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A Curious Concession? Australia's Withholding Tax Exemption for Franked Dividends

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# A CURIOUS CONCESSION? AUSTRALIA'S WITHHOLDING TAX EXEMPTION FOR FRANKED DIVIDENDS

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This article considers the tax treatment of dividends paid by Australian companies to non-resident shareholders, which benefit from a withholding tax exemption to the extent that the dividend is “franked” under Australia’s imputation system. The article considers the appropriateness of maintaining the withholding tax exemption now that more than 35 years have passed since the imputation system was introduced in Australia in 1987. It examines the original rationale for introducing the exemption and questions whether that rationale remains valid in 2023, given changes to corporate and individual tax rates in the intervening periods. The article also notes that to a potentially significant extent, the ongoing availability of this concession benefits foreign revenue authorities where non-resident shareholders live in countries which maintain a “classical” approach to taxation of dividends and allow credits for foreign withholding tax to be offset against tax liabilities in the country of residence. The article concludes that a comprehensive policy-based review of the concession is long overdue, that removal or modification of the exemption should be considered, and that the potential additional Australian tax revenue resulting from changes to the concession could be significant.

## I. INTRODUCTION

This article examines the exemption from Australian dividend withholding tax for franked dividends paid by Australian companies to non-resident shareholders. It considers the potential revenue cost of this concession. It also looks at the circumstances in which the concession was introduced and its rationale, and questions whether the reasons that may have underpinned the introduction of the concession remain valid now that more than 35 years have elapsed since it was first introduced, especially when viewed from a horizontal equity perspective. In this context, the article also gives some consideration to the concessional Australian tax treatment of dividend distributions to non-resident shareholders in a broader international comparative context.

## II. TAX TREATMENT OF DIVIDENDS PAID TO NON-RESIDENTS.

For an Australian-resident shareholder in an Australian company, it has been said that ‘company income tax acts as a prepayment of the personal income tax liabilities of shareholders on future dividends.’<sup>1</sup> It is akin to a domestic withholding tax on dividends because the full benefit of underlying company tax paid on company profits flows through as “franking credits” which can be offset against personal tax liabilities assessed on shareholders, when a company’s after tax profits

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<sup>1</sup> Ken Henry, *Australia’s Future Tax System*, (The Treasury, Canberra, 2009) 194.

are distributed to shareholders as dividends.<sup>2</sup> For an Australian-resident shareholder who pays the top marginal rate of tax, the resulting “top up” tax payable based on current tax rates is 15% (not including Medicare levy), being the gap between the company tax rate (30%) and the highest marginal tax rate (45%).<sup>3</sup> Where a resident taxpayer’s franking credits exceed the tax assessed, the excess is refundable. In combination, this approach means that for resident shareholders, the tax that is ultimately paid on company profits distributed to them as dividends is calculated by reference to their own personal tax rate. This reflects clear policy and design choices about the operation of the dividend imputation system for Australian residents.

The same is not necessarily true for foreign shareholders receiving Australian-sourced franked dividends. Foreign shareholders do not receive a direct benefit for franking credits, under the Australian imputation system i.e., there is no flow-through of credits for the underlying Australian company tax paid on the profit that is the source of the dividend paid to the non-resident.<sup>4</sup> However, in these cases, Australia has unilaterally applied a full exemption from withholding tax otherwise payable on the cash dividend payment, to the extent that the dividend is franked.<sup>5</sup> For a distribution of unfranked dividends, the standard withholding tax rate is 30%, which may be reduced where the shareholder is a tax resident of a country with which Australia has a double tax agreement (DTA).<sup>6</sup>

