vehicles by Australian residents.

- Income tax rate schedule

The following table summarises the current tax rates on the income which are applied to individuals, companies and trusts.

**Table 6 Australia resident income tax rate schedule for 2010/11**

<table>
<thead>
<tr>
<th>Tax entities</th>
<th>Income Bracket / Income type</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual (resident)</td>
<td>$0 - $6,000</td>
<td>Nil</td>
</tr>
<tr>
<td></td>
<td>$6,001 - $37,000</td>
<td>15%</td>
</tr>
<tr>
<td></td>
<td>$37,001 - $80,000</td>
<td>30%</td>
</tr>
<tr>
<td></td>
<td>$80,001 - $180,000</td>
<td>37%</td>
</tr>
<tr>
<td></td>
<td>$180,001 and higher</td>
<td>45%</td>
</tr>
<tr>
<td>Individual (non-resident)</td>
<td>$0 - $37,000</td>
<td>29%</td>
</tr>
<tr>
<td></td>
<td>$37,001- $80,000</td>
<td>30%</td>
</tr>
<tr>
<td></td>
<td>$80,001 - $180,000</td>
<td>37%</td>
</tr>
<tr>
<td></td>
<td>$180,001 and higher</td>
<td>45%</td>
</tr>
<tr>
<td>Company</td>
<td>All taxable income</td>
<td>30%</td>
</tr>
<tr>
<td>Trust</td>
<td>Trustee income</td>
<td>30%</td>
</tr>
<tr>
<td></td>
<td>Beneficiary income</td>
<td>Taxpayer’s marginal rate</td>
</tr>
</tbody>
</table>

Note: Currency is in Australia dollars.

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69 TR 2005/14 “Income Tax: application of the Australia-New Zealand double tax agreement to New Zealand resident trustees of New Zealand foreign trusts”.
6.2 Capital gains tax

In 1985, Australia introduced a general realisation regime for taxing capital gains and losses. By the third year of operation, capital gains tax revenues leapt to more than 20 times the five-year projection (Burman and White, 2003). Revenue from capital gains is a substantial contributor to revenue. The official estimate of capital gains tax paid on the net capital gains of taxable individuals, companies and funds in the year 2006/07 was AUD$17.3 billion. About 61.4 per cent of the total capital gains reported in taxpayer schedules were sourced from share transactions.\(^70\)

The absence of a social security tax means Australia has put a high tax burden on capital income compared with other OECD countries. Among the OECD-10 countries, Australia has one of the highest top personal tax rates on capital gains. Australian uses a discount system for taxing capital gains, meaning only a proportion of the gain is taxable. Compared with other OECD countries, Australia receives a lower share of tax revenue from labour income and a greater share from capital income. Taxes on capital income account for about 33 per cent of tax revenue.

**Graph 5** Comparative tax rates on capital income, OECD-10 (2007)

In Australia, capital gains and losses are only realised for tax purposes when an asset is sold. Gains or losses on assets held by individuals for at least 12 months are considered long-term and are subject to a 50 per cent exclusion. The top effective tax rate on long-term capital gains is 23.25 per cent.

Earnings in superannuation (pension) funds are subject to a 15 per cent flat rate, but long-term gains and losses are subject to a one-third exclusion, yielding a top effective tax rate of 10 per cent. Companies are subject to tax on net capital gains at a 30 per cent tax rate with no exclusion. Corporate income tax is integrated with individual income tax so that company tax paid is imputed to shareholders to the extent that profits are paid out as dividends and the credit may be claimed against individual income tax.

6.3 Goods and services tax

Goods and services tax was introduced in Australia on 1 July 2000. GST revenue is collected by the Commonwealth and distributed to the states and territories. In return, the states and territories agreed to abolish certain taxes and charges. The distribution of GST revenue is applied using horizontal fiscal equalisation principles. The allocation reflects the capabilities and needs of each state.

The introduction of GST is the result of the major tax reforms undertaken since the 1980s. It indicates a significant shift in the mix of taxation from direct to indirect tax. The current GST rate is 10 per cent on goods and services consumed in Australia. The following graph shows that the tax collected on goods and services has increased dramatically since 2002.

Graph 6 Taxes on goods and services in Australia

Source: OECD Statistics
Comparison and summary

For the purpose of collecting tax, it is relevant whether there is an agreement to minimise double taxation between New Zealand and Australia. A double tax agreement grants privilege to taxpayers who are “resident” in accordance with the definition in the treaty. Generally speaking, New Zealand resident trustees have no tax liability on accumulating income in respect of trusts with foreign settlors and foreign sourced income.\textsuperscript{71} In contrast, trustees are liable for taxes on accumulating income from such trusts if they are resident in Australia.\textsuperscript{72} Trusts with foreign settlors and foreign sourced income are more likely to take advantage of the New Zealand tax regime.

Comparing the current income tax systems in New Zealand and Australia, both countries apply similar income tax rules and tax rates (see Table 7). New Zealand adopted a lower tax rate on companies from 1 April 2011. Australia has considered reducing its current company tax rate to 29 per cent. The individual top marginal tax rate in Australia is higher than that in New Zealand. However, adopting an identical tax rate is not the main purpose of tax harmonisation. This will be discussed in Part III.

\textbf{Table 7} Current income tax rate schedule in New Zealand and Australia

<table>
<thead>
<tr>
<th>Tax entities</th>
<th>New Zealand</th>
<th>Australia</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Income Bracket / Income type</td>
<td>Tax rate</td>
</tr>
<tr>
<td>Individual (resident)</td>
<td>$0 - $14,000</td>
<td>10.5%</td>
</tr>
<tr>
<td></td>
<td>$14,001 - $48,000</td>
<td>17.5%</td>
</tr>
<tr>
<td></td>
<td>$48,001 - $70,000</td>
<td>30%</td>
</tr>
<tr>
<td></td>
<td>$70,001 and higher</td>
<td>33%</td>
</tr>
<tr>
<td></td>
<td>$234,001 and higher</td>
<td></td>
</tr>
<tr>
<td>Individual (non-resident)</td>
<td>$0 - $14,000</td>
<td>10.5%</td>
</tr>
<tr>
<td></td>
<td>$14,001 - $48,000</td>
<td>17.5%</td>
</tr>
<tr>
<td></td>
<td>$48,001 - $70,000</td>
<td>30%</td>
</tr>
<tr>
<td></td>
<td>$70,001 and higher</td>
<td>33%</td>
</tr>
<tr>
<td>Company</td>
<td>All taxable income</td>
<td>28%</td>
</tr>
</tbody>
</table>

