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# Dividend and Capital Streaming

## **Abstract**

The Australian economy and its taxation system is in a period of unprecedented change. It is apparent that with this change it is becoming difficult to keep tax legislation simple. This paper examines the imputations system of taxing company income, dividend streaming, capital streaming and taxation reform and suggests that there are further opportunities for reform of the company taxation regime.

## **Keywords**

capital streaming, taxation system, legislation, tax

## DIVIDEND AND CAPITAL STREAMING

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**The Australian economy and its taxation system is in a period of unprecedented change. It is apparent that with this change it is becoming difficult to keep tax legislation simple. This paper examines the imputations system of taxing company income, dividend streaming, capital streaming and taxation reform and suggests that there are further opportunities for reform of the company taxation regime.**

### INTRODUCTION

This article considers the nature and use of the Australian dividend imputation regime in the context of streaming and the likely forthcoming Ralph<sup>1</sup> reform changes.

The context of these provisions and the ongoing taxation reform process is that they are a part of an increasingly competitive marketplace. The marketplace has a significant impact upon government policy and it is becoming increasingly apparent that complex legislation is a poor solution for the effective taxation of a complex business environment. The difficulty lies in determining what constitutes “better” taxation legislation or indeed improved taxation legislation.

The current taxation system does not encourage companies allocating imputation credits so that those shareholders that can benefit most from them receive them. The reasons for this include what are considered to be the two major defects in the imputation system. These defects are said to be “the different tax treatment of debt and equity” and the fact that non-resident shareholders are unable to take advantage of available tax relief.<sup>2</sup> Further,

<sup>1</sup> Commonwealth of Australia, *Review of Business Taxation: A Platform for Consultation, The Taxation of Entities*, Discussion Paper 2, vol II (the “Ralph Report” after its chairman, John Ralph) (1999 AGPS) at 347.

<sup>2</sup> Tran-Nam B, “Introduction and Summary” in Tran-Nam (ed), *Tax Reform and the GST: An International Perspective* (1998 Prospect Media Pty Ltd) at 28

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there has recently been an increase in the number of companies incorporating as well as an increase in the number of shareholders. This increase in the number of shareholders is said to be encouraged by government policies such as the privatisation of public entities.<sup>3</sup> Because of the increased number of shareholders seeking tax advantages from imputation credits, the government has, amongst other things, moved “against dividend streaming”<sup>4</sup> and capital streaming.

Most items are available for purchase on the open market. Imputation or franking credits are no exception. It is common knowledge that the trade in franking credits occurs. This benefits superannuation funds and individuals on high incomes without exposing them to the economic risk of owning shares.<sup>5</sup>

There are many different rationales for government policy as are there many different theories regarding how society should be run.<sup>6</sup> However, in relation to the income tax law, Adam Smith’s four canons of taxation (equity, neutrality, certainty, and administrative certainty)<sup>7</sup> must be considered when determining tax policy, and in particular whether companies should be able to allocate imputation credits to those who can best utilise them.

This article will consider the nature and impact of the imputation system, the dividend streaming provisions, and the impact of the Ralph Reform process on them.

## IMPUTATION SYSTEM

There are a number of methods of taxing companies, these being: the full integration system; the integration of distributed profits system; and the no integration system.<sup>8</sup>

Under the integration system, profits, gains and losses pass through the company, like a conduit, to shareholders.<sup>9</sup> Where all corporate equity passes

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approving Warren A, *Reporter’s Study of Corporate Tax Integration* (1993 American Law Institute).

<sup>3</sup> Warren NA, *Tax Facts and Tax Reform* (1998 Australian Tax Research Foundation) Research Study No 31 at 84.

<sup>4</sup> Ibid.

<sup>5</sup> Dinnison I, “Australia Dilutes Imputation” (1997) *International Tax Review* 41.

<sup>6</sup> For example, laissez faire liberalism, libertarianism and utilitarianism.

<sup>7</sup> Ross S and Burgess P, *Income Tax: A Critical Analysis* (1991 The Law Book Company Ltd) at 17.

<sup>8</sup> See below n 28.

<sup>9</sup> Integration is:

[a] tax system in which all income earned at the corporate level - that is, both retained and distributed earnings - is attributed to shareholders and taxed at the

to the shareholders (ie, both distributed and undistributed earnings) full integration is said to occur and the shareholders are taxed at individual rates on amounts received from the company. Any tax paid by the company is likened to a form of withholding tax, serving “solely as a prepayment for the income tax”.<sup>10</sup> This system might be seen to be the most equitable because it recognises each shareholder’s entitlement, wherever held. However, it has the disadvantage that profits are not retained at the corporate level.

In Australia the integration system is on distributed profits (in the form of dividends) and is known as the imputation system.<sup>11</sup> It is a form of partial integration achieved at the shareholder level.<sup>12</sup> Under this system shareholders receive credits for tax paid by the company on distributed profits while corporate shareholders’ credit is “passed on by the shareholder to its shareholders”.<sup>13</sup>

### What are franking credits?

Under this system, where a resident company pays tax on its taxable income prior to the income being distributed to shareholders as dividends,<sup>14</sup> the shareholders receive from the company a dividend (known as a franked dividend)<sup>15</sup> as well as a credit for the tax paid by the company. Not all dividends, however, are franked dividends. For example, loans to shareholders that are deemed to be dividends pursuant to s 108 of the Income Tax Assessment Act 1936 (Cth) (“the 1936 Act”)<sup>16</sup> are not franked dividends.

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rates applicable to the incomes of the various shareholders. Under the *full* (or *total*, or *complete*) *integration*, all corporate earnings are used in calculating gross-up and credit.

McLure CE, *Must Corporate Income Be Taxed Twice?* (1975 The Brookings Institute) at 252.

<sup>10</sup> Cnossen S, “The Role of the Corporation Tax in OECD Member Countries” in Head JG and Krever R (eds), *Company Tax Systems* (1997 Australian Tax Research Foundation) Conference Series No 18 at 50.

<sup>11</sup> The imputation system is defined as “a method of dividend relief in which all or a part of the corporate tax liability on distributed earnings is ‘imputed’ to the shareholders and treated as withholding against their personal income tax on dividends”. McLure, above n 9 at 252.