On its face, the Australian approach is very generous, at least with respect to the franked component of dividends, especially given that under the terms of most of Australia’s DTAs, credits for any foreign tax liability borne by a non-resident shareholder on receipt of Australian-sourced dividend income will usually be provided by the foreign shareholder’s “home” revenue authority i.e., a credit would be allowed for the amount of the Australian withholding tax paid.<sup>7</sup> The final tax outcome for a non-resident shareholder is, of course, affected by various other factors in the shareholder’s country of residence, including the rate of tax payable on dividend income, the availability of tax concessions under that country’s domestic law, and different approaches to the taxation of entities. Some countries impose no tax on dividends received from offshore (e.g., Singapore and Hong Kong) whilst others provide concessional tax rates (e.g., the United Kingdom and the United States of America).<sup>8</sup> It is beyond the scope of this article to quantify the after-tax cost to any particular foreign investor as a result of any future changes to Australia’s dividend withholding tax arrangements. Some investors may not be adversely affected due to the availability of foreign tax credits for any additional Australian tax payable. Others may be worse off.

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<sup>2</sup> See also John Head and Richard Krever, ‘Australian Business Income Tax Reform in Retrospect: An Analytical Perspective’, in C. Evans and R. Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect*, (Thomson Reuters, 2009) 26.

<sup>3</sup> Note that only Australian residents are entitled to benefits from the Medicare scheme, and for that reason non-residents do not bear the impost of the levy.

<sup>4</sup> See Part A, p.4, of the Explanatory Memorandum, *Taxation Laws Amendment (Company Distributions) Bill 1987; Income Tax (Franking Deficit) Bill 1987; and Income Tax Rates Amendment Bill 1987*.

<sup>5</sup> *Income Tax Assessment Act 1936*, s 128B(3)(ga).

<sup>6</sup> See Australian Taxation Office website: [www.ato.gov.au/Business/International-tax-for-business/In-detail/Withholding-from-dividends-paid-to-foreign-residents/](http://www.ato.gov.au/Business/International-tax-for-business/In-detail/Withholding-from-dividends-paid-to-foreign-residents/).

<sup>7</sup> Double tax agreements made by Australia routinely provide for taxpayers to be allowed a credit for foreign tax paid as permitted by the terms of the agreement, to provide relief from double taxation; see, for example, Article 22 of the *United States Convention*. Many countries, as does Australia, also allow foreign tax credits under their domestic law, independently of any tax treaty obligations to do so.

<sup>8</sup> Henry (n 1) 192.

### III. REVENUE COST OF THE DIVIDEND WITHHOLDING TAX CONCESSION.

Perhaps surprisingly, an estimate of the annual cost to revenue of the exemption from Australian withholding tax that applies on payment of a fully franked dividend to a non-resident shareholder is not explicitly disclosed in the Australian Treasury's annual *Tax Expenditures and Insights Statement*, although the concession is mentioned obliquely in the context of the broader cost to revenue of the dividend imputation concessions. The most recent Statement indicates that in 2019-20, around \$67 billion of franking credits were distributed by Australian companies and it also mentions in a footnote that apart from distributions to Australian individuals and entities, '\$20 billion of credits distributed flowed elsewhere, including to foreigners not able to use them to offset Australian tax paid'.<sup>9</sup>

Although this disclosure fails to explicitly mention the dividend withholding tax exemption that applies to the distribution of franked dividends, it can be inferred that the "cost" of that exemption is substantial by extrapolation from the \$20 billion sum mentioned, and thus would potentially be a multi-billion-dollar annual amount. Another indicator of the potential revenue cost of the concessional dividend withholding tax approach for franked dividends can be gleaned from Australian Bureau of Statistics data on revenue collection in 2021-22 released on 26 April 2023, which indicates that Dividend Withholding Tax of \$621 million was collected in that year.<sup>10</sup> Note that this represents withholding tax paid by non-residents on the *unfranked* component of Australian-sourced dividend income. "Taxation Statistics" data published by the ATO<sup>11</sup> confirms that franked dividend distributions (\$183.7 billion in 2020-21) substantially exceed unfranked dividend distributions (\$38.3 billion in 2020-21), from which it can then be deduced that revenue foregone from the exemption for franked dividend distributions would be substantially greater than the revenue actually collected in respect of unfranked distributions.<sup>12</sup> Illustratively, based on the above data, an equation of  $(183.7 - 38.3) \times 621$  would indicate a foregone revenue cost (i.e., dividend withholding tax on franked dividends presumptively paid to non-residents) of \$2.98 billion.