Trust

<table>
<thead>
<tr>
<th></th>
<th>New Zealand</th>
<th>Australia</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Trustee income</td>
<td>33%</td>
</tr>
<tr>
<td>Beneficiary income</td>
<td>Taxpayer’s marginal rate</td>
<td></td>
</tr>
<tr>
<td>Minor beneficiary income</td>
<td>33%</td>
<td></td>
</tr>
<tr>
<td>Distribution from a non-complying trust</td>
<td>45%</td>
<td></td>
</tr>
<tr>
<td>Income of Maori authorities</td>
<td>17.5%</td>
<td></td>
</tr>
</tbody>
</table>

Note: One Australia dollar is converted to 1.30 New Zealand dollars in measuring the income bracket in Australia.

\textsuperscript{71} ITA07, s HC 26.

\textsuperscript{72} ITAA97, s 98.
Capital gains tax is the main difference between the Australia and New Zealand tax bases. The thinking on capital gains tax has changed because of dramatic economic changes in recent years. The TWG proposed that introduction of Capital Gains Tax (CGT) or Land Tax would broaden the existing tax base in New Zealand. The Government did not adopt this proposal in its current Budget. The effect of imposing CGT will be discussed in Part III. The difference in GST tax rates becomes more significant after the change in GST in New Zealand. It is 5 per cent higher than in Australia currently.

The following section will examine the options for tax reform and tax harmonisation between New Zealand and Australia. Both governments maintain independent powers on the amendment of the tax system. But tax harmonisation provides a stronger bond between both countries under a SEM.
Part III: A Good Tax System and Options for Tax Harmonisation

Overview

There are strengths and shortcomings in Australia’s and New Zealand’s tax systems. Tax harmonisation does not mean combining two different tax systems into one identical tax system for both countries. Even if there is no perfect tax system for all countries, tax experts are keen to find out an ideal tax model for collecting tax revenue and boosting economic growth. The principles of a good tax system are defined as efficiency, equity, adequacy and simplicity. Promoting the neutrality of the tax system is a major objective of tax reform (Sandford, 1998). Tax harmonisation is considered as a special tax reform in this research project.

This research proposes some solutions for tax harmonisation, which aims to improve the current tax systems to work better in a SEM. The principles of a good tax system are also the standard for evaluating successful tax harmonisation. In this research project, author suggests three steps in tax harmonisation. First, harmonisation of the tax base; secondly, harmonisation of the tax entities and tax rate; and lastly, selecting the tax rules which are going to be harmonised.

7.0 Principles of a Good Tax System

Tax harmonisation would not mean using an identical tax system in New Zealand and Australia. It is just the most significant improvement in creating a SEM. Some good experiences of tax harmonisation can be seen in the European SEM. According to the results of a survey, more than 1,000 top executives believe greater tax harmonisation across the European Union (EU) would benefit them more than any other improvement to the EU single market (Guerrera & Taylor, 2003).

The history of tax reform in Australia and New Zealand reflects the trends on tax harmonisation in the Pacific. The initial purpose of this major tax reform is promoting the neutrality of tax system. It is inevitable that the existing tax system is compared with that of other countries. But it would not be a coincidence if these tax systems were reformed to be more similar, as the motivation for tax reform reflects the changes in the current economic environment and demands on tax revenue.
The *Oxford English Dictionary* gives two meanings of reform: “to make better by the removal or abandonment of imperfections, faults or errors” and “to form again”. The first meaning refers to improvement, and the second refers to restructuring. However, whether a tax change constitutes an improvement or not is a value judgment. Further, major restructuring in tax is evaluated differently by different people (Sandford, 1992). Sandford (1998) took six English-speaking countries as examples of the tax reform of the 1980s. New Zealand’s tax reform of the 1980s was considered to be probably the most successful during that period. A goods and services tax was introduced to broaden the income tax base and income tax rates were reduced.

Promoting the neutrality of the tax system is one of the main objectives of tax reform (Poh, 2003). It is often framed by axioms such as efficiency, equity, adequacy and simplicity. The Tax Working Group Report sets out “six principles of a good tax system”. These are: efficiency and growth; equity and fairness; revenue integrity; fiscal cost; compliance and administration cost; and coherence.

**Table 8 The TWG principles of a good tax system**

<table>
<thead>
<tr>
<th>Principle</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Efficiency and growth</strong></td>
<td>Taxes should be efficient and minimise as far as possible impediments to economic growth. That is, the tax system should avoid unnecessarily distorting the use of resources (e.g. causing biases toward one form of investment versus another) and imposing heavy costs on individuals and firms. An important question is how various taxes affect key economic and social variables such as employment, investment, savings, productivity growth and international competitiveness.</td>
</tr>
<tr>
<td><strong>Equity and fairness</strong></td>
<td>The tax system should be fair. The burden of taxes differs across individuals and businesses depending on which bases and rates are adopted. Assessment of both vertical equity (the relative position of those on different income levels or in different circumstances) and horizontal equity (the consistent treatment of those at similar income levels, or similar circumstances) is important. The timeframe is also important, including how equity compares over peoples’ life-times.</td>
</tr>
<tr>
<td><strong>Revenue integrity</strong></td>
<td>The tax system should be sustainable over time, minimise opportunities for tax avoidance and arbitrage, and provide a sustainable revenue base for government.</td>
</tr>
<tr>
<td><strong>Fiscal cost</strong></td>
<td>Tax reforms need to be affordable given fiscal constraints.</td>
</tr>
<tr>
<td><strong>Compliance and administration cost</strong></td>
<td>The tax system should be as simple and low cost as possible for taxpayers to comply with and for the Inland Revenue Department to administer.</td>
</tr>
<tr>
<td><strong>Coherence</strong></td>
<td>Individual reform options should make sense in the context of the entire tax system. While a particular measure may seem sensible when viewed in isolation, implementing the proposal may not be desirable given the tax system as a whole.</td>
</tr>
</tbody>
</table>

Source: TWG (2010, p 15)

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73 Sandford considered these six countries as the leaders in tax reform: Australia, Canada, Ireland, New Zealand, the United Kingdom and the United States.