<sup>12</sup> While Australia has a partial integration system, it is “in a sense, a system of full imputation. The full amount of the company tax paid is attributed to shareholders”. Gates SJ, *Tax Aspects of Corporate Restructuring* (1996 Australian Tax Practice LBC) at 5.

<sup>13</sup> Scholtz W, *Australian Corporate Taxation: Dividends, Imputation, Reorganisations, Liquidation, Losses* (1995 Longman Business & Professional) at 57.

<sup>14</sup> The term “dividend” is defined in s 6(1) of the 1936 Act.

<sup>15</sup> To be a franked dividend it must be franked in accordance with the criteria set down in s 160AQF of the 1936 Act (s 160AP of the 1936 Act).

<sup>16</sup> See also s 46M(3) and (4), ss 109 and 46D and Division 7A of Pt III of the 1936 Act for further examples of dividends that are not frankable.

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Where a resident (excluding companies) receives a franked dividend, he or she will be required to include two amounts in their assessable income for the relevant year. First, he or she will include the amount of the dividend received being assessable income<sup>17</sup> and, second, an additional amount<sup>18</sup> that is in effect the amount of the "imputation credit".<sup>19</sup> In order to ensure that the shareholder is not "double taxed", the taxpayer receives a rebate (or offset) of tax equal to the amount previously included in assessable income pursuant to s 160AQT.<sup>20</sup> This rebate amount is deducted from basic tax payable in determining the taxpayer's net tax payable for the year.<sup>21</sup> Australian resident corporate shareholders add "the credit to their franking accounts and, franked dividends paid by them".<sup>22</sup> They do not gross up the dividend under s 160AQT of the 1936 Act and nor are they able to take advantage of the rebate system under s 160AQU of the Act. The advantage for a resident company of receiving franked dividends is that, pursuant to s 46A of the 1936 Act, a resident company can obtain an intercorporate dividend rebate for the tax paid.<sup>23</sup> This ensures that that there is no double taxation. Pane considers that the term "franking credits", "in commercial parlance ... is often used to describe the benefits enjoyed by shareholders receiving franked dividends".<sup>24</sup> This can be compared to shareholders that receive unfranked dividends (ie, where a company has not paid tax on the income being distributed) where no such credit will be available.

Non-residents and tax exempt residents are unable to take advantage of franked dividends.<sup>25</sup>

<sup>17</sup> Section 44 of the 1936 Act.

<sup>18</sup> A "grossed up" amount.

<sup>19</sup> Section 160AQT of the 1936 Act.

<sup>20</sup> Section 160AQU of the 1936 Act.

<sup>21</sup> Section 4-10(3) of the Income Tax Assessment Act 1997.

<sup>22</sup> Butler M, *Australian Federal Company Taxation* (1994 Butterworths) at 39.

<sup>23</sup> Intercorporate rebates are not available to all resident companies, eg, eligible superannuation funds or eligible ADFs: s 300 of the 1936 Act and certain registered organisations: s 116J of the 1936 Act.

<sup>24</sup> Pane T, "Are Franking Credits Available?" in 1989-99 Convention Papers (1998 Taxation Institute of Australia) vol 1 at 223.

<sup>25</sup> Section 160 AQT of the 1936 Act. Vann R, "Legal Implications of Reform of Business Tax" in Collins DJ (ed), *Reform of Business Taxation* (1985 Australian Tax Research Foundation) Conference Series No 4 at 180 states:

it is not simply parochialism and a desire to protect revenue which justifies these proposals. It is very difficult to collect directly tax from non-resident shareholders in view of the rule found in many legal systems ... in the case of non-resident shareholders only their Australian source income is included in assessable income, with the result that, under the progressive rate scale, their tax will often be less than may be appropriate given their world-wide income.

## The purpose of imputation

When the former Treasurer, Mr Keating, introduced the imputation system into Parliament in 1987,<sup>26</sup> he said that it was “the most significant business taxation reform in this country in the post-war years”.<sup>27</sup> Advantages of the imputation system over the classical system<sup>28</sup> include the removal of a number of biases. These biases included “biases to investment and choice of business organisation; biases to dividends and firm financial policy; and biases to portfolio decisions”.<sup>29</sup> It is considered the main reasons for its introduction are for reasons of equity, efficiency and for administrative purposes.<sup>30</sup>

### 1 Equity reasons

Equity is about treating all taxpayers fairly and equally.<sup>31</sup> The replacement of the classical system with the imputation system is said to achieve this goal because it removes double taxation. Thus shareholders are taxed on dividends received at their individual marginal tax rates. However, is the objective actually achieved? Consider the following example:<sup>32</sup>

<sup>26</sup> Taxation Laws Amendment (Company Distributions) Bill 1987.

<sup>27</sup> Keating PJ, Taxation Laws Amendment (Company Distributions) Bill 1987 Second Reading Speech, 2 April 1987 in *Taxation Laws of Australia Legislation and Official Explanations* (1987 Butterworths) vol 18 at 156.

<sup>28</sup> The classical system of taxation is an example of where there is no integration. Under this system a company is taxed as well as shareholders on dividends received. The classical system was introduced into Australia in 1940 on the premise that companies and shareholders, as separate legal entities, should both be taxed (see, eg, the Ligertwood Committee, *Report* (1961 AGPS) at 2). It is argued that different shareholders often have different interests, especially in relation to the distribution of dividends. Likewise, company directors will probably have different interests again (see, eg, McLure, above n 9 at 28). The classical system has received great criticism from practitioners, academics and others, including the Carter Royal Commission in Canada, the Campbell Report in Australia and the United States Treasury. In September 1985 the then Treasurer announced the introduction of the imputation system, commencing 1 July 1987 (Keating PJ, *Reform of the Australian Taxation System* (1985 AGPS) at 69).

<sup>29</sup> Bengt M, “The Australian Full Imputation Reform” in Head JG and Krever R (eds), *Company Tax Systems* (1997 Australian Tax Research Foundation) Conference Series No 18 at 162.

<sup>30</sup> Bird RM, “International Aspects of Tax Reform” in Head JG (ed), *Australian Tax Reform in Retrospect and Prospect* (1989 Australian Tax Research Foundation) Conference Series No 8 at 168.

<sup>31</sup> Ross SD, Burgess P and Krever R, *Income Tax: A Critical Analysis* (1991 The Law Book Company Ltd) at 17.

<sup>32</sup> See Scholtz, above n 13 at 59; and Cnossen, above n 10 at 59.

