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30 April 2009

Australia's Future Tax System

Submission by Philanthropy Australia

Philanthropy Australia is the national peak body for philanthropy and is a not-for-profit membership organisation. Our Members are trusts and foundations, families and individuals who want to make a difference through their own philanthropy and to encourage others to become philanthropists. Our Vision is "A giving and caring nation[1]".

Philanthropy Australia is concerned at suggestions that have been made about the possible discontinuation of the current dividend imputation regime as part of the Tax Review and, therefore, would like to make a submission to the Tax Review Panel.

The arguments to maintain dividend imputation we believe are strong:

1. The tax principles of fairness, efficiency, and simplicity are as relevant today as they were in 1987 when dividend imputation was introduced to remove the double taxation of Australians dividend income generated by Australian companies' domestic activity.

2. By providing companies with an incentive to pay fully-franked dividends, companies are encouraged to invest, create jobs and pay tax in Australia rather than off-shore.

3. Discontinuing the imputation regime would severely reduce the attractiveness of investing in Australian companies for domestic investors, which, like many retail shareholders and superannuation funds, charitable trusts and foundations have been willing to do in large part due to the franking credit regime. Australian investors provide a significant source of long-term equity capital funding for Australian companies. Without dividend imputation, investment in overseas companies becomes relatively more attractive.

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4. There is no justification for considering the *de facto* reimposition of taxation on tax-exempt entities. Charities would suffer directly when the need for their services is growing and philanthropy's capacity to assist them would also be significantly reduced through the reduction in income available to distribute.

Furthermore there appears to be no economic reason to justify the reintroduction of double taxation on Australians' dividend income (or any other income). Philanthropy Australia is aware of two arguments that have been advanced to support elimination of imputation:

1. The first argument is that other countries that had imputation have returned to a classical system of company taxation. As the Tax Review Consultation Paper notes (page 127), this has been for European-specific legal reasons and "there is no general trend away from providing relief to shareholders for company tax[1]" Furthermore, the principle of what is right for Australia should underpin tax policy.

2. The second argument is that the abolition of imputation to finance a reduction in the company tax rate would promote foreign direct investment and enhance economic growth. However, proponents of this view have not demonstrated that Australia has difficulty in attracting foreign investment inflows (because our company tax regime allows inadequate returns to foreigners) - in fact data in the Review's Consultation Paper show the opposite[1]. Furthermore, the proposal would likely be ineffective in making returns on Australian assets more attractive to foreigners because of the high leakage of Australian company tax revenue forgone to foreign treasuries[1]. In addition, to the extent that the net-of-all-taxes returns to foreign investors were actually increased, the effect would be for Australia to forgo tax revenue in order to encourage foreigners, rather than Australians, to own our companies and develop our resources – which would seem to be contrary to the national interest.

Both of these arguments are weak and Philanthropy Australia considers that the imputation regime has been of significant benefit to Australian business and Australian shareholders. Specifically for charitable trusts and foundations imputation has increased the level of income being distributed to community organisations and has focused investment portfolios on Australian companies paying Australian taxes; both of which benefit Australia.

Gina Anderson
CEO,
Philanthropy Australia 2009

PROPOSAL TO ABOLISH COMPANY TAX IMPUTATION IN ORDER TO FINANCE A REDUCTION IN COMPANY TAX RATE

Prepared by Dr Ian McKenzie[1]
April 2009

These notes analyse the proposal to abolish Australia's company tax imputation system in order to finance a revenue-neutral reduction in the company tax rate to 19%.

1. Key Weaknesses of a Non-imputation System of Company Taxation

A basic objective of taxation system design is neutrality: to tax even-handedly all classes of income. A classical company tax system (i.e. no imputation) violates this principle by taxing twice income from companies: firstly, at the company tax rate in the hands of the company and, secondly, at the shareholder's marginal tax rate when company income is distributed. Such a system taxes more heavily income earned within company structures vis-à-vis income earned from all other sources.

Thus, under a classical company tax system, the tax-exempt status of the tax-exempt sector (e.g. non-profit charitable bodies) is undermined because these entities' dividend income from investments in companies is still taxed at the company tax rate, even though it is exempt from tax at the shareholder level.

In addition, because company financing in the form of borrowings is not subject to such double taxation, non-imputation biases the financing decision of companies to favour debt vis-à-vis equity. Recent upheavals in the global financial system underline that this is a bias to be avoided!