74 “A tax system for New Zealand’s future” (January 2010) report from the Victoria University of Wellington Tax Working Group at 15.
(a) Efficiency

A good tax system should be efficient and minimise the tax impediments to economic growth as far as possible. As discussed in Part I, tax policies are used to encourage saving and influence investors behaviour. Politicians utilise new tax policies to attract more votes before an election. However, a good tax system should not be affected by different interest groups. Tax should be levied on inelastic tax bases where there is least likely to be any behavioural change from the imposition of a tax (Ramsay, 1927). Johansson et al. (2008) conclude that increasing the GST rate or property tax rate is more efficient than increasing company tax rates or personal taxes. The GST and payroll taxes have similar effects on efficiency and final economic incidence.

Since the mid 1980s, New Zealand’s tax policy has focused on removing high tax rates, avoiding distortion and eliminating dead-weight compliance costs (Hoare, 2007). Hoare considers that “lowering the tax rate encourages the retention of funds for growth, supports international competitiveness and assists in economic growth”.

In New Zealand, the TWG (2010) suggests making the tax system more efficient by changing the tax mix and broadening the base. The absence of a comprehensive capital gains tax was concerned to be a disadvantage in the current tax base. Imposing taxes on land and property may have lower economic costs than increasing tax on income and consumption.

In fact, most of the tax reforms are responses to new circumstances like new skills or technologies, new roles of government, new awareness or conceptions of societal needs, and new forms of economic competition. Each reform may be logical in relation to a design feature, or even several design features, of the existing income tax system, yet not help produce coherency in the tax system as a whole.

Increasing global competition for labour and capital brings more challenges for the design of a tax system. In 1991, New Zealand’s 33 per cent corporate tax rate was one of the lowest in OECD countries. After two decades, the average rate for OECD countries is now 24 per cent. The New Zealand Government announced a tax cut on corporate tax in Budget 2010. The tax bases are becoming more elastic.

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75 The taxation of capital gains, background paper for section 3 of the Victoria University of Wellington Tax Working Group, prepared by the Policy Advice Division of the Inland Revenue Department and by the New Zealand Treasury, September 2009.

76 For analysis of the political economy reasons for New Zealand’s broad-base, low-rate income tax reforms of 1984-1988 being less enduring than the broad-base, low-rate consumption tax reforms of 1984-1988, see White (2009).
(b) Equity

In common legal usage, equity refers to “the recourse to principles of justice to correct or supplement the law as applied to particular circumstances”.\(^77\) For the purposes of income tax policy analysis, tax equity is defined as the fair treatment of individuals who have the same or different income as others. This represents a normative choice on allocating the tax burden of funding for public service and government expenses (Infanti, 2007). Infanti identifies tax equity as taking into consideration both sameness and difference in determining allocation of the income tax burden.

A good tax system should be fair to most taxpayers. The burden of taxes has to be passed on to individuals and companies relatively equally. It reflects in imposing tax on vertical equity and horizontal equity.\(^78\) Improving vertical equity was the dominant motive for the reforms in the 1960s and 1970s. Vertical equity was seen as a constraint rather than an objective (Sandford, 1998). The reformers sought to improve horizontal equity in the reforms of the 1980s. Most of reformers sought to ensure that tax reform did not increase inequities. Demographic change places greater tax pressure on a smaller proportion of the population.

Tax equity is an abstract concept and seldom examined when imposing tax. Economics becomes the ideal means for determining equity. In order to distinguish the personal tax and GST changes on tax equity, Minister Hon. Bill English drew a table describing “How will changes to personal tax rates and GST affect me” (see Appendix 3).\(^79\) It indicates that taxpayers who earn more than $40,000 would be more than $10.00 better off after tax changed.\(^80\) According to the report from Statistics New Zealand, only 27 per cent of total taxpayers earned more than $40,000.\(^81\) It shows these tax changes do not affect the majority of taxpayers. In other words, tax equity is similar to what it was before the tax changes. Tax equity is one of most important standards for measuring whether tax reform is successful or not. This could be used as a principle in the process of tax harmonisation.

\(^{78}\) Vertical equity refers to the relative position of those on different income levels or in different circumstances. Horizontal equity means the consistent treatment of those at similar income levels or similar circumstances.
\(^{79}\) New Zealand Budget 2010, “Key facts for taxpayers”.
\(^{80}\) The actual changes to the amount of GST an individual pays will depend on an individual’s spending and saving choices.
\(^{81}\) Analysis is based on Household Economic Survey data sourced from Statistics New Zealand. Survey is projected for the year ended March 2011.
(c) Adequacy

One of the fundamental elements of a good tax system is having sufficient taxes to fund government expending. However, it does not mean governments should levy all kinds of taxes without considering the economic conditions of the country. Tax reform is not a one-off innovation. It should be adjusted in accordance with internal economic growth and external competition pressure. Changes in the form of population aging will have an impact on the adequacy of tax revenues. The tax base is required to maintain or increase revenues in order to maintain existing levels of public services. Adequacy is too subjective to analyse in details.

(d) Simplicity

Simplifying complicated tax legislation is one of the essential goals of tax reform. Tax simplicity could be achieved by modernising and simplifying both the personal and business tax system. In August 1998, the Australian Government announced a plan for reform of the Australian taxation system and nominated Mr John Ralph as chairman of the Review of Business Taxation. In July 1999, the committee made hundreds of recommendations for a fundamental redesign of the business taxation system, the processes of ongoing policy making, the drafting of legislation and tax administration. The Government adopted the introduction of a simplified accounting system and the implementation of the consolidation regime.

The compliance cost model in one of the useful methods for monitoring the simplicity of the tax system. There are thousands of active companies and businesses in every country, many of which have related companies because of association through common ownership. Simplifying the corporation tax treatment could help to reduce administrative and compliance costs. A major gain for simplicity would be achieved if most of people were able to file their tax returns themselves.