### IV. ORIGINS OF THE CONCESSION

Proposals for reform of the company tax system to prevent the double tax on profits distributed to shareholders (under the "classical" approach to taxation of dividend income prevailing in Australia at the time) were canvassed in the Draft White Paper released by the Australian Government in June 1985, in the leadup to the National Tax Summit which started on 1 July 1985.<sup>13</sup>

<sup>9</sup> Treasury, *Tax Expenditures and Insights Statement*, (February 2023) 52.

<sup>10</sup> Australia Bureau of Statistics, *Data Downloads, Tables 1-10, Taxation Revenue, Australia* (Report, 26 April 2023) [www.abs.gov.au/statistics/economy/government/taxation-revenue-australia/latest-release#data-downloads](http://www.abs.gov.au/statistics/economy/government/taxation-revenue-australia/latest-release#data-downloads).

<sup>11</sup> Australian Taxation Office, *Taxation Statistics 2020-21, Company – Table 1*, (Downloadable spreadsheet, 27 September 2023) accessed at [https://data.gov.au/data/dataset/taxation-statistics-2020-21/resource/ed52f383-40e9-4a48-af07-41a16acf8b08?inner\\_span=True](https://data.gov.au/data/dataset/taxation-statistics-2020-21/resource/ed52f383-40e9-4a48-af07-41a16acf8b08?inner_span=True).

<sup>12</sup> In similar vein, an Australian Institute paper *Further cuts in company tax cuts and resulting gifts to foreign investors*, apparently published in 2020, estimated that an extension of company tax cuts to high turnover companies would "gift" \$2.3 billion to foreign shareholders, although it did not discuss the significance of the withholding tax exemption, see <https://australiainstitute.org.au/wp-content/uploads/2020/12/estimating-the-value-of-the-remaining-tax-cuts-for-foreign-investors.pdf>.

<sup>13</sup> Paul Tilley, '1985 Reform of the Australian tax system' (Working Paper No 7/2021, Tax and Transfer Policy Institute, Crawford School of Public Policy, Australian National University, April 2021) 15.

Subsequently, in a Ministerial Statement to the House of Representatives on 19 September 1985, then Treasurer Mr P.J. Keating announced the Government's decision to introduce a package of wide-ranging tax reform measures, including 'a system of full imputation on company income distributed to resident individual shareholders'.<sup>14</sup> In that statement, Mr Keating also announced an increase in the company tax rate from 46 per cent to 49 per cent, 'to help defray the cost' of the imputation measures.<sup>15</sup>

Further details about implementation of the dividend imputation system in Australia were announced by Mr Keating in a Press Release on 10 December 1986.<sup>16</sup> As made clear in that Press Release, the intention of the system was to ensure the amount of tax borne on company profits distributed to resident individual shareholders would be 'no more than 49 cents in the dollar'. This was because at the time the imputation system was introduced in 1987, the new company tax rate and the top marginal personal tax were aligned at 49% (not including Medicare levy), meaning that no "top-up" tax was payable by an individual shareholder on receipt of a franked dividend. An individual shareholder whose income fell below the 49% tax rate threshold was entitled to offset excess franking credits against the tax liability on other income, but not to a refund of any excess. In the 10 December 1986 Press Release, Mr Keating also announced that there would be a withholding tax exemption for franked dividends paid to non-resident shareholders, but the Press Release did not provide an explanation for introducing the exemption.