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**Company A**

	\$
Taxable income:	100
Income tax payable (36%):	<u>36</u>
Net profit available for distribution:	<u>64</u>

*Imputation system:*

	<b>Shareholder A</b> (tax rate 20%) \$	<b>Shareholder B</b> (tax rate 47%) \$
Dividend income:	64	64
+ imputation		
Gross-up (s160AQT):	<u>36</u>	<u>36</u>
Assessable income	<u>100</u>	<u>100</u>
Income tax	20	47
- rebate (s160AQU)	<u>20</u>	<u>36</u>
Income tax payable	NIL	11

Currently, shareholder A, whilst notionally entitled to a rebate of \$36, is in fact only entitled to a rebate of \$20 pursuant to s 160AD of the 1936 Act.<sup>33</sup> Shareholder A does not receive a refund for the excess tax paid, nor can he or she carry forward the \$16 of wasted imputation credit (rebate). Therefore the shareholder does not receive the full benefit of the rebate. This can be compared to shareholder B who does enjoy the full benefit of the rebate. This does not appear to be equitable because a resident on lower income is unable to take full advantage of receiving franked dividends.

The Federal Government has announced its plan to give refunds for excess imputation credits for resident taxpayers who are individuals, complying superannuation funds and certain charitable organisations.<sup>34</sup> This is in keeping with the principles of vertical equity, as otherwise low income earners are, in effect, paying a proportionately higher rate of tax on the same income as is received by high income earners.<sup>35</sup> Therefore under the proposed changes, allocating credits may not be such as issue.

<sup>33</sup> *Kellas v FC of T* 99 ATC 4314.

<sup>34</sup> Commonwealth of Australia, *A Tax System Redesigned - More certain, equitable and durable* (1999 AGPS) Refunding excess Imputation Credits, recommendation 11.7 at 421-424.

<sup>35</sup> Vann R discusses the lack of availability of a refund when the imputation system was introduced into Australia: *Company Tax Reform* (1988 The Law Book Company Ltd) at 8.



Putting aside the government's proposed changes, it could be argued that a company should not be "forced to allocate credits to shareholders who cannot use them, or be penalised for not giving credits to those who cannot use them" (for example, non-resident shareholders). Why should some credits, in effect, be "wasted"? This would mean that those who can take advantage of the credits receive more franked dividends while those on lower incomes and non-residents receive fewer franked dividends (assuming any shortfall would be made up). This may make companies more attractive to prospective shareholders. However, it is not equitable. If allowed, those on lower incomes would be further disadvantaged. It would be contrary to the principles of horizontal equity in that like taxpayers would not be treated in a like manner. Further, it would be vertically inequitable because those taxpayers who are on high incomes would be, in effect, paying less tax in proportion to income received compared to those shareholders on lower incomes. Pursuant to the definition of "dividend streaming arrangement" in s 160APA and s 160AQCB of the 1936 Act, shareholders from the same class are to be treated the same. Therefore, the above example should not occur, at least within the same class of shareholders. However, the argument that "dividing the available franking credits equally over all shareholders may be viewed as contributing to an equity objective"<sup>36</sup> has been questioned. The Industry Commission doubted whether this objective had been satisfied because of the differing way the imputation system treats non-residents to residents.<sup>37</sup>

Compliance costs make it difficult to allocate credits to those who can best utilise them. While it may be possible for directors of private companies and those small listed companies (for example, those that would fail the 20/75% rule)<sup>38</sup> to know which shareholders would benefit from such a system, the compliance costs may make it impractical for large companies to know this information. Neutrality may be affected because investors may prefer smaller companies because their individual requirements may be considered to a greater extent.

<sup>36</sup> Industry Commission, *Implications for Australia of Firms Locating Offshore* (1996 AGPS) Report No 53 at 136.

<sup>37</sup> See Harris PA, "The Taxation of Transnational Corporate Income Under the Composite Tax Principle: Should International Dividend Streaming be Permitted?" (1997) 13 *Australian Tax Forum* 453 at 464.

<sup>38</sup> Section 103A(3) of the 1936 Act.

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## 2 Efficiency reasons<sup>39</sup>

The imputation system is said to improve efficiency because it reduces “the advantages of trusts over companies and...remove[s] the incentive for the retention of company earnings”.<sup>40</sup>

Some argue that for true equity shareholders, and not companies, should be taxed on dividends and capital gains.<sup>41</sup> It is said that although a company is a separate legal entity “companies should be seen as conduits for their shareholders”.<sup>42</sup> This can be likened to how S corporations<sup>43</sup> are taxed in the United States or how a partnership is taxed. The entity is seen as a conduit for the allocation of profits and losses. For true efficiency all entities should be taxed in a like manner. In some ways the imputation system is like this in that the company collects tax (like a withholding tax system) but the actual tax paid is by the shareholders at their individual rate of tax. So it can be argued that there is some neutrality between companies and trusts because under each entity the amounts received by the shareholder/beneficiary are taxed at their marginal tax rate. The purpose of the imputation system, however, does not extend to allowing companies to allocate credits to those who can best use them. To do so would be contrary to the principles of neutrality and efficiency.

<sup>39</sup> Efficiency is said to:

look at the way economic resources should be utilised to maximise aggregate satisfaction ... A tax system is inefficient if it causes taxpayers to choose one transaction rather than another purely for tax reasons. An efficient tax system is one that does not encourage allocational inefficiencies.

Fitzpatrick K and Manoranjan M, “Tax Policy Development” in *Tax Practice Briefing* (1995 Australian Taxation Office Continuing Professional Development) at 3. Fitzpatrick and Manoranjan continue to say that neutrality is “another aspect of efficiency. The Asprey Committee (1975) was of the view that, in general, the tax system should be neutral as between alternative business or consumption choices”.

<sup>40</sup> Bird, above n 30 at 168.

<sup>41</sup> Bird RM, “Why Tax Corporations” in McIntyre, Sanders FE and Westfall D (eds), *Readings in Federal Taxation* (2<sup>nd</sup> edn 1983 The Foundation Press Inc) at 596; Bengé, above n 26 at 167.

<sup>42</sup> Dwyer TM and Larkin JT, *The Taxation of Company and Business Income* (1995 Australian Tax Research Foundation) Research Study No 25 at 31.