Non-imputation also biases the decision of the company concerning the use of earned income in favour of its retention by the company rather than its distribution to shareholders as dividends, since the latter choice triggers double taxation of the income, unlike the first.

These and other drawbacks of the classical company tax system are expanded upon in the 1985 Draft White Paper on Tax Reform.

2. Key Features of an Imputation System

An imputation system means that the company tax regime is effectively just a withholding tax structure in respect of Australian resident shareholders. This is because the tax collected at the company level is (by virtue of the imputation credits attached to franked dividends) subsequently credited against Australian shareholders' individual tax liabilities when such income is distributed. Imputation credits are refundable in cash where an individual shareholder's marginal tax rate is less than the company tax rate. This feature ensures that all income distributed by companies to Australian shareholders is effectively taxed only once at the shareholder's marginal tax rate. Accordingly, apart from the timing disadvantage that income retained by Australian companies is taxed at the time that is **earned** -- rather than when it is **distributed** to shareholders – Australia's imputation system achieves for Australian investors the highly desirable attribute of neutrality of taxation treatment of company income vis-à-vis income from other sources.

Thus, for example, the tax-exempt status of the tax-exempt sector is preserved by Australia's imputation system since the tax-exempt sector receives a refund for the underlying company tax paid on its dividend receipts, as illustrated in Table 1.

Table 1. Taxation of Dividend Income in Hands of Tax-exempt Australian Investor.

	(a) Current imputation system	**(b) Imputation abolished & Australian company tax rate reduced**
Company taxation	A$	A$
Company income	100	100
Less Company tax paid	(30)	(19)
After-company-tax income (assumed to be fully distributed)	70	81
Shareholder taxation		
Dividend receipt (1)	70	81
Taxable income	100 (= Dividend receipt + attached imputation credit, which equals amount of company tax paid)	81 (= Dividend receipt)
Shareholder tax liability at rate of 0%	nil	nil
Plus Imputation credit (2)	30	nil
Net after-tax return to shareholder [= (1) + (2)]	**100**	**81**

A revenue-neutral abolition of imputation would thus reduce the dividend investment income of charities and other tax-exempt entities by 19%.

Because an imputation company tax system is basically just a withholding tax structure for Australian resident shareholders, its revenue-raising impact is essentially upon foreign shareholders. The Australian company tax regime represents the core mechanism by which the Australian nation shares in the profits earned by foreign investors from Australian sources. This arises because foreign investors do not receive the full benefit of imputation credits - only the lesser benefit of abolition of Australian dividend withholding tax in respect of franked dividends (such dividends would otherwise be taxed at a dividend withholding tax rate of 30% if the foreign investor were resident in a country with which Australia has a double tax agreement and 15% otherwise.)

The impact of the recent commodities boom on company tax revenue illustrates the importance of the company tax system as a mechanism by which Australians generally share in the profits realised by foreign investors in exploiting Australia's resource base. At a company tax rate of 19% rather than 30%, much of this benefit would have been given away to foreigners.

3. Impact of a Revenue-neutral Reduction in the Company Tax Rate Financed by the Abolition of Imputation

(i) Distributional Effects

A revenue-neutral reduction in the company tax rate financed by the abolition of imputation would increase taxation of Australia residents' dividend income and, correspondingly, reduce taxation of foreign residents' Australian-source dividend income. Specifically, it would:

- double tax company income distributions received by Australian resident shareholders. Instead of being taxed only once at the shareholder's marginal tax rate, this income would, in addition, bear company tax at 19%.

reduce the Australian company tax paid by foreign investors.
In most circumstances, this would largely represent a loss of Australian income tax revenue for the benefit of revenue in the foreign shareholder's country of residence. This is because of foreign tax credit arrangements whereby a foreign investor typically receives a credit against his tax liability in his country of residence for the underlying company tax he has paid in the foreign country from which the income was sourced.

This is illustrated in the following examples which consider the distribution of $100 of Australian-source income as dividends to a foreign investor, firstly, under the existing imputation system (Table 2) and, secondly, with abolition of imputation (Table 3).