Legislation to implement these measures was subsequently enacted in 1987.<sup>17</sup> The Explanatory Memorandum that accompanied the package of amending Bills on their introduction to Parliament confirmed that they would implement the proposal 'to align the company tax rate with the new maximum marginal personal tax rate of 49 per cent, commencing with the 1987-88 financial year'.<sup>18</sup> However, while these amending Bills led to the enactment of the withholding tax exemption for franked dividends to non-resident shareholders, again, the Explanatory Memorandum did not include an explanation for providing this concession.

Nevertheless, it may be observed that under the original imputation system introduced in 1987, a foreign shareholder bore the same effective tax cost as an Australian resident shareholder (paying tax at the highest marginal rate) on a fully franked dividend i.e., the 49% company tax rate. This outcome was achieved by providing the dividend withholding tax exemption to non-resident shareholders. If the exemption had not been so provided, a non-resident shareholder would have borne a greater amount of Australian tax than an otherwise comparable Australian resident shareholder. However, the alignment of the company tax rate and the top personal tax rate for Australian residents lasted only one year, with a reduction in the company tax rate from 49% to 39% announced in May 1988.<sup>19</sup> Since then, the effect of the dividend withholding tax exemption is that a non-resident shareholder bears a lower Australian tax cost on franked dividend distributions than a resident shareholder taxed at the highest marginal (individual) rate (the final rate of tax borne by a non-resident shareholder will depend on the tax treatment of foreign-source dividend income in the shareholder's country of residence, which may vary widely between

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<sup>14</sup> Commonwealth, *Hansard*, House of Representatives, 19 September 1985, 1353.

<sup>15</sup> *Ibid.*

<sup>16</sup> Treasury (Cth), 'Business Tax Reform: Ending the Double Tax on Company Dividends' (Press Release No. 135, 10 December 1986).

<sup>17</sup> *Taxation Laws Amendment (Company Distributions) Act 1987* (Cth); *Income Tax (Franking Deficit) Act 1987*; *Income Tax Rates Amendment Act 1987* (Cth).

<sup>18</sup> Explanatory Memorandum (n 4) 19.

<sup>19</sup> Tilley (n 13) 26.

different countries). The extent of the disparity is increased whenever the Australian company tax rate is reduced, and this issue was commented on widely in 2020 in the context of proposals then under consideration to reduce the tax rate for high-turnover companies to 25%.<sup>20</sup>

## V. POLICY CONSIDERATIONS AND THE NEED FOR REVIEW

The absence of any specific disclosure of the cost to revenue of the withholding tax exemption for franked dividends in the annual *Tax Expenditures and Insights Statement* published by the Australian Treasury perhaps helps to explain the lack of any public debate about the rationale for maintaining that exemption, either in the academic literature or in broader political debate, or during the reviews of the Australian tax system undertaken since 1987. Whilst the exemption is well known to tax academics, tax practitioners and the international investment community, this knowledge has not translated to a broader consideration of whether the ongoing availability of the exemption can be justified, notwithstanding the apparent significant cost to the revenue that is associated with it. This is even more curious considering the controversy surrounding a policy proposal announced by the Australian Labor Party prior to the 2019 Australian Federal Election, to remove the refund of unused franking credits for Australian resident shareholders, and thereby return to the original 1987 policy approach in which a refund of excess franking credits was not available. The Parliamentary Budget Office estimated the tax saving that would be achieved by adoption of this proposal (to abolish refunds of excess franking credits) would be \$5.6 billion in the 2020-21 year.<sup>21</sup>

Although the exemption from withholding tax for franked dividend distributions to non-resident shareholders is likely to have a foregone revenue cost significantly less than the cost of refunding excess franking credits to resident shareholders (see previous discussion about the possible cost to the revenue of the withholding tax exemption), it is nevertheless likely to be a multi-billion-dollar annual amount. A key difference between the two concessions, at least from an Australian domestic political perspective, is that the dividend withholding tax exemption only benefits shareholders who are not tax residents of Australia, and its removal or modification would therefore be unlikely to attract the same domestic political controversy as was the case with the previous proposal to abolish refunds of excess franking credits for Australian resident taxpayers. However, such conjecture is a matter for political leaders to consider, whereas this article is focused on whether there remains a policy rationale for maintaining the exemption.