Based on the analysis of the principles of a good system, the objective of tax harmonisation would be to modify the current tax system to serve both countries under a SEM. The new tax changes would aim to improve the efficiency, equity, adequacy and simplicity of the current tax systems. The New Zealand and Australian governments maintain independence in imposing the tax changes in the process of tax harmonisation.
8.0 Tax Harmonisation in New Zealand and Australia

In January 2004, the Australian and New Zealand governments announced the intention of creating a seamless trans-Tasman business environment.\(^{82}\) This required reducing the tariff barriers for business, consumers and investors across the Tasman. Under section BH 1(4), the DTA is paramount over other taxation law. The new DTA is the first major step in building up a tariff alliance. On 22 March 2010 an updated DTA between New Zealand and Australia replaced the agreement entered into in 1995. The new DTA reduces withholding tax rates on certain non-portfolio dividends and cuts the tax rate on royalties from 10 per cent to 5 per cent. It also includes a provision for the trans-Tasman mobility of pensions.\(^{83}\)

In order to achieve maximum tax benefits, there is a high demand for tax harmonisation under a SEM. The present Australia and New Zealand governments’ tax reform proposals express awareness of tax coordination across the Tasman. Considering the long-term benefits, both governments are taking more ambitious steps to achieve tax harmonisation. In 2010, the New Zealand Parliament passed three taxation amendment Acts: the Taxation (Budget Measures) Act 2010, the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver and Remedial Matters) Act 2010 and the Taxation (GST and Remedial Matters) Act 2010. One of the major changes is the introduction of the trans-Tasman portability of retirement savings schemes. On 20 May 2010, the New Zealand Finance Minister Hon. Bill English delivered a Budget which focused on reducing personal tax rates, increasing the GST rate and changing depreciation in respect of buildings. These changes enlarged the existed gap in the GST rates and reduced the difference in the personal tax rates between Australia and New Zealand.

New Zealand undertook a review of its current tax system recently. During 2009, Victoria University in Wellington convened a Tax Working Group to address tax challenges in the medium term. The Working Group presented a report to the Government in January 2010. Based on the principles of the report, the future of the New Zealand tax system will aim to create a “world class tax system”. Most of the proposals direct the New Zealand tax system to harmonise with the Australian tax system in the medium term.

\(^{82}\) Information is retrieved from <http://mfat.govt.nz/Countries/Australia/Australia.php>.  
52
Tax harmonisation represents the process of tax system convergence aligned with a common set of rules. In this dissertation, the researcher suggests three steps in the tax harmonisation process. First, harmonise the tax base; secondly, harmonise tax entities and tax rates; and lastly select the tax rules which are going to be harmonised. All these initiatives aim to develop a low-cost, innovative and more seamless trans-Tasman operating environment for business. The following sections will demonstrate the options for harmonising the current tax system in terms of tax bases, tax rates and tax rules in the current tax systems of Australia and New Zealand.

8.1 Harmonisation of tax base

The harmonisation of the tax base would not reduce competition, but it would make competition more transparent. Based on the experience of taxation harmonisation in the EU, the basic problem is the different principles of taxation among the countries (Christiaanse, 1972). The first major step in harmonisation was for all the countries to change to a common value-added tax system. Indirect taxes are dominant in Italy, France and Belgium, while direct taxes provide the greater portion of government revenue in West Germany, the Netherlands and Luxemburg. Indirect taxation plays a neutral role in market competition within the European Economic Community.

In the mid-1980s, New Zealand base-broadening reforms were sparked by an economic crisis of the period. In recent years, the whole world has experienced another major economic crisis. Harmonising the tax base with Australia might help New Zealand to walk out of an economic crisis in a shorter period. The following section will examine the possibilities for the introduction of a new indirect tax base in New Zealand and Australia.

Indirect tax is considered to be a solution in achieving equity and fairness in sharing the tax burden. Tax reforms aim to shift the tax mix away from income taxation towards consumption taxation. A successful model in tax reform is the introduction of GST, which replaced narrower-based consumption taxes. In 1986 New Zealand succeeded in implementing the GST regime with a comprehensive base. In 1986 Wells and Fraser estimated that 87 per cent of consumption on goods and services was covered by GST. The Draft White Paper proposals of June 1985 proposed an approach combining the introduction of a new broad-based retail sales tax with a major tax-mix switch from
personal income tax to indirect consumption tax. The sales tax reform and tax-mix proposals failed at the National Taxation Summit in July of that year. In 2000, Australia introduced GST using a political deal that proposed the zero rating of basic food.

Head and Krever (2009) considered that major gaps in the tax base allow the wealthy to easily avoid tax. A huge tax revenue loss results from the income tax loopholes exploited by the wealthy. At the same time as implementing indirect taxes, it is necessary to build up a sustainable revenue base for government in order to achieve revenue integrity. In 2007 the OECD recommended two broad options that are worth considering: adapting the system within a comprehensive income approach or adopting a dual income tax system.

(a) Tax broadening via a capital income tax and /or a land tax

New Zealand and Australia have a similar tax base. Apart from the tax levied by state and territory governments, the capital gains tax would be the main difference between the tax bases. Before the twentieth century none of the present OECD countries had a capital gain tax (Muten, 1995). After the tax reform movement of the late 1980s, 14 countries had introduced comprehensive capital gains taxes. In fact, a capital gains tax has been applied on personal property acquired for the purpose of resale in New Zealand. This section in the dissertation focuses on identifying the key features of capital gains tax and proposing that this tax be included as part of the New Zealand tax base.

In 1985 Australia introduced the capital gains tax which enlarged its tax base. The Government decided to exempt from tax assets that had been purchased before the effective date for this legislation. People did not have to try to establish the cost basis for an asset that had been held for decades and for which records might be scant or nonexistent. They also do not assess the value of assets already in their portfolio, but only newly purchased ones. However, this cut-off arrangement created a horrendous lock-in effect. Assets held in 1985 were to be tax exempt, whereas a newly purchased asset would be taxable on any future gain.