Table 3. Taxation of Australian-source dividend income by foreign investor.
Case B: Foreign shareholder's marginal tax rate in his home country is lower than Australia's company tax rate

	(a) Current imputation system	(b) Imputation abolished & Australian company tax rate reduced
Australian taxation	A$	A$
Australian income	100	100
Less Company tax liability	(30)	(19)
Less Dividend withholding tax	nil (since assume all income distributed as franked dividend)	nil
Equals Cash dividend income after Australian tax (1)	**70**	**81**
Foreign country taxation		
Income	100	100
Foreign income tax liability (assume 25% marginal tax rate)	(25)	(25)
Foreign tax credit	25 (assume credit capped at amount of foreign tax liability)	19
Net foreign tax paid (2)	**nil**	**6**
Foreign investor's cash receipt after Australian and home tax liabilities [= (1) – (2)]	**70**	**75**

In this example, the Australian revenue again forgoes $11, of which the amount corresponding to the excess of the Australian company tax rate above the foreign shareholder's home marginal tax rate ($6 in this example) is simply a transfer to the benefit of the foreign treasury. Only the balance ($5 in this example) goes to the foreign shareholder.

Thus, the benefit of the Australian revenue forgone in respect of foreign-source income will go either wholly (Case A) or partly (Case B) to the foreign treasury. Therefore the "bang per buck" in the translation of the revenue forgone by Australia into a higher after-tax return to foreign investors is weak.

(ii) Overseas practice
By virtue of the 1985 Australian tax reforms and the replacement of the wholesale sales tax by GST, Australia's tax system would be ranked highly by tax policy professionals on the criteria of efficiency, neutrality and fairness relative to overseas tax systems. The fact that most OECD countries retain double taxation of company income is a poor argument for Australia to "go backwards" and would surely not be an argument accepted by Australian Treasury in respect of other proposals for adoption by Australia of defects of foreign tax systems e.g. erosion of tax bases due to widespread tax concessions.

(iii) Implications for double tax agreements
Abolition of imputation would likely require Australia to renegotiate its double tax agreements. In order to obtain foreign country agreement, Australia would likely be required to make new concessions in respect of the division of taxation rights between Australia and its foreign partners. This would likely represent a further loss of revenue by Australia.

(iv) Rationale for measures to encourage foreign investment
Analysis fails to demonstrate that Australia's ability to attract foreign investment is a policy problem and therefore that measures to lower taxes on foreign investment in Australia are a policy priority.

As a nation that is well endowed with attractive investment opportunities, Australia has traditionally run a current account deficit financed by foreign capital inflow. The exchange rate is the primary variable that adjusts to ensure that Australia maintains external balance over time. While there are inevitably swings in international investor sentiment, the historical record seems inconsistent with the proposition that Australia has difficulty in attracting foreign investment inflows because our company tax regime affords inadequate returns to foreigners. This view is further supported by the current bidding for natural gas assets by players such as BG Group and Shell, and the interest of various Chinese parties in acquiring iron ore and other mineral assets in Australia.

4. Arguments Advanced in Favour of a Revenue-neutral Reduction in the Company Tax Rate Financed by the Abolition of Imputation[1]

(i) "Imputation is not valued by investors"

In advocating the abolition of imputation, Nicholas Gruen is reported to conclude that he is "unable to reject the hypothesis that companies with dividend imputation do not attract any share price premium". It is unclear what this means. The introduction of imputation would be expected to have resulted in a **one-time** upward revaluation of the shares of Australian companies at around the time of announcement/implementation of the policy change and this effect is generally considered to have occurred.

Gruen's claim is contradicted by the finding of a variety of academic studies. For example, academic analyses of so-called "dividend drop-off" effects indicate a heavy factoring in of the benefits of imputation into Australian share prices. These analyses examine the magnitude of the fall in the share prices of Australian companies at the point in time when shares go "ex dividend", specifically when shares lose their right to receive a franked dividend. These typically show that the size of the share price drop is not just the cash amount of the dividend but also an additional amount equal to approximately 70% of the face value of the franking credits attached to the dividend. In other words, these share price movements suggest that investors factor approximately 70% of the face value of franking credits into share prices[1].

An academic study which compare the trading prices of shares that differ only in the right of the holder to receive a one-off franked dividend have suggested an even higher franking credit valuation close to 100%.