One of the concerns addressed in this article is that under the current arrangements, foreign shareholders are major beneficiaries of any Australian domestic company tax reduction, especially in cases where the Australian company tax is the final tax they pay on payment of dividends (i.e. this is the treatment that may apply to shareholders resident in tax havens, or other low-tax countries which do not tax residents on foreign-source income such as Singapore). However, in other cases, where additional foreign tax is payable by a non-resident shareholder on Australian-sourced dividends, Australia's policy approach is effectively to sacrifice Australian revenue in favour of the foreign revenue authority i.e., on the basis that if the dividend withholding tax exemption was not available, the foreign country would generally grant a foreign tax credit for the withholding tax paid by the shareholder. Although the resulting revenue transfer to foreign revenue

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<sup>20</sup> Australian Institute (n 12).

<sup>21</sup> Parliamentary Budget Office, *Dividend imputation credit refunds*, reply to Senator Leyonhjelm, May 2018, <https://www.pbo.gov.au/publications-and-data/publications/costings/dividend-imputation-credit-refunds>.

authorities that results from the Australian policy approach is unknown, it is also likely to be a substantial amount, perhaps more than a billion dollars per annum.

Notwithstanding the absence of any publicly stated reason for introducing the dividend withholding tax exemption, in the broader context of the 1985 tax reforms and the specific design of the 1987 imputation reforms, a reason for introducing the exemption can nevertheless be deduced. As previously explained, under the 1987 imputation system, the company tax rate and the top marginal personal tax rates for residents were aligned, so the effect of the withholding tax exemption ensured parity of tax treatment between non-resident and resident shareholders (at least those paying tax at the highest marginal rates) in respect of a franked dividend. Tilley has explained that the key tax reform criteria of fairness (or equity), efficiency (or neutrality) and simplicity guided the policy thinking (of Treasury) in the 1985 tax reform process.<sup>22</sup> In that context, the withholding tax exemption ensured that “horizontal equity” was maintained between resident and non-resident shareholders, in the sense that “equals should be treated alike”.<sup>23</sup> However, this justification was short-lived, as a result of the 1988 company tax reduction and the subsequent ongoing differences between corporate tax and personal tax rates that have applied in Australia since then. A “horizontal equity” argument therefore no longer justifies the dividend withholding tax exemption; indeed, there is now a misalignment (at least for Australian shareholders bearing tax at the highest marginal tax rate) between their Australian tax treatment and that applied to foreign shareholders. This then raises a further issue with respect to horizontal equity arguments: between whom is equity to be maintained? The answer to that question is not a simple matter either, having regard to the different approaches to entity taxation and the differing tax approaches in different jurisdictions that would bear on answering the question. There is no single yardstick by which horizontal equity can be measured in dealing with comparative tax treatment of dividend distributions afforded to resident and non-resident shareholders in Australian companies. To the extent that a “horizontal equity” argument in favour of a dividend withholding exemption may have been justified at the time the imputation system was introduced, it might equally be argued that horizontal equity now requires the reinstatement of a dividend withholding tax to restore some parity between the overall amount of Australian tax on Australian company profits distributed as dividends to Australian and non-resident shareholders. It should also be noted that non-residents deriving other Australian source income (and not subject to special arrangements under DTAs and general tax law) are generally subject to the same marginal rates of Australian tax as an Australian resident, but without the benefit of the tax-free threshold.<sup>24</sup>

When the reduction to the company tax rate from 49% to 39% was announced in May 1988, the then Treasurer (Mr Keating) noted that: “[t]he 39% Australian company tax rate will be competitive by developed world standards, particularly when account is taken of the state or local income taxes imposed in many other countries, and the benefits of Australia’s full imputation system”.<sup>25</sup> The announcement made no mention of the dividend withholding tax exemption, which remained in place. However, the announcement does indicate that “international competitiveness” was one of the key drivers for the company tax rate cut, and Dr Ken Henry, one of the architects of the 1980s tax reform in Australia, later observed in 2010 (in the general context of his subsequent comprehensive tax review of the Australian tax and transfer system mentioned previously):

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<sup>22</sup> Tilley (n 13) 11.