<sup>43</sup> S corporations are corporations, domestic to the USA, that elect S corporation status. There can be no more than 75 shareholders, all of whom must be individuals, certain trusts and estates that are not non-resident aliens.

In general, an S corporation does not pay any income tax. Instead, the corporation’s income and expenses are divided among, and passed through to, its shareholders. The shareholders then must report the income and expense on their own income tax returns.

CCH Editorial Staff Publication, *1998 US Master Tax Guide* (1998 CCH Inc) at 115.

### 3 *Administrative reasons*

The imputation system serves “as a ‘practical’ approximation of full integration, which is really the ‘ideal’ system from both an equity and efficiency point of view – and indeed, the only way to achieve the first and second objectives”.<sup>44</sup>

The role of the imputation system has, however, expanded over time with trading in franking credits, dividend stripping and the use of redeemable shares becoming popular methods of obtaining tax advantages. These activities are not considered to be the purposes of the imputation system. The current Treasurer, Mr Costello, suggests two of the main reasons for the introduction of the imputation system:

first, that tax paid at the company level is in broad terms imputed to shareholders proportionately to their shareholdings; and second, that the benefits of imputation would be available only to the true economic owners of the shares, and only to the extent that those taxpayers were able to use the franking credits themselves.<sup>45</sup>

However, the government is proposing to introduce the entity taxation regime so that certain trusts are to be taxed like companies (the regime will not apply to partnerships or sole traders)<sup>46</sup> as well as introduce full franking of all distributions. This proposal will enhance efficiency and equity as all recipients will receive fully franked distributions.

## **DIVIDEND STREAMING**

### **What is dividend streaming?**

Harris defines dividend streaming as:

a practice whereby dividends (or dividends of a specific type for tax law purposes)  
(i) are distributed by a company to persons not holding rights in the company of equivalence with those typically associated with shareholders, or

<sup>44</sup> Bird, above n 30 at 168.

<sup>45</sup> Treasurer, *Measures to Prevent Dividend Streaming* Press Release, 13 May 1997.

<sup>46</sup> Commonwealth of Australia, *A Tax System Redesigned - More certain, equitable and durable* (1999 AGPS) Entity-Specific Issues, s 13 at 469-486.

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- (ii) are not distributed to all persons holding rights in a company of equivalence with those typically associated with shareholders in accordance with the manner suggested by such typical rights.<sup>47</sup>

### Why dividend stream?

While there are non-tax reasons to stream dividends, we will consider the tax reasons for doing so.<sup>48</sup> There are two tax reasons to stream dividends. First, to minimise tax and second, to defer tax that is payable.<sup>49</sup>

Prior to the enactment of the imputation legislation, it was quickly recognised that dividend streaming could be used as a way of obtaining additional benefits under the new system. For example, Dixon and Vann considered that:

The tax arbitrage opportunities in pre-taxed terms in the case of franked dividends is, however, likely to be more significant, at least in terms of the extent of funds invested in company shares.

If superannuation funds and non-resident investors were able to arrange transactions to replace franked dividends by other income such as non-franked dividends, interest or capital gains not subject to the scope of company tax, there is substantial scope to increase both their pre-tax and post-tax incomes.<sup>50</sup>

Mr Keating, in his second reading speech on the Taxation Laws Amendment (Company Distributions) Bill 1987 commented on imputation credits stating that in order:

to prevent blatant channelling of imputation credits to particular shareholders in preference to others ... all dividends paid as part of the one distribution, for example, interim dividends paid to ordinary shareholders, or as part of another distribution made on the same day, are franked to the same extent.<sup>51</sup>

Currently, trading in franking credits is commonplace. Trading may occur in a number of ways, for example:

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<sup>47</sup> Harris PA, "Dividend Streaming" (1998) 27 *Australian Tax Review* 132 at 134. See, eg, Stanley I, "Reappraisal of Dividend and Franking Credit Streaming" in Deutsch R and Rumble T (eds), *Innovative Financial Products* (1996 Prospect Media Pty Ltd) at 31.

<sup>48</sup> Harris, above n 47 at 135 states a non-tax reason to stream dividends is to reduce transaction costs.

<sup>49</sup> Ibid.

<sup>50</sup> Dixon DA and Vann RJ, "An Examination of the Imputation System in the Context of the Erosion of the Company Tax Base" (1987) 4 *Australian Tax Forum* 63 at 75.

<sup>51</sup> Keating, above n 27 at 158.

Australian subsidiaries of multinationals have been able to pass on their imputation credits to third party Australian investors, who pay a fee to the foreign parent ... the foreign parent receives an increased after tax return from its Australian shares and the Australian investor benefits from the franked dividend stream.<sup>52</sup>

Another example is where high-income earners and superannuation funds are able to “receive imputation credits, without having the economic risk from the underlying equity”.<sup>53</sup>

The government has introduced a number of measures to reduce the abuses occurring by dividend streaming. Taking advantage of imputation credits by dividend trading is eroding the revenue base. Further, because these taxpayers are able to obtain tax advantages that are not available to other taxpayers, it is horizontally inequitable when compared with taxpayers on a like income. It is also vertically inequitable, because those on a lower income will be paying a proportionately greater amount of tax.

## Provisions hindering dividend streaming

### *1 Anti-dividend streaming provisions*

#### *(i) Streaming within the same class of shares:*

Where some shareholders in a class of shares receive dividends under one resolution and others from the same class receive dividends under another resolution, s 160AQG of the 1936 Act will be triggered. This section states that in these circumstances all the dividends are to be a “combined class of dividends”<sup>54</sup> and that all dividends are considered to be the dividends “paid under the resolution under which the first of those dividends was paid”.<sup>55</sup> Such an activity may also contravene s 160AQCBA(2) of the 1936 Act, which will be dealt with in greater detail later.

#### *(ii) Streaming different classes of shares:*

Normally different classes of dividends can be streamed, so long as each shareholder within that class is treated similarly. However, under certain circumstances s 160AQCBA(2) will intervene and equally divide the franking surplus between the classes. This will occur where:

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<sup>52</sup> Dinnison, above n 5.

<sup>53</sup> Ibid.

<sup>54</sup> Section 160AQG(2) of the 1936 Act.

<sup>55</sup> Ibid.