(ii) "The (pre-tax) rate of return on Australia assets is determined by foreigners and, accordingly, reducing the Australian company tax rate would induce a significant increase in foreign investment"

This argument starts from the proposition that in a small capital-open economy like Australia's the return on investment on Australian assets is determined in a global market because capital flows work to arbitrage away asset return differences. There are various reasons why international capital flows, while an important influence, do not arbitrage away all differentials in asset returns across countries:

- It is a well established proposition in macroeconomics (associated with Robert Mundell) that a small capital-open economy is unable to conduct an independent monetary policy (i.e. determine the level of domestic interest rates) if its exchange rate is fixed but that a flexible exchange rate restores independence. Under a flexible exchange rate, the expected movement in the value of the domestic currency breaks the rigid nexus between the domestic interest rate and the global interest rate.
- Risk – countries with higher investment risk due to say political, industrial or legal uncertainties must offer a premium return in order to attract investment (investors will require a higher return in Pakistan compared with Norway)
- Tax – domestic and foreign investors are subject to different to tax rules and so will require different pre-tax returns in order to obtain an acceptable after-tax return. (This is why the abolition of imputation in Australia would have the potential to change the relative attractiveness of Australian-versus-foreign investment for both foreign and Australian investors.)

The key flaw in the much of the analysis, however, is ignoring that, for the investment decision of foreign investors, the relevant return on Australian investment is after **all** taxes – both Australian and in the foreigner's home country –not just the return after Australian taxes. It is for this reason that analysis neglects the revenue transfer effects to foreign treasuries, described above, which undermine his arguments that imputation abolition would lead to a significant increase in foreign investment and uplift in Australian asset values.

(iii) "Imputation abolition would lead to an uplift of Australian asset values"

Australian investors face a tax bias in favour of investing in Australian companies vis-à-vis offshore companies because Australia has eliminated double taxation of company income whereas most foreign jurisdictions have not. (Australian investors effectively receive a refund of Australian, but not foreign, company tax paid by their investee companies.) Abolition of imputation could therefore be expected to induce Australian investors to undertake some portfolio switching away from Australian, in favour of, foreign assets. Since the Australian share market is traditionally considered to be owned roughly one-third by Australian retail investors, one-third by Australian institutions and one-third by foreigners[1], such switching could exert a significant one-off downward force on Australian asset prices. This would offset any offsetting upward influence from imputation abolition in attracting additional foreign investment, an effect which – as noted above – would be muted because of the high leakage of revenue forgone by Australia to foreign treasuries.

(iv) "A reduction on the company tax rate would stimulate growth"

The appeal to academic studies that claim that a reduction in the company tax rate produces an increase in growth needs to be discounted since these studies refer to a **genuine** reduction in the company tax rate, not a "sham" reduction via imputation abolition which increases the tax burden on Australian residents' investment in Australian companies and dissipates the reduction in tax burden on foreign investors by transferring most of the revenue forgone to foreign treasuries[1].

(v) Imputation abolition would simplify the Australian tax system"
It is true that the Australian tax system would be simplified by imputation abolition, just as it could be simplified by dispensing with other features, such as the foreign tax credit system or capital gains tax, that would be widely considered to be indispensable in improving the fairness and efficiency of the tax system. Having been in place for over twenty years, imputation is now well understood and accepted in Australia, its implementation problems have been ironed out and its compliance appears to arouse little complaint.

(vi) Beneficial optics of a lower company tax rate
It is hard to accept the assertion that the optics of a reduction in the "headline" Australian company tax rate from 30% to 19% would delude Australian investors into favouring such a change when the reality would be that double taxation of company income was being reintroduced. Almost anyone with practical experience of financial markets would attest that, in reality, professional investors do analyse returns on a "net of all taxes" basis and would quickly see through the sham.

In like vein, international rankings of Australia's company tax rate need to be discounted since these rankings do not compare like with like. The real-world burden of company tax is clearly lower in countries like Australia, where company tax is an imputation system, compared with the majority of other countries where company tax is a genuine double tier of taxation.

5. Summary

Abolition of imputation to finance a reduction in the company tax rate would be contrary to Australian residents' interests by reintroducing a distortionary second tier of tax on company income in order to finance the provision of a benefit primarily to foreigners. It would be an ineffective policy in making returns on Australian assets more attractive to foreigners because of the high leakage of Australian company tax revenue forgone to foreign treasures. Proponents of imputation abolition do not demonstrate that Australia has difficulty in attracting foreign investment inflows because our company tax regime allows inadequate returns to foreigners. Accordingly, policy measures such as imputation abolition which tax Australian investors more heavily in order to "subsidise" foreign investment in Australia (thus encouraging foreigners, rather than Australians, to own our companies and develop our resources) would be counter to the national interest.