The tax regimes for capital gains in most OECD countries, including Australia, follow neither the pure income nor consumption tax model. Typically, capital gains are taxed

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84 ITA04, s CB 3.
85 Australia also decided to index gains for inflation, a decision that led to considerable complexity and was ultimately reversed.
when realised, not as accrued, and losses are not deductible. It is difficult to clarify an appropriate baseline for capital gains tax whether as income tax or consumption tax. Capital gains should be taxed as accrued under an ideal income tax, whereas gains would be untaxed under a consumption tax. Taxing capital gains is one form of taxing savings. If the capital gain is taxed as an income tax, savings are taxed twice. It is an influence on economic efficiency. However, capital gains assets face a lower effective tax rate than assets that pay returns because of deferral. If double taxation is a concern, the solution is to move capital gains tax to a consumption tax, in which all forms of capital income would be exempt from tax and interest expenses would not be deductible.

New Zealand has a very limited capital gain tax. The Tax Working Group proposes methods to broaden the tax base by including the introduction of a land tax and extending the capital gains tax. It considers that “taxing capital gain ‘on accrual’ would bring the tax system closer to taxing comprehensive income” and refers to a capital gains tax as “a more comprehensive option for base broadening”. A recent study (OECD, 2007) demonstrates that the international supply of capital is not highly elastic for both large and small countries.

(b) Dual income tax system

The proposals of the McCaw Report (1982) successfully introduced a remarkably broad-based value-added tax (GST), along with a base-broadening and rate-lowering reform of the personal and company income tax system. The New Zealand government is considering in the long term an adjustment or reform of its personal and corporate income tax system. A dual income tax system might be an option, depending on the economic environment in New Zealand.

During the early 1990s the Nordic countries undertook a series of sweeping tax reform which combined ambitious base-broadening measures with dual income tax. The Nordic dual income tax combines progressive taxation of labour and transfer of income with a low, flat tax on all capital income (Eggert & Genser, 2005). It separates the taxation of labour income from the taxation of capital income. Under this system, the taxpayer’s net incomes are added together, and then subjected to progressive marginal tax rates.

A fundamental principle of dual income tax is that it taxes all forms of capital income neutrally. The total revenue collected by the New Zealand government is smaller than in the Nordic countries. In addition, the labour markets of New Zealand and Australia are highly integrated. New Zealand has higher international mobility of labour than the Nordic countries. Although dual income tax works well in Nordic countries, it might not work well in New Zealand because of the characteristics of the New Zealand economy.

8.2 Harmonisation of taxable entities

New Zealand and Australia apply tax on individuals, partnerships, companies and trusts. However, there are some special rules governing the same taxable entities. In Australia, limited partnerships are treated as companies for tax purposes. In New Zealand, both limited and general partnerships are taxed in the same manner under the Income Tax Act. A loss limitation rule applies to restrict losses claimed by limited partners to the value of their economic investment in the limited partnership. For limited partners, a 25 per cent interest threshold must be met before the limited partner and the partnership will be associated.

Generally speaking, there are the same taxable entity categories in New Zealand and Australian. It is only necessary to harmonise the tax treatments of those taxable entities. The following sections will discuss the harmonisation on tax rates and tax rules.

8.3 Harmonisation of tax rates

The second step in tax harmonisation is reviewing the different tax rates in both countries. As demonstrated in Part II, Australia and New Zealand have different rates for income tax and consumption tax. Over the last ten years, New Zealand lost its competitiveness in corporate tax compared to the average rate among OECD countries (refer to Appendix 1). That was the main reason for the urgent new tax reform proposals in 2009. It is time to narrow the gap in tax rate differences with other OECD countries. Otherwise, it is going to harm New Zealand’s economic growth, especially during worldwide economic recession. There has been a tendency for OECD countries to flatten personal taxation structures.
There are some difficulties in achieving the same tax rate in both Australia and New Zealand. Any rate increase in Australia requires the unanimous agreement of the six state governments and the federal government, and is therefore politically extremely difficult to achieve. Under the EU treaty, the Member states do not have to harmonise their corporate tax rates or bases. Conssen (2009) suggests that harmonisation is to be approximated

“only if required for the functioning of the internal market. But greater approximation of capital income tax systems could promote investment, improve the tax burden distribution and, last but not least, reduce compliance and administrative costs.”

(a) Reduce corporation tax rate

The Australian tax reform initiative of 1985 combined the introduction of a new broad-based retail sales tax with a mix of direct income and indirect consumption taxes. However, the new Australian company tax system was abandoned after one full year (1987-1988). The Australian government reduced its company tax rate from 49 per cent to 39 per cent because a number of major developed countries declined their company tax rates. Domestic tax policy objectives are affected by international tax competition.

Arthur B. Laffer drew a curve for the hypothetical relationship between tax revenue and tax rates on 4 December 1974 (Saunders, 2006). In 1991, Gerald Scully used IMF data for 103 countries to estimate Australia’s maximum tax revenue at 22.5 per cent as marginal income tax. Most of the OECD countries have reduced their tax rate on corporate income since the 1980s (refer to Appendix 1). Compared with the average tax rate of 24 per cent, Australia and New Zealand had the same high tax rate of 30 per cent in 2010.

The Australian and New Zealand governments decided to reduce the current tax rate to 29 per cent and 28 per cent respectively. This was the first corporate tax cut for the last ten years in Australia. Reducing the tax rate on corporations affects its contribution to tax revenue. New Zealand increased its GST rate in order to compensate for this tax cut. However, there no such tax package has been launched in Australia. Tax adequacy would be an issue if there is no tax compensation for the loss from tax cuts. In the near future, there is less chance for further tax cuts on corporations if both countries are willing to align the top personal tax rate with the corporate tax rate.
(b) Alignment of tax rates

The tax rate on individual income tax is similar in both countries. But there is no tax-free threshold on personal income tax in New Zealand. The New Zealand government introduced the Working for Families scheme, which reduces the tax burden for low-income families. However, low-income single tax payers do not qualify for this benefit. The New Zealand government could consider adopting the no-tax threshold and abolishing the accommodation benefit for low-income taxpayers.

The present tax system has a large gap between the company tax rate and the top personal tax rate. Corporate entities are used for shifting this form of income in most tax avoidance cases. Tax avoidance problems become more serious because the inequities and distorting effects remain. The tax rate on trustee income is similar to the tax rate on companies. But beneficiary income is taxed at the top personal tax rate.