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- (a) the right to the dividend is fixed and stated in the Memorandum or Articles and is payable before the end of the franking year (this covers preference shares, at least where the preference relates to dividends); or
- (b) the dividend has been declared but has not yet been paid although it will be paid before the end of the year of income: sec 160APA.<sup>56</sup>

(iii) *Section 160AQCBA(2) of the 1936 Act:*

Where a company streams dividends so that, irrespective of a franking year, some shareholders receive dividends and "other benefits" so that "franking credit benefits are ... received by shareholders (advantaged shareholders) who would ... derive a greater benefit from the franking credits than other shareholders; and the other shareholders (disadvantaged shareholders) will receive"<sup>57</sup> fewer or no franking credits benefit, the Commissioner may either cancel the franking credit or ensure the franking account is debited "in respect of each dividend or other benefit paid or given to a disadvantaged shareholder".<sup>58</sup>

The purpose for the introduction of s 160AQCBA(2) is said to be to avoid wasting imputation credits. Cashmere considers that,

Where franked dividends are paid equally to shareholders all shareholders receive them, although some may not be able to benefit from them as much as others because of the circumstances that apply specifically to them. These shareholders include non-residents, tax-exempt entities and low rate taxpayers. In relation to them the benefit is lost because they are unable to use the franking credit or rebate. Any attempt to prevent that wastage occurring is to be regarded as dividend streaming.<sup>59</sup>

This is correct and it is in keeping with Harris' definition of dividend streaming. The advantages for a company and shareholders undertaking such activities include enhancing business efficacy, especially in an open market. However, there are good reasons why dividend streaming is not permitted. For example, it is inequitable, complex and it also erodes the revenue base.

<sup>56</sup> Woellner RH et al (eds), *1999 Australian Taxation Law* (9<sup>th</sup> edn CCH) at 1146. For further information see *Taxation Determination* TD 93/166.

<sup>57</sup> Section 160AQCBA(2) of the 1936 Act. See Harris, above n 47 at 137-142.

<sup>58</sup> Paragraph 160AQCBA(2)(3)(b) of the 1936 Act.

<sup>59</sup> Cashmere M, *Tax and Corporate Financing into the New Millennium* (1999 CCH) at 209.

## 2 *Debt dividends*

It may be beneficial for a company to ensure that those who can benefit from imputation credits receive them. For example, instead of paying interest back to a lender, who may or may not be a shareholder, a company may instead pay in the form of a distribution of fully franked dividends. Pursuant to s 46D of the 1936 Act, a debt dividend will not be franked. What amounts to a debt dividend was recently considered by the full Federal Court in *FC of T v Radilo Enterprises Pty Ltd*.<sup>60</sup> In this case Lee J held that s 46D is “concerned with the relationship between the share-issuing corporation and the subscribing taxpayer”.<sup>61</sup> This is determined objectively.

Further, a similar provision has been introduced into Parliament to address this issue where the taxpayer is a company, beneficiary in a trust, or partner in a partnership. Where there is a “finance arrangement” intercorporate dividends will not be allowed where the dividend is repaying the loan.<sup>62</sup> Also, beneficiaries and partners will “find that franking credits associated to the relevant dividends received by the trust or partnership will not provide them with the usually associated tax benefits”.<sup>63</sup>

## 3 *General anti-avoidance provisions: s 177EA of the 1936 Act*

Until the enactment of s 177EA of the 1936 Act, Part IVA did not apply to “rebates, franking credits and intercorporate dividend rebates”.<sup>64</sup> This was because “such schemes would not result in a tax benefit being obtained as defined by s 177C of Part IVA”.<sup>65</sup> The factors that must be satisfied in s 177EA<sup>66</sup> are:

- (a) a scheme “for a disposition”<sup>67</sup> or “interest in shares”<sup>68</sup> in a company;
- (b) a frankable dividend has or will be paid “in respect of the interest”;
- (c) the dividend is or is expected to be franked;
- (d) it is reasonable to expect that a person will receive franking credits from the dividend or distribution; and

<sup>60</sup> (1997) 72 FCR 300.

<sup>61</sup> (1997) 72 FCR 300 at 307.

<sup>62</sup> Clause 45ZA of Taxation Laws Amendment Bill (No 4) 1998.

<sup>63</sup> Pane, above n 24 at 232.

<sup>64</sup> Cashmere, above n 59 at 180.

<sup>65</sup> Ibid.

<sup>66</sup> See Harris, above n 47 at 142-147.

<sup>67</sup> “Scheme for a disposition” is defined in s 177EA(14) of the 1936 Act to include “issuing the shares or creating the interest [or]...creating, altering extinguishing a right, power or liability attaching to, or otherwise relating to, the shares or interest”.

<sup>68</sup> “Interest in shares” is defined in s 177EA(13) of the 1936 Act. This definition includes both legal and equitable interests in the shares.

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- (e) the scheme was entered into for the purpose of obtaining franking credit benefits. The purpose does not need to be the dominant purpose but it cannot be an incidental purpose.<sup>69</sup>

The Commissioner may make a determination pursuant to s 177EA(5), the effects of that are contained in ss (10) and (11). There are also two proposed anti-dividend streaming provisions. These are:

(i) *Restricting access to franking credits*

Taxation Laws Amendment Bill (No 2) 1999 has introduced into Parliament a quarantining provision so that companies owned by non-residents or tax-exempt shareholders will not be able to access franking credits. Further, existing credit balances will be cancelled. "These changes were introduced to prevent foreign shareholders effectively selling the imputation credits of their wholly-owned subsidiaries to unrelated Australian investors."<sup>70</sup>

(ii) *Holding rules*

Another provision introduced by this Bill is the 45 day holding requirement for shares (90 days for preference shares). It is proposed that shares must be held for at least 45 days by a shareholder before being eligible to take advantage of the imputation credits or intercorporate dividend rebates. This is said to restrict short-term franking credit trading by limiting "the availability of franking credits".<sup>71</sup>

## Tax reform

With the proposed changes to the tax laws outlined in "Tax Reform: Not a New Tax a New Tax System"<sup>72</sup> (ANTS) all distributions to shareholders would be taxed under the deferred company tax regime.<sup>73</sup> This means that, unlike now, tax preferred profits would be subject to tax at the company level and would be distributed as a franked dividend. The Ralph Report<sup>74</sup> considers this would "improve the integrity of the system and provide the basis for greater simplicity".<sup>75</sup> This is correct, as it would improve the tax collection system as well as improve simplicity because all taxes have been collected at the entity level. Further, because the deferred company tax regime would

<sup>69</sup> Section 177EA(3) of the 1936 Act.

