

ASA Submission: Australia's Future Tax System

The AFTS Review (the Review) has a broad focus on all areas of taxation (with the exception of GST). The ASA represents retail investors in Australian shares and has an interest in the areas of company tax and the related dividend imputation system.

Company tax and dividend imputation

Broadly the policy objectives which should drive the nature of taxation of company profits should be; to obtain an appropriate level of revenue; to attract foreign investment in Australia; encourage Australian firms to invest domestically and to recognise profits in Australia; to increase the savings generally of Australians held in equity; increase the number of Australians who fund their own retirement and to provide for the equitable treatment of taxpayers.

These objectives come with a level of conflict. The ASA's view is that the current system of company tax and imputation credits creates the right balance between those objectives, and that compelling arguments have not been made to change the system.

The argument for changing the imputation credit system appears largely to stem from a desire to use revenue gained to fund a decrease in the company tax rate. There is no valid argument that imputation itself creates a disincentive to foreign investment. Further there is no reason why the imputation credit system should be targeted as the means of funding any reduction. Although it relates to company tax, there is no reason why funding could not come from another area of taxation.

The possible advantages of such a reduced company tax rate are said to be increased foreign investment and for shareholders higher profits leading to potentially higher dividends which would offset the loss of franking credits.

Whilst the applicable tax regime is clearly a contributing factor in investment decisions it is one of a number of considerations. Other country specific factors which figure in investment decisions include but are not limited to: geographic location; size of the domestic market; costs of labour; infrastructure; political, economic and regulatory stability and particular competitive advantages such as lack of competitors, availability of natural resources to exploit.

Whilst a complete abolition of the imputation credit system might fund a worthwhile reduction of the corporate tax rate, it is unlikely that this would be achieved by replacing the system with another system of credit for company tax paid.

Reduction in the company tax rate may increase net profits, however a corresponding increase in profits paid out to shareholders would not be guaranteed. Changing the dividend imputation system coupled with a decrease in the company tax rate could result in higher tax paid by resident investors. Abolishing or replacing the imputation system would return to a system where the profits of companies are taxed twice with the likely net effect that investors would face an increased tax burden.

Unintended effects of dividend imputation

Whilst the primary reason for the imputation system is to prevent inequity through double taxation there are a number of positive side effects to the practice. As imputation credits are only paid on Australian taxed profits it encourages companies to Australian recognise profits here. Without that incentive there may be cases where it is more attractive for companies to recognize profits in another jurisdiction, paying tax there, despite a lower headline rate applicable in Australia.

Imputation credits also provide an incentive for Australian investors, both individual and institutional to invest in Australian equities. Without this additional incentive, investment in foreign markets may become more attractive and discourage the same level of Australian investment in Australia.

Finally, the imputation credit system encourages the payment of dividends, which provides an advantage over other jurisdictions in attracting equity investment.

International comparisons

Although there is an international trend away from imputation systems globally, this trend in itself should not be given as a reason for making changes in Australia. Australia has a high level of direct ownership of shares with 46% of Australians owning shares and compulsory retirement savings via superannuation¹. It is therefore difficult to judge Australia against the context of countries such as the UK and USA. Further although some European countries have recently abolished similar systems, the reason for doing so was because European Union rules prevent discrimination between countries.

Effect on retirees and those nearing retirement age

In the short to medium term many older Australians would be severely disadvantaged by any change to the current dividend imputation system. Changing the dividend imputation would be extremely inequitable to those investors who have structured their retirement incomes on the basis of the current system. These investors would effectively be trapped in a structure which would become inefficient leading to a significant reduction in their retirement income.

For many retirees already hard hit by the current crisis changes would mean that they would no longer be able to fund their own retirement and would be forced to rely on state benefits. For others it would lead to a considerable reduction in their income and

correspondingly in their spending, which would reduce their standard of living in retirement and have negative impacts on the economy.

In summary

- Taxation is only one factor in investing and therefore reduction in taxation provides no certainty of attracting greater foreign investment in Australia
- It is unclear whether changes to the current system would be sufficient to fund a reduction in statutory/ effective rates of company tax to attract greater foreign investment in Australia
- Australia cannot return to a system of double taxation of company profits, yet there does not appear to be an appropriate replacement for imputation credits
- Changes made to the current system could have very severe negative impacts for many Australians.

ASA recommendations

The Review would need to have much greater certainty that reduction of the statutory tax rate would in fact attract a much greater level of foreign investment in Australia before considering whether the rate should be changed.

If a reduction in company tax is warranted, it should not be funded by making changes to the dividend imputation system.

ⁱ ASX Share Ownership Study 2006