After the new changes to tax rates, there is a 5 per cent gap between the company tax rate and the top personal tax rate in New Zealand. In view of the present 16 per cent gap between the company tax rate and the top personal tax rate, Australia is under more pressure to make a large cut in the top personal tax rate in order to align the tax rates. Unless a flat rate on personal income is adopted, both governments will face a huge shortage in tax revenue if the top personal tax rate aligns with the current low corporate tax rate. That would against the alignment of the tax rate for individuals, companies and trust.

(c) Increase GST

After the increase in New Zealand GST, the gap in the tax rate between the countries is increased by 5 per cent. The New Zealand Government promoted the GST increase with the reduction of income tax as a compensatory package. It shows the Government is keen to move the tax system towards relying on consumption tax. This is an inevitable trend in international tax reforms. The New Zealand 2010 half-year financial report showed the increase in GST compensated for the tax cuts on income tax. It is helping to achieve the tax revenue budget in an economic recession. This could be a good example for Australian tax reform. Setting the same GST rate should be the main direction in tax rate harmonisation.
The process of forming a SEM needs to happen across a range of areas including banking regulation, business law co-ordination, competition and consumer policy and taxation.\(^\text{87}\) Owing to different interpretations of rules and regulations, it is impossible to have an identical tax law for both countries. As a result, harmonisation of tax rules will focus on the principles of tax law rather than the wording of the rules.

This section outlines the recent harmonisation of the venture capital limited partnership regime, the imputation system, international tax rules, and the change of the thin capitalisation rules between Australia and New Zealand.

(a) Venture capital limited partnership regime

Tax reform of venture capital is a recent example of tax rule harmonisation between New Zealand and Australia. There were two goals in the Australian and New Zealand venture capital reforms (Stewart, 2006). Both governments were seeking to attract foreign venture capital investment by removing tariff obstacles to investment. They were attempting to expand the venture capital measures by adopting a domestic venture capital measure.

In 2002, Australia modified the venture capital limited partnership regime after having enacted venture capital tax concessions for foreign investors for three years since 1999. New Zealand also enacted new venture capital tax measures accompanying the tax changes in Australia. A new limited partnerships was introduced with a separate legal entity and flow-through tax treatment.

Tax harmonisation of venture capital tax and the imputation system indicate the intense capital mobility between New Zealand and Australia. Foreign tax credits are available to New Zealand partners of Australian limited partnerships if the tax is paid as income tax or non-resident withholding tax. On 25 March 2010 the IRD issued public binding rules for taxing income earned by Australian limited partnerships and foreign tax credits.\(^\text{88}\)

\(^{87}\) New Zealand Ministry of Foreign Affairs and Trade website, “The SEM work programme”.

\(^{88}\) BR Pub10/01, “Australian sourced income earned by Australian limited partnerships and foreign tax credits”, BR Pub 10/20, “Distributions made by Australian limited partnerships and foreign tax credits”, BR Pub 10/30, “Distributions made by Australian unit trusts to Australian limited partnerships and foreign tax credits”, BR Pub 10/04, “Franked dividends received by Australian limited partnerships and
Limited partnerships are treated as companies under Australian law, but they are still treated as partnerships for tax purposes in New Zealand. Limited partnerships are considered as separate legal entities like companies, but they retain the flow-through tax treatment as general partnerships. It is not appropriate to treat them as companies for tax purposes. There is still a gap on the reconciliation of limited partnerships in New Zealand and Australia.

(b) Trans-Tasman imputation system

Alliance of imputation systems is another successful example of tax rule harmonisation in New Zealand and Australia. Both countries have similar rules on income tax which govern net incomes derived from any source. In order to avoid double tax on income, both countries introduced an imputation system which grants the taxpayer the right to claim a tax credit with dividend attached from New Zealand or Australia.

The Australia and New Zealand governments have extended their imputation systems to include companies resident in the other country. The reforms are aimed at what is known as the “triangular tax” problem, whereby Australian shareholders in a New Zealand company operating in Australia were unable to access Australian-sourced franking credits, with the same problem applying in reverse for New Zealand shareholders in Australian companies operating in New Zealand. The Australian rules are contained in ITAA97 Div 220. New Zealand companies have a “franking choice” to maintain an Australian franking account reflecting Australian tax paid (including income tax payments, franking credits attached to dividends received and Australian withholding tax on dividends, interest and royalties). The election form (Nat 8775) is available on the ATO website and can be lodged electronically. A New Zealand company that makes a franking choice is known as a “franking company”.

Imputation legislation was reformed in Australia and New Zealand in 2003. The enactment of legislation made it possible for New Zealand companies to use the Australian franking credit rules and Australian companies to use New Zealand’s imputation credit rules. Shareholders can be allocated imputation credits representing Australian tax paid and franking credits representing New Zealand tax paid. The credits for each country can only be claimed by its residents.

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89 ITAA97, ss 220-25 to 220-50, ss 220-205 to 220-300.
The dividend-imputation system acts as a tax-minimisation strategy which lowers corporate tax liability and lowers the tax credit available to shareholders. Under this trans-Tasman imputation system, Australian and New Zealand shareholders of trans-Tasman companies can allocate franking credits representing Australian tax paid and imputation credits representing New Zealand tax paid.  

This rule applies only from the time that the parent company, the New Zealand recipient company and the franking donor company make the franking choice. Trans-Tasman companies that elect to do so will distribute Australian franking credits and New Zealand imputation credits to all shareholders in proportion to their shareholdings in the company. However, each country’s credits can be claimed only by residents of that country. For the purpose of the imputation rules, the currency rate is the close of trading spot exchange rate for the Australian dollar for the date on which the dividend is declared or the date on which the dividend is paid.

(c) International tax rules

The Taxation (International Investment and Remedial Matters) Bill 2010 (227-1) was introduced on 26 October 2010. It includes proposals to help New Zealand-based companies compete more effectively overseas. The Bill extends the active income exemption to non-portfolio foreign investment fund (FIF) companies that are controlled by New Zealand investors. The active income exemption is set for interest of between 10 per cent and 50 per cent in companies that are not controlled by New Zealanders. If the investors are unable to use the active income exemption, they are only able to choose to use the comparative value methods. The amendment also prevents PIEs from using the attributable FIF income method. These changes apply to income years beginning on or after 1 July 2011. The change proposes to replace the grey list exemption with an Australian exemption.