<sup>70</sup> Dinnison, above n 5 at 42; see also Pane, above n 24 at 231.

<sup>71</sup> Cashmere, above n 59 at 225.

<sup>72</sup> Federal Government, above n 34 at 116.

<sup>73</sup> Commonwealth of Australia, *A Tax System Redesigned - More certain, equitable and durable* (1999 AGPS) Distributions, s 12 at 427-468.

<sup>74</sup> See above n 1.

<sup>75</sup> Ibid.



remove the need for the anti-dividend streaming rules, the taxation regime would become simpler.<sup>76</sup> This notion is in keeping with the government's policy that companies should not be able to allocate franking credits to those who can best utilise them. There may be fewer compliance and administrative costs because companies no longer would be able to allocate shares to those who can best use them, as all dividends would be taxed prior to the shareholder receiving them.

The Ralph Report suggests two other options other than the deferred company tax regime for taxing companies, the resident dividend withholding tax (RDWT) and the taxation of unfranked inter-entity distributions. Under the RDWT method:

a withholding tax would be levied on unfranked distributions paid from a resident entity to resident investors, ... unfranked distributions paid to foreign investors would be subject to the existing non-resident dividend withholding tax.<sup>77</sup>

The RDWT method will not resolve dividend streaming concerns. The Ralph Report states this is "because refunds would only be provided for RWDT, not company tax, paid on franked dividends distributed to non-residents. Anti-streaming rules would therefore need to be retained".<sup>78</sup> Because this system would not be as simple as the deferred company tax method, it may cause an increase in compliance costs. The equity issues would remain.

The taxing of unfranked inter-entity distributions involves "taxing distributions of tax-preferred income in the hands of resident recipients"<sup>79</sup> and "is directed at removing the problems with the s 46 inter-corporate dividends rebate, without requiring full franking of all distributions".<sup>80</sup> This would not, however, resolve the dividend streaming issues<sup>81</sup> and thus would not simplify the income tax law nor reduce compliance costs as different calculations would need to be made.

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<sup>76</sup> Ibid at 352.

<sup>77</sup> Ibid at 350.

<sup>78</sup> Ibid at 354.

<sup>79</sup> Ibid at 352.

<sup>80</sup> Ibid.

<sup>81</sup> Ibid at 355.

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## CAPITAL STREAMING

### What is capital streaming?

Due to changes introduced by the Company Law Review Act 1998 to the Corporations Law, companies are able to issue shares at any value.<sup>82</sup> Par value shares no longer exist<sup>83</sup> and “share premium accounts and paid up capital accounts have been abolished. Companies now need only maintain one account – a share capital account”.<sup>84</sup> This enables companies to return capital far more easily to shareholders. Shareholders can now receive capital from a number of sources including profits that have been capitalised<sup>85</sup> and the issuing of bonus shares without the company increasing its share capital.<sup>86</sup> In receiving this capital shareholders may technically not be in receipt of dividends and therefore may not be obliged to pay tax on the capital received (as can be seen in the capitalisation of profits). To ensure tax advantages are not obtained because of the changes to the Corporations Law the Taxation Laws Amendment (Company Law Review) Act 1998 addresses the following issues so that the revenue base is not eroded and so that equity between taxpayers is not only maintained but improved. These issues are:

#### *1 The streaming of bonus shares and minimally franked and unfranked dividends*

Where shareholders cannot take advantage of the credits available from fully franked dividends, it may be advantageous for shareholders that the company not distribute fully franked dividends. The company instead may stream a distribution so that some shareholders who cannot take advantage of franking credits (for example, a non-resident) receive shares, while those who can take advantage of some credits receive minimally franked dividends. Such a structure has the advantage that shareholders in receipt of shares may not be liable to pay tax. This structure has been made simpler to execute after the changes to the Corporations Law in 1998. This practice coincides with the principle that a company should be able to allocate credits to those who cannot use them. However, such a practice is not approved.

Pursuant to s 45 of the 1936 Act, where some shareholders receive shares and others receive “minimally franked dividends”, the value of the share is deemed to be an unfranked dividend. A “minimally franked” dividend is

<sup>82</sup> Lipton P and Herzberg A, *Understanding Company Law* (8<sup>th</sup> edn 1999 LBC Information Services) at 158.

<sup>83</sup> Section 254C of the Corporations Law.

<sup>84</sup> Woellner et al, above n 56 at 21-748.

<sup>85</sup> Section 254S of the Corporations Law.

<sup>86</sup> Section 254A(1) of the Corporations Law.

either an unfranked dividend or one that “is franked to less than 10% in accordance with s 160AQF or 160QFA”.<sup>87</sup> Therefore, a company can avoid s 45 of the 1936 Act by franking dividends by more than 10%.<sup>88</sup>

Not included in this deeming provision are shares which fall under s 6BA(5) of the 1936 Act, namely where a “shareholder has a choice whether to be paid a dividend or to be issued shares and the shareholder chooses to be issued with shares”. Such a dividend will be franked due to the definition of “frankable dividend” in s 160 APA of the 1936 Act.<sup>89</sup> Sullivan states that s 6BA(5) covers situations similar to “the dividend reinvestment type process rather than the classical bonus share issue where a shareholder receives shares with no cost”.<sup>90</sup>

Under s 45 there is a prohibition on the streaming of shares and minimally franked dividends. The meaning of “stream” is not defined in the income tax law. In relation to franking credits, the *Explanatory Memorandum* is of little assistance in determining the meaning of stream in s 45 of the 1936 Act.<sup>91</sup> Cashmere states that s 45 is:

not directed at non-residents and tax exempt entities. In addition, shareholders choice appears to have no relevance since the section applies only where a company streams the benefit.

The rationale behind the new measure appears to be an attempt to limit the ability of a company to allow shareholders to obtain untaxed value from a company from the distribution of share equity.<sup>92</sup>

It is suggested that while Cashmere is correct in his statement, he does not answer why some shareholders “who do not receive the shares receive or will receive minimally franked shares”? Why is there a requirement that there needs to be a mix of distributions under s 45(1) of the 1936 Act?