<sup>23</sup> James Repetti and Diane Ring, ‘Horizontal Equity Revisited’, (2012) 13(3) *Florida Tax Review* 135, 136.

<sup>24</sup> Australian Taxation Office, *Foreign resident tax rates 2023-2024* (Web Page, 27 September 2023) <https://www.ato.gov.au/Rates/Tax-rates---foreign-residents/#Foreignresidentstaxrates2023to2024>.

<sup>25</sup> Paul J Keating, *Economic Statement May 1988*, Australian Government Publishing Service, Canberra, 76.

Given that company tax acts as a final tax on foreign equity investment, lower rates of company tax can attract marginal investments. Foreign direct investment is desirable, especially on grounds of technology transfer and knowledge spillovers. Lower company taxes would lower the cost of corporate capital at the margin, encouraging capital-deepening in all sectors, in turn increasing labour productivity and boosting real wages.<sup>26</sup>

The reason company tax acts as a final tax for foreign shareholders is because of the withholding tax exemption; as explained in this article, the Australian tax paid on company profits distributed to foreign shareholders as fully franked dividends is limited to the underlying company tax. It would therefore appear (based on Henry's observation) that the reason for continuing to provide the dividend withholding tax exemption may be to provide *preferential* tax treatment for "foreign direct investment", for the reason (explained by Henry in 2010) that such investment is desirable. Whilst the need for horizontal equity may have explained the introduction of the original 1987 exemption, it therefore appears the rationale for maintaining the exemption has since changed, or at least has changed in its primary emphasis, to one that provides a tax preference to non-resident shareholders in Australian companies and thereby ensure Australia's international competitiveness in attracting foreign capital investment.

However, while Henry's observation about encouragement of "direct foreign investment" may well have been the rationale for providing the dividend withholding tax exemption, it is only a partial justification. According to the Australian Department of Foreign Affairs and Trade:

**Foreign direct investment (FDI)** is when an individual or entity from outside Australia establishes a new business or acquires 10 per cent or more of an Australian enterprise, and so has some control over its operations. Common examples include the establishment of Australian branches of multinational companies or joint ventures between Australian and foreign companies.<sup>27</sup>

Of course, as described here in the Australian context, the current dividend withholding tax exemption is not confined to shareholders with an investment stake greater than 10%, and extends also to any portfolio investment (less than 10 per cent).

In this respect, it is notable that New Zealand also introduced an imputation system around the same time as Australia, and it adopts a substantially similar approach to taxing franked dividends paid to resident shareholders. Australia and New Zealand are the only two OECD member countries which continue to operate full dividend imputation systems, whilst other countries such as the United Kingdom ("UK"), Germany, Finland, Norway, Malaysia, and Singapore have all abandoned their own dividend imputation systems over the past 25 years.<sup>28</sup> In member countries of the European Union, the removal of imputation appears to have been a response to concerns expressed by the European Court of Justice in the context of non-discrimination requirements in the treatment of investors 'so that capital can move freely'.<sup>29</sup> Changes to the UK arrangements were apparently made to promote greater investment by companies rather than distribution of profits to shareholders (as dividends).<sup>30</sup>

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<sup>26</sup> K Henry, 'Tax Reform: Opportunities and Challenges', in C Evans, R Krever and P Mellor (eds) *Australia's Future Tax System: The Prospects after Henry*, (Thomson Reuters, 2010), 4.

