17 April 2009

AFTS Secretariat - The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir

PROPOSALS TO ABOLISH IMPUTATION CREDITS ON DIVIDENDS

I wish to make a submission to the review of Australia's Future Taxation System (the Review).

In recent weeks the Chairman of the Review, Ken Henry, has floated the idea of abolishing the imputation credit system on dividends paid by Australian shares.

As a self employed person, I have invested in shares via a self managed superannuation fund, to provide for the future of both my wife and myself. Eventually, our annual income will depend in large part on dividends from Australian shares and associated imputation credits.

Our concerns are:

1) Removing imputation credits will reduce the net income to investors from listed shares, due to the double taxation of company income. Reducing company taxation will not adequatley compensate for this change (see 6 below.)
2) Reduced incomes from listed shares could mean a permanent one-time downward readjustment to the value of the Australian share market, because its valuation ultimately is the net present value of anticipated net cash flow to investors. This will be an unfair intergenerational cost due to policy change, borne primarily by those due to retire in the next ten years. Those investors in this category have already suffered from the global financial crisis, and they have little opportunity to change their working life or investment strategy in time to compensate for additional losses.
3) Removing imputation credits, and taxing companies at a lower rate, will cause market distortions, due to :
    a. The increased differential between company and personal taxes. This will:
        i. Provide a greater incentive for business to be conducted through companies, rather than as a sole trader. This means increased complexity and compliance costs, especially in the small business sector that generates the majority of employment, as there will be two entities required to file tax (the individual and the company), when previously there was no need.
        ii. Provide an incentive to retain earnings within companies, as this is less costly than paying out dividends that are taxed a second time and at a higher rate. Retained earnings may be useful as a source of investment capital, but this would also lead to:
            1. Distortion of investment from individuals (who can take an active personal interest in their investment) to investment by companies (often run by third parties, with less interest in investment effectiveness and allocative efficiency, and a greater interest in personal rewards - as recently experienced in the global financial crisis) .
            2. Diversion of investment away from employment-producing activity towards passive investments such as housing and commercial property. Reduced employment will mean long term reductions in superannuation

contributions, which provide funds for long term investment and reduce social security costs.

3. A greater emphasis on capital gains tax issues, rather than activity based taxes. Many investments will be in companies traded with higher retained earnings, or property that has increased in price due to diversion of investment from the share market.

b. Currently the imputation regime means that companies that have not made a taxable profit cannot pay dividends with imputation credits attached. This means that when companies pay dividends, those which have not made a real profit (accepting that taxable profits are true picture of a company's real returns) do not pay dividends with imputation credits attached, and therefore are less attractive to investors. The advantages of the current arrangement with imputation credits are therefore:

   i. Companies that do not make a profit are discouraged from paying dividends, because they cannot offer imputation credits, and shareholders are better off allowing earnings to be retained and offset agaisnt past tax losses. Dividends from unprofitable bsuinesses are not really payments from earnings, but repayments of capital. It would be more transparent if companies in this situation were made to justify such dividends as a return of capital, which would also ensure clarity of the tax position for shareholders.

   ii. Companies that do not pay company tax are highlighted to shareholders. It is in the interest of the state to encourage companies to pay fair taxes, but it also benefits shareholders. Many listed companies have extremely complex financial structures. Experts are hard put to analyse the accounts of firms famous for their 'financial engineering'. In these circumstances, it is usually safe to assume that a firm that is paying a dividend without franking credits (i.e. when it has had no taxable income) is either:

      1. Catching up after accrued losses in the past
      2. Paying dividends from capital
      3. Operating a variation on a Ponzi scheme.

   iii. If companies are taxed universally at a lower rate than now, and then income is taxed without franking credits, companies paying dividends will be treated on an equal footing, regardless of their real profitability. This is unrealistic. Companies that do not pay company tax have made losses, and therefore have reduced their shareholders' funds. They are therefore higher risk, because they have increasingly thinner capitalisation than other businesses. Allowing them to make dividend payments on the same basis as profitable businesses will exacerbate this problem. Paying dividends from unprofitable businesses increases the risk to shareholders, and by extension the average risk levels of the whole market. This will then lead to either demand for a higher risk premium on share returns, which will drive share values lower due to higher costs of capital, or greater volatility of the market in times of uncertainty.

4) Compensating investors for removal of imputation credits by applying a lower rate of company tax does not assist those who have no other source of income than shares and investments, and who have a marginal income tax rate that is lower than the company tax rate. Many pensioners who have tried to save for their old age will be in this position.

While we fully support simplification of the tax system, we respectfully request that the current imputation tax credit system be retained.

Yours sincerely,

<u>Richard Pitchforth</u>
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