Section 45 does not mention that the streaming must be to shareholders in the same class. Nor does it mention that the distribution need occur in the same financial year. To allow such distributions would be inequitable because if a shareholder were to receive a fully franked dividend, the appropriate amount of tax would be required to be paid. However, if a shareholder can receive shares in lieu of a fully franked dividend, for example, then no income tax would be payable. Also, because such a distribution can occur in different

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<sup>87</sup> Section 45(3) of the 1936 Act.

<sup>88</sup> Pane, above n 24 at 230.

<sup>89</sup> Ibid.

<sup>90</sup> Sullivan R, “Corporations Law Tail Wagging the Tax Dog” in 1998-99 Convention Papers vol 1 (1998 Taxation Institute of Australia) at 88. See also Cashmere, above n 59 at 238.

<sup>91</sup> Cashmere, above n 59 at 239.

<sup>92</sup> Ibid.

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financial years, manipulation may occur so that shareholders may obtain tax advantages that may not otherwise be available.

Under the proposed entity taxation regime, distributions of profits are to be taxed under a "redesigned imputation system".<sup>93</sup> The Ralph Report suggests that "for entities subject to the new entity tax system, the only relevant non-assessable amounts would be distributions of contributed capital. All other distributions from an entity would be profit distribution".<sup>94</sup> This coincides with s 45. It is important that such a system be maintained, otherwise, companies will manipulate the system so that less tax is paid.

## 2 The streaming of capital

It may be possible to stream capital and dividends so that shareholders who would benefit more from receiving capital benefits than other shareholders do so, while other shareholders who would not gain such an advantage receive dividends. While this type of scheme may occur in different classes as well as within a class of shareholder, it may be more horizontally equitable if used with different classes. However, while it could be argued that such a scheme is not neutral (because a shareholder may prefer one class of share ahead of another), one would assume that for business efficacy this is why different classes of shares exist.

Pursuant to s 45A of the 1936 Act, where capital benefits are given to shareholders<sup>95</sup> "who would derive a greater benefit" as compared to other shareholders and where those other shareholders receive dividends,<sup>96</sup> the Commissioner of Taxation may determine the amount of the capital benefit to be an unfranked dividend. Further, no rebate will be allowed.<sup>97</sup> A "capital benefit" is the provision of shares, share capital or "something done in relation to a share that has the effect of increasing the value of a share (which may not be the same share) held by the same shareholder".<sup>98</sup> However, not covered in s 45A of the 1936 Act is the situation where those in receipt of a "capital benefit" receive shares while other shareholders receive (or will receive) fully franked dividends.<sup>99</sup> Further, where shareholders receive partly franked dividends the Commissioner may make a determination "in relation

<sup>93</sup> "Imputation and the Company Tax Rate", Commonwealth of Australia, *A Tax System Redesigned - More certain, equitable and durable* (1999 AGPS) s 11 at 409-425.

<sup>94</sup> Ibid at 442.

<sup>95</sup> Shareholders in receipt of a capital benefit are known as "advantaged shareholders": para 45A(1)(a) of the 1936 Act.

<sup>96</sup> Shareholders in receipt of dividends are called "disadvantaged shareholders": para 45A(1)(b) of the 1936 Act.

<sup>97</sup> Section 45C of the 1936 Act.

<sup>98</sup> Section 45A(3) of the 1936 Act.

<sup>99</sup> Section 45A(5) of the 1936 Act.

to so much of the capital benefit as the Commissioner considers relates to the unfranked part of the dividend".<sup>100</sup>

### 3 *Schemes providing capital benefits*

This aversion to allowing companies to utilise imputation credits so that those shareholders who can use them receive them and those that cannot do not, can further be seen with the prohibition against shareholders receiving payments "paid in substitution of dividends".<sup>101</sup> Where this occurs, such payments are treated as dividends for tax purposes pursuant to s 45B of the 1936 Act.

To come within the ambit of s 45B, the following criteria must be satisfied:

- (a) a person is provided with a "capital benefit by a company" under a scheme. The terms contained within s 45B(8) are to be given the same meaning as in Part IVA of the 1936 Act;<sup>102</sup>
- (b) a taxpayer obtains a "tax benefit".<sup>103</sup> The taxpayer does not need to be the person receiving the capital benefit; and
- (c) the scheme was entered into for the purpose of enabling the taxpayer to obtain a tax benefit. It does not need to be the dominant purpose for entering into the scheme, but it cannot be an incidental purpose.<sup>104</sup>

Pursuant to s 45C of the 1936 Act, where the Commissioner is satisfied that the criteria in either s 45A or 45B are met, the "amount of the capital benefit" is considered to be an unfranked dividend, and "no entitlement to a rebate arises under section 46 or 46A in respect of the dividend".<sup>105</sup> Further, the Commissioner may determine that a debit to the company's franking account should be made.

<sup>100</sup> Section 45A(6) of the 1936 Act.

<sup>101</sup> Section 45B(1) of the 1936 Act. See also Sullivan, above n 90 at 89.

<sup>102</sup> Cashmere, above n 59 at 242.

<sup>103</sup> "Tax benefit" is defined in s 45B(7) of the 1936 Act to mean the tax payable by the taxpayer "would, apart from this section, be less than the amount that would have been payable, or would be payable at a later time than it would have been payable, if the capital benefit had been a dividend". It is considered that an objective test is used in determining whether a tax benefit has been obtained: Cashmere, above n 59 at 243.

<sup>104</sup> Under s 45B(5) of the 1936 Act the relevant factors to consider include "the extent to which the distribution is attributable to profits of the company or an associate and the pattern of distributions by the company": Cashmere, above n 59 at 244. The eight factors in s 177D of Pt IVA of the 1936 Act are included in this determination: para 45B(5)(k). Note the concerns raised in relation to para 45B(5)(d) and pre-CGT assets by Sullivan, above n 90 at 90.

<sup>105</sup> Section 45C(1) of the 1936 Act.