(d) Thin capital rules

In 1997, thin capitalisation rules were introduced to prevent non-residents from understating their New Zealand income by excessively gearing their operations in New Zealand. It aims to limit the amount of interest deduction against the New Zealand tax base. Thin capital applies to inward investment by non-resident and outbound...
investment by a New Zealand resident. The provision of most interest to foreign companies is the maximum of 75 per cent debt/asset ratio of 110 per cent of the group’s worldwide debt/asset ratio. Instead of considering the tax credit claim-back issue, this rule provides investors more flexibility in choosing a profitable company for investment within both countries. New Zealand businesses could attract more capital from Australia. It also encourages more businesses to set up a branch in New Zealand because of its lower operating costs.

The thin capitalisation rules are modified on application to investors with CFCs. A new thin capitalisation test is proposed for New Zealand companies with overseas investing activities. They can choose the test for thin capitalisation, which is based on a ratio of interest expenses to pre-tax cash flows. This change took effect for income years beginning on or after 1 July 2009. Non-resident companies without a fixed establishment will no longer be subject to thin capitalisation rules if their New Zealand sourced income is non-resident passive income. This proposal will be applied for income years beginning on or after 1 July 2011. From the 2011/12 income year, the 75 per cent threshold for inbound investment is reduced to 60 per cent.
9.0 Harmonisation of Tax Administration

The fundamental purpose of tax administration is interpreting and applying tax provisions. Tax administration assists in administering the levies decided by sovereign powers, protects and develops certain economic actives, and analyses the personal and family situations of the taxpayers. Tax administration executes a function of interpreting legal provisions within the tax rulings procedure.

Taking a more strategic approach to tax reform could be one way of improving the quality of tax administration (James et al., 2006). Klun (2004) measured tax administration in five areas: simplicity of the tax system, administrative and compliance costs, voluntary tax compliance, tax inspection and tax administration productivity.

- Self-assessment and filing system

The new system of tax administration seeks to minimise compliance costs and the administrative burden. A high degree of voluntary compliance is needed in order to create an effective tax system. In the late 1980s, an important decision was made on tax administration -- the tax authorities introduced a “self assessment” system of tax administration. As it shifted the compliance obligation to “get it right” from the tax authorities to taxpayers, it increased the real and perceived costs and risks for taxpayers. The Commissioner of Taxation still issues a notice of assessment to some taxpayers. There was an increased demand for the tax office to clarify requirements. The massively increased volume of written tax guidance shows the complexity of the tax laws.

The development of microcomputer technologies and inter-networks has enabled tax departments to integrate parts of the administrative process with computer information systems. To assist in reducing compliance costs, the tax department provides an online service which assists taxpayers in meeting their tax obligations. The new computer technology allows taxpayers to file their tax return over the internet. Jenkins (1997) considers a modern tax administration system for third party information used to assist in the enforcement of taxes needs to be integrated with other public programs which are administered by the revenue system and other related tax systems.

New Zealand’s IRD has used computers systems to collect tax revenue for more than 20 years. The system contains all the information on the registration of taxpayers. The online real-time system assists the IRD staff to update information directly into the
database from any processing centre. It reduces compliance costs and improves the quality of service to taxpayers. The system is also designed for monitoring compliance and identifying people who do not pay taxes. The Australian ATO has a similar information system for tax administration.

The Taxation (Tax Administration and Remedial Matters) Bill 2010 (257 - 1) was introduced on 23 November 2010. The Bill amends the Tax Administration Act 1994 to improve the ability of the Commissioner to disclose information in defined circumstances. It proposes a new framework for sharing IRD information with other government agencies. This change enhances the power of the IRD and ATO for investigating issues of tax avoidance under trans-Tasman arrangements. Due to the different tax treatment of non-resident income, the Australian ATO has to put more time and effort into detecting the status of taxpayers. For the purpose of harmonisation of tax administration, the New Zealand IRD and Australian ATO may consider integrating their information systems and sharing the information of taxpayers who are liable for paying tax in both countries. It could reduce compliance costs and improve the efficiency of detecting tax avoidance issues.

- Tax collection issues

In the current economic environment, the main concern of the ATO is to protect Australia's tax base. A 2009/10 Compliance Program revealed an unprecedented level of compliance activity with the support of significant resources, improved technology and increased cooperation with other government agencies. It has resulted in AUD$5 billion additional tax being collected and a further AUD$8 billion in additional liabilities being raised in the last 12 months. The main objective is to ensure a level playing field by ensuring that all taxpayers are paying their fair share of tax. Reducing tax system complexity and compliance costs are the main concerns of tax administration.

Many countries have serious concerns about offshore investment, which provides taxpayers opportunities to hide money or assets offshore. A recent survey identified over 190 offshore compliance initiatives avoided billions of dollars of uncollected tax for government. It is important to increase international cooperation by renewing programmes to ensure that offshore arrangements are no longer available for taxation avoidance.

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92 Sixth meeting of the OECD forum on tax administration, Istanbul, 15-16 September 2010.
As Australia and New Zealand have built up an alliance in information exchange systems, both could utilise these significant data-matching capability and increased information exchange powers to review tax returns, including checking for correct reporting of shares, options and interest income and to trace payments received from New Zealand or paid from Australia to New Zealand accounts. The tax information exchange agreement has become an instrument for administrating the exchange of information between contracting states regarding tax collecting issues.

- Rulings

A formal rulings system has been introduced for fostering transparency between taxpayers and tax administration. It reduces the number of conflicting interpretations and applications of law by the tax administration system, taxpayers and tax courts. The need to coordinate the rulings policy has become important due to the coordination of tax systems and information exchange system.

In the 1990s legislative amendments sought to increase certainty and simplicity through the introduction of the rulings system. In Australia, the Tax Rulings System was introduced as a method of disseminating decisions on the interpretation of the laws administered by the Commissioner of Taxation. The system ensures that the Commissioner fulfils the ATO’s obligations under the *Freedom of Information Act* 1982 by making available for public scrutiny copies of documents used by ATO officers in making decisions.

