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30 April 2009

AFTS Secretariat  
The Treasury  
Langton Crescent  
PARKES  
ACT 2600

Dear Sir or Madam

**RE: RETENTION OF THE DIVIDEND IMPUTATION SYSTEM**

We are writing in response to your request for written submissions in regard to the Consultation Paper for Australia's Future Tax System. The consultation paper does not specifically seek comments on the dividend imputation system but there have been public comments that consideration is being given to removing it or substantially changing it. We believe that the removal of, or substantial diminution of, the dividend imputation system would be a very damaging development for the country's equity markets.

The system of dividend imputation was first introduced in 1987 with an objective of removing the double taxation of company earnings, once in the hands of the company and secondly in the hands of the shareholder. Since that time the dividend imputation system has become deeply embedded in the equity markets and is extremely well understood and valued by many retail investors, superannuation funds and not for profit organisations. It is a key component in the formation of medium to long term equity capital by Australian companies.

We regard the dividend imputation system as one of the major contributing reasons why Australia has one of the highest levels of retail direct investment into company shares in the world. As such, retail investors form a large block of long term investors in many Australian companies. Any change which lessens the attractiveness of equity to retail investors could have quite significant consequences as they switch to instruments with more attractive after tax investment returns.

The domestic superannuation industry has also benefitted from the system of full dividend imputation. The ability to reclaim franking credits has been a key driver in causing many such funds, and asset allocation advisers, to be overweight Australian equities. The Australian Market is approximately 2% of world markets but most superannuation funds would have weightings in the Australian equity market of between 30% to 40%.

Even though international equity markets over the last 18 months have fallen precipitously, Australian companies have still been able to call on their Australian shareholders for additional equity in ways which have not been available in many international markets. In large part we believe this is a result of the attractiveness of shares to Australian investors and particularly the role of dividend imputation in that attractiveness.

One argument given for removing dividend imputation is that Australian companies will have more ready access to global capital markets. We are not aware of any evidence that international investors are avoiding Australia because of our system of dividend imputation. Such investors do have the benefit of not paying withholding tax on fully franked dividends. Furthermore any increase in attractiveness to foreign investors that might result from removing dividend imputation would be more than offset by a very significant decline in the attractiveness of Australian company shares to retail and superannuation investors within Australia. We have also seen the rapid changes of sentiment by overseas investors when more attractive global opportunities arise. The result could well be increasing volatility in a company's shareholder base as longer term retail shareholders are replaced by shorter term foreign institutional shareholders.

Another reason given for the removal of the dividend imputation system is that company tax could be significantly lowered to say 20%. It is argued that this will result in an increase in the value of the underlying shares because of the improvement in company profitability. While we can understand why a reduction in the company tax would be desirable, a shareholder can only benefit from increased values when they sell their shares. Furthermore, on our calculations any increased dividend payout resulting from lower company tax would not make up for the double taxation resulting from the abolition of dividend imputation. We believe it is preferable by far to keep the dividend imputation system which encourages shareholders to retain their shares, not sell them, to obtain benefits.

Another aspect of the dividend imputation system is that it has encouraged companies to pay Australian tax on their Australian income to obtain the franking credits to distribute as fully franked dividends. Companies have paid out a significant proportion of their profits as dividends because the franking credits attached to franked dividends have more value in the hands of shareholders than being retained by the company.

Under the dividend imputation system shareholders readily appreciate and accept that companies pay full Australian corporate tax because they understand company earnings will not be taxed twice. Re-introduction of double taxation would be an extremely retrograde step.

While the Australian imputation system may well be virtually unique globally, it has provided an underpinning to Australian equity markets in both good times and in very difficult times.

Yours sincerely

*Ross Barker*  
Managing Director