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#### 4 *Redeemable preference shares*

Paragraph 254A(1)(b) of the Corporations Law allows companies to issue redeemable preference shares. This type of shares is said to be analogous to a company borrowing money, because in "both cases the company pays a set rate of return and at the end of a period of time the funds acquired by the company are repaid".<sup>106</sup> Redeemable preference shares can only be redeemed from company profits or from "the proceeds of a new issue of shares made for the purpose of the redemption".<sup>107</sup>

Under paragraph 6(1)(e) of the 1936 Act a redeemable preference share is not a dividend, so long as "the amount is debited to the company's share capital account"<sup>108</sup> and the company has given a notice when it redeems the share. Therefore, "a redemption from profits will be an assessable dividend and will fall within the definition of sec 6(1)(a)".<sup>109</sup> It is therefore important that care be taken with how preference shares are redeemed. If a redemption is funded from profits the distribution to shareholders will be a dividend, eligible to be franked. Therefore, the issue of a company not having the ability to give imputation credits to those who can best use them may surface. It would not be an issue where one class of shareholder is treated uniformly. But where this does not occur, the activity may fall under the umbrella of one of the anti-avoidance provisions.<sup>110</sup> Section 46D of the 1936 Act may also be of concern. Where a dividend satisfies certain criteria in s 46D(2) the shareholder will not be entitled to the benefit of any rebate.<sup>111</sup>

#### 5 *Tainted share capital account*

Section 254S of the Corporations Law allows companies to capitalise profits. Companies can now capitalise profits and then make a distribution from the share capital account from these profits. This allows companies to manipulate the system so that a non-dividend distribution can be made. This would especially benefit those shareholders who cannot benefit from imputation credits.

The use of such a scheme may allow those in receipt of such a distribution to obtain a tax advantage as compared to those who receive either franked or unfranked dividends. This is horizontally inequitable and is an important factor, not only from an equity view-point, but also from an anti-avoidance perspective. If taxpayers perceive that the tax system is unfair then there may

<sup>106</sup> Lipton and Herzberg, above n 82 at 164.

<sup>107</sup> Paragraph 254K(b) of the Corporations Law.

<sup>108</sup> Subparagraph 6(1)(e)(iii) of the 1936 Act.

<sup>109</sup> Cashmere, above n 59 at 259.

<sup>110</sup> Ibid.

<sup>111</sup> Section 46D(3) of the 1936 Act.

be an increase in tax avoidance. Under the self-assessment system it is important that taxpayers comply with their obligations voluntarily. If this does not occur there may be a breakdown in the system.<sup>112</sup> This will cause a further erosion of the tax base. As a consequence, where a “company transfers an amount to its share capital account from any of its other accounts” the share capital account is said to be “tainted”.<sup>113</sup>

If the share capital account is tainted, the franking account will be debited<sup>114</sup> and any distribution cannot be considered a franked dividend<sup>115</sup> or be eligible for an intercorporate rebate.<sup>116</sup> There is a number of exceptions to the tainting rule, for example, the transferring “from the existing share premium account or capital redemption reserve to its share capital account”<sup>117</sup> and a transfer of an amount to a company’s share capital account under a debt/equity swap.<sup>118</sup> Where the share capital account is tainted, it can be untainted by making a written election to do so.<sup>119</sup>

## 6 General anti-avoidance provisions

Part IVA<sup>120</sup> and s 177EA of the 1936 Act provide general anti-avoidance measures against companies wishing to enter schemes so as to avoid tax.

## Tax reform

A “profits first” rule might be considered. Under the profits first rule a distribution is treated “as coming from profits to the extent that there were ‘distributable profits’ available. Once distributable profits were reduced to zero, distributions would be treated as coming from contributed capital”.<sup>121</sup> This may help reduce capital streaming in that companies will not have the same ability to stream. Linked with this rule is the “slice approach” to distributions. The slice approach applies where a return of capital to a company (for example, a share buy-back) occurs. In such circumstances “the

<sup>112</sup> Fitzpatrick and Manoranjan, above n 39 at 2.

<sup>113</sup> Section 160ARDM(1) of the 1936 Act.

<sup>114</sup> Section 160ARDV of the 1936 Act.

<sup>115</sup> See the definition of “share capital account” in s 6(1) of the 1936 Act.

<sup>116</sup> Sullivan, above n 90 at 90-91.

<sup>117</sup> Ibid at 91.

<sup>118</sup> Section 160RDM(2) of the 1936 Act.

<sup>119</sup> Sections 160ARDR and 160ARDW of the 1936 Act. Untainting does not give rise to a franking credit: s 160ARDO.

<sup>120</sup> See, eg, Cashmere M, “Does Part IVA Apply to Tax Effective Financing Transactions in the 1990s?” in Deutsch R and Rumble T (eds), *Innovative Financial Products* (1998 Prospect Publishing) at 59.

<sup>121</sup> *Review of Business Taxation*, see above n 1 at 427.

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member surrendering the interest can be seen as receiving in return the 'slice' of contributed capital and taxed and untaxed profits relevant to their ownership interest".<sup>122</sup>

The Ralph Report, however, acknowledges these methods will not stop capital streaming. There will remain "some scope for capital streaming (for example, by buying back shares from non-resident shareholders on-market and from resident shareholders off-market)".<sup>123</sup> The Ralph Report considers that "reformed general anti-avoidance provision"<sup>124</sup> may be required to counter residual capital streaming.

## CONCLUSION

In Australia the imputation system has been operating for over 10 years. While the system is much fairer and more neutral than the classical system there are still unresolved issues, especially in relation to companies allocating imputation credits to those who can best utilise them. Whether a company pays dividends, retains those funds, or engages in capital and dividend streaming has an impact on the greater taxpaying community's burden. In the current environment of change there are a number of factors that will influence how companies should be taxed (including whether companies should be able to allocate credits to shareholders who can best utilise them). These factors include the "growing international linkages in goods, services and factor markets (especially capital markets) [that] will impair the ability of national governments to raise tax revenue" and the globalisation of society (which has an undermining effect on the role of the nation).<sup>125</sup> These issues will ensure that the topic of company taxation will remain open for debate and that "corporate taxation is never sacrosanct, because of its vital importance to our fiscal well being. In fact we should open ourselves to the possibility of further efficiency enhancing reforms".<sup>126</sup>

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<sup>122</sup> Ibid at 426.

<sup>123</sup> Ibid at 526.

<sup>124</sup> Ibid.

<sup>125</sup> Bird RM and Mintz JM, "Introduction" in Bird and Mintz (eds), *Taxation to 2000 and Beyond* (1994 Canadian Tax Foundation) at 26-27.

<sup>126</sup> Tran-Nam, above n 2 at 28.