From 1 April 1995, the New Zealand Commissioner of Inland Revenue has been able to make binding rulings on the application of taxation laws. There are four types of binding rulings: public rulings, private rulings, product rulings and status rulings. A ruling may terminate with a change in the law. The current New Zealand tax dispute process has become more transparent with the new amendments to the binding rulings regime. It has helped to improve the simplicity of the tax system. In order to achieve consistency in the rulings, both countries have reviewed their current rulings regarding trans-Tasman taxable activities.

A number of new rules were introduced to govern trans-Tasman taxable activities in New Zealand. The Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 introduced trans-Tasman portability of

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retirement savings, flexibility in a provision applying to resident co-operative companies, and a further five-year tax exemption on profits for non-residents operating offshore rigs or seismic vessels in New Zealand. The portability arrangements allow a person who has retirement savings in both Australia and New Zealand to consolidate them in one account in their current country of residence. Any member tax credits may be transferred to Australia. New section CW 29B of *Income Tax Act 2007* provides that Australian-sourced retirement savings will be treated as exempt from tax at the point of transfer under the portability arrangements.

The Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 also contains some amendments to the binding rulings legislation: the general prohibition on determinations of fact is replaced with a provision that the Commissioner can rule only on the basis of the facts as provided by the applicant; the Commissioner’s discretion not to rule on matters before the courts is clarified by limiting its application to cases involving substantially similar arrangements; promoters of arrangements, or those with an interest similar to that of a promoter, may apply for a product ruling for prospective arrangements.

- Disputes process

As global trade and investment increase, both governments and business need effective procedure to minimise cross-border tax disputes. The Commissioner may make a binding ruling if the arrangement is the subject of a dispute by way of notice of proposed adjustment (NOPA) but the application for the ruling relates to a different tax type from that in the NOPA; if the rulings is no longer valid but the reason for the invalidity applies only to a certain tax type or types involved in the ruling, the other parts of the ruling relating to other tax types can continue to apply. The disputes resolution process could be broken down into six phases: issue of a NOPA, conference, disclosure, adjudication and review, assessment or amended assessment, and litigation. The author suggests that the same dispute process should be applied to solve trans-Tasman tax disputes.

Harmonisation of tax administration could improve compliance and efficiency in governing trans-Tasman taxable activities. Integrating the current tax electronic file system reduces the compliance cost burden on taxpayers. One tax return filed for both countries is the ideal solution for detecting tax avoidance and evasion across the Tasman. In addition, it is necessary to review all the rulings regarding the determination
and interpretation of trans-Tasman activities. The same dispute process could apply to solve trans-Tasman tax disputes in both countries.
10.0 Limitations

Every government prefers independence in their own tax system. However, the changing economic environment brings more internal and external pressures on the two governments. At the time of drawing Budget 2011, the New Zealand government could not foresee the extra tax expenses from the February Christchurch Earthquake. The Australian government could not forecast the huge economic losses caused by the flooding in Victoria. Tax revenue forecasting is based on historical estimations. All amendments to the tax system are designed for funding government spending.

In the initial period of setting up a SEM between New Zealand and Australia, and along the way, there are many uncertainties in achieving the goal of tax harmonisation. One of the main difficulties is achieving agreement on amending the tax legislations in Australia within the six states. This dissertation provides some proposals for tax harmonisation between both countries. There would be criticism as to how far the tax harmonisation was successful. It would be desirable to undertake further research on the actual process of tax harmonisation.

Even though the current tax reforms indicate that both governments have been working toward harmonisation of their tax systems, there has been no official announcement on the tax harmonisation process. It is difficult to anticipate the outcome of tax harmonisation proposals -- there might be some by-products from tax harmonisation. The researcher has a strong interest in doing further analysis in this area in the near future. There is also a requirement for more data collection over a longer period.
Conclusion

During the recovery period from economic recession, it becomes more important to develop a strong economic union. Australia and New Zealand intend to create a single economic market following after the EU. This dissertation demonstrates the importance of tax harmonisation in developing a strong economic union. Based on the analysis of current tax reforms in both countries, both governments are working towards enhancing their competitiveness regarding mobile capital and labour. Tax harmonisation is a higher level of tax coordination which reduces the harm to tax competition.

Tax harmonisation does not mean combining two different tax systems in one identical tax system for both countries. It is considered as a special tax reform in this research project. Comparing the current tax systems in New Zealand and Australia, there are some similarities and differences in the tax base, tax entities, tax rates and tax rules. Apart from the tax on capital gains, income tax and GST are the main sources of tax revenues in both countries.

Author suggests three steps in tax harmonisation. First, harmonising the tax base; secondly, harmonising the tax entities and tax rates; and lastly, selecting the tax rules which are going to be harmonised. The principles of a good tax system will be applied to tax harmonisation between New Zealand and Australia under a SEM. All these initiatives aim to develop a low-cost, innovative and more seamless trans-Tasman operating environment for business.

Harmonisation of tax administration systems could ensure both governments achieve information on detecting offshore arrangements. Integrating the current electronic filing systems might reduce the compliance costs of tax filing and revenue collecting. The IRD and ATO could publish the same rulings regarding trans-Tasman taxable activities. Simplifying the current tax filing and disputes processes would encourage more businesses and individuals to carry out the business in both countries.

Because of insufficient data for analysing the by-products of tax harmonisation, this dissertation does not evaluate the effect of tax harmonisation between Australia and New Zealand. It might take another a couple of decades to complete the process of tax harmonisation under a SEM.
## Appendix

### Appendix 1: Taxation of corporate and capital income for OECD countries

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Source: OECD
### Appendix 2: Top rate of central government personal income tax for OECD countries

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Source: OECD
### Appendix 3: How will changes to personal tax rates and GST affect me

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Note: After-tax changes in disposable income presented above are indicative only. The net after-tax changes apply to a single income earner and do not include tax credits (except the independent earner tax credit), tax rebates and the ACC levy. In addition, actual changes to amount of GST and individual pays will depend on an individual’s spending and savings choices.

Source: New Zealand Budget 2010
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