<sup>27</sup> Department of Foreign Affairs and Trade, 'About Foreign Investment' (Web Page) <https://www.dfat.gov.au/trade/investment/about-foreign-investment>.

<sup>28</sup> Henry (n 1) 190, 191.

<sup>29</sup> A Ainsworth, 'Dividend Imputation – the International Experience', (2016) JASSA: The Journal of the Securities Institute of Australia 58, 59.

<sup>30</sup> Ibid.



Although New Zealand introduced its dividend imputation system in 1988 (soon after Australia), its initial approach to dividend distributions to non-resident shareholders was quite different from Australia's and resulted in higher rates of effective tax for non-resident shareholders than for New Zealand resident shareholders. Imputation benefits 'were expressly denied to non-residents' and 'non-resident investors suffered a much higher overall tax burden than equivalent resident shareholders'.<sup>31</sup> This was the result of the retention of dividend withholding tax at a 30% rate, reduced to 15% under applicable DTAs. In considering reasons for this approach, Smith noted that:

There is reluctance to reduce taxes on non-residents' income where the amount of tax conceded will then be collected by the resident country due to reduced foreign tax credits being available. From the source country's perspective such a concession is pointless as it merely transfers tax revenue between governments without increasing the non-resident investor's net income.<sup>32</sup>

Subsequently, New Zealand made significant changes to the tax treatment of dividends paid to non-resident shareholders with a withholding tax exemption announced in the 1991 New Zealand Budget for fully imputed dividends (i.e., resulting in alignment with the Australian approach).<sup>33</sup> However, this exemption approach was apparently short-lived, with a new approach announced shortly after the 1993 Budget.<sup>34</sup> This involved a complex arrangement 'designed to ensure that the tax relief provided in New Zealand will not be clawed back by foreign governments in the investor's home country under foreign tax credit provisions'.<sup>35</sup> However, further changes were introduced in 2010, largely as a result of the negotiation of new DTAs with Australia, the United States and Singapore.<sup>36</sup> As a result of the 2010 changes, New Zealand's current approach to applying dividend withholding tax to non-resident shareholders is as follows:

- 0% for fully imputed dividends paid to a shareholder holding 10% or more of the direct voting interests in the company and fully imputed non-cash dividends.
- 15% for fully imputed cash dividends paid to a shareholder holding less than 10%.
- 30% in most other cases, subject to any relief available under a DTA.<sup>37</sup>

As may be observed, the current New Zealand approach distinguishes between foreign direct investment (i.e., those shareholders with a direct equity interest in the company of 10% or greater) and portfolio investors holding a lower percentage shareholding. A lower dividend withholding tax rate (15%) applies to "fully imputed" (i.e., "franked" in Australian parlance) dividends paid to shareholders holding equity interests below the 10% threshold, whilst non-imputed dividends are taxed at 30% (subject to DTA relief). This approach appears to recognise that substantial (non-portfolio) foreign direct investors are likely to hold shareholdings through interposed corporate

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<sup>31</sup> A Smith, 'Dividend Imputation and International Equity Investment: Unilateral Extension of Imputation to Non-resident Investors', (1994) 11 *Australian Tax Forum* 248, 257.

<sup>32</sup> Smith (n 31) 252.

<sup>33</sup> *Ibid* 259.

<sup>34</sup> *Ibid*.

<sup>35</sup> *Ibid*.

<sup>36</sup> Inland Revenue Department (NZ), *Taxation of Outbound Dividends* (Web Pag, 2009), <https://www.taxtechnical.ird.govt.nz/new-legislation/act-articles/2009-63/taxation/taxation-of-outbound-dividends>.

<sup>37</sup> PricewaterhouseCoopers, 'New Zealand Corporate Withholding Taxes', Note 3, *Worldwide Tax Summaries*, <https://taxsummaries.pwc.com/new-zealand/corporate/withholding-taxes>.

entities, so that any foreign tax credit for withholding tax paid would effectively be lost on pass-through to underlying shareholders, whereas a “portfolio” investor would be more likely to be entitled to the benefit of foreign tax credits for withholding taxes paid e.g., an individual shareholder.<sup>38</sup> In turn, the design of the current New Zealand approach seems to achieve a balance between promoting foreign direct investment by substantial investors (determined by reference to the 10% investment threshold) which is desirable for the reasons articulated by Henry,<sup>39</sup> whilst avoiding a unilateral transfer of revenue to foreign governments in respect of dividend payments to smaller non-resident portfolio shareholders who are more likely to benefit from foreign tax credits for dividend withholding tax payments.

While the United Kingdom is a notable exception (generally, it does not impose dividend withholding tax, except in respect of “property income dividends”), many other countries such as the United States of America, France, Netherlands, Japan, Indonesia, and Germany continue to impose withholding tax on dividends paid to non-resident shareholders. However, like New Zealand, most of these countries also allow lower withholding tax rates to apply to shareholders with substantial shareholdings, generally under the terms of applicable DTAs, although the treatment afforded by individual countries varies.<sup>40</sup>

The New Zealand approach provides a useful point of comparison with the less-targeted approach of the current broadly-available Australian dividend withholding tax concession, which is available for both foreign direct investment and portfolio investment, and the New Zealand approach could therefore serve as a model for future Australian reform.

## VI. CONCLUSIONS

Australia’s imputation was regime introduced in 1987. The focus of this article is not on the imputation arrangements that apply to Australian residents in receipt of Australian-source dividend income. Rather, its focus is on the Australian withholding tax exemption for franked dividends paid to non-resident shareholders, which apparently was introduced to ensure parity in the Australian tax treatment of Australian-sourced dividends paid to both foreign and domestic shareholders and thereby achieve horizontal equity. However, as this article has explained, this rationale was short-lived, due to the misalignment of corporate tax rates with the highest marginal tax rates for resident individuals, commencing in 1988. Since then, it appears that the main reason for maintaining the dividend withholding tax exemption is to provide preferential tax treatment for direct foreign investment in Australian companies.

It is curious that the availability of the exemption has escaped scrutiny in major tax reviews conducted in Australia since the imputation system was first introduced in 1987. Part of the reason may be that the exemption is not separately costed and disclosed in the annual *Tax Expenditures and Insights Statement*, and in that respect, it is a concession that could be said to be hiding in plain sight. As explained in this article, the cost of the concession could exceed \$3 billion per annum.

Now that more than 35 years have passed since the imputation system was introduced, Australia should therefore undertake a comprehensive review to assess whether the cost of the current dividend withholding tax exemption for franked dividends can be justified. Australia’s approach

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<sup>38</sup> See especially the discussion in Smith (n 31) 253, 254.

<sup>39</sup> Henry (n 26).

<sup>40</sup> See generally: PricewaterhouseCoopers, *Worldwide Tax Summaries Online*, accessed 15 October 2023 at <https://taxsummaries.pwc.com>.

does not follow that taken in most other countries, which typically impose a general dividend withholding tax whilst often allowing a concessional rate to apply to non-resident non-portfolio investors (often under the terms of a DTA).

The New Zealand approach serves as a model for reform. New Zealand and Australia are the only two OECD countries which continue to operate a full imputation system, and New Zealand continues to impose a dividend withholding tax on franked dividends paid to non-resident portfolio shareholders who hold less than 10% of the equity in the company paying a dividend, whilst allowing foreign direct investors (holding more than a 10% shareholding) a withholding tax exemption for franked dividends. The benefit of the New Zealand approach is that it promotes desirable direct foreign investment for the reasons explained by Henry, whilst removing the concessional treatment of dividend income that is provided to non-resident portfolio investors under the current Australian approach.