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29 April 2009

Dr Ken Henry AC
Chairman
Australia's Future Tax System Review
AFTS Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

By email: AFTSubmissions@treasury.gov.au

Dear Dr Henry,

AUSTRALIA'S FUTURE TAX SYSTEM **- CONSULTATION PAPER DECEMBER 2008**

The Securities & Derivatives Industry Association was formed in 1999 at the time of the demutualisation of the Australian Stock Exchange to represent the interests of market participants. Currently we have 66 member organisations which account for 98% of trading by value on ASX. In addition we have over 1000 individual members and are working to build the profession of stockbroking. Our Member firms employ in excess of 20,000 people and account for some \$3b worth of trading daily on ASX.

SDIA Members, particularly those who advise and deal in securities for Retail Clients, have an interest in one aspect of the Review in particular, namely the **Dividend Imputation** system of company dividends, which is discussed in Section 6 of the Consultation Paper.

The Consultation Paper contains extensive discussion of the advantages and disadvantages of dividend imputation. Recently the subject has attracted extensive comment in the financial press. The Government has responded to the debate in a manner that suggests that dividend imputation is not to be changed:

"...dividend imputation has delivered an enormous benefit to the Australian economy. I'm somewhat puzzled by the continued reports that there is some threat to dividend imputation."¹

¹ The Hon Wayne Swan MP, Treasurer *Doorstop Interview* Parliament House Canberra, 22 April 2009
from www.treasurer.gov.au

In the Consultation Paper, some of the pertinent points in relation to the advantages of dividend imputation include:

Other aspects of international tax competition

There are a number of other international tax competition trends.

...

- A move away from dividend imputation, with most European countries abolishing imputation systems for other forms of shareholder relief (generally for European Union specific reasons).
 - However, there has been no general trend away from providing relief to shareholders in recognition of company tax paid. For example, the United States has recently moved to provide dividend tax relief (by applying a lower rate of personal tax to dividend income taxed at the company level).

(Section 6.1 Page 127)

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An alternative view is that since capital is not fully mobile, resident shareholder tax treatment affects the cost of capital of Australian firms and, hence, investment decisions. Submissions that support retaining imputation argue that imputation credits are valued by the market and by firms (which would be unlikely if non-residents set the cost of capital) and so lower the cost of capital for Australian firms. There is some limited, though mixed, evidence that imputation credits have a market value and so affect the cost of capital.

Submissions supporting imputation also point to other advantages, such as the integrity benefits of providing incentives to pay Australian, rather than foreign, company tax and reduced incentives to avoid tax. Another advantage claimed is imputation provides a more neutral tax treatment between debt and equity finance, though (as discussed in Section 6.5) this also depends on an assumption about the mobility of capital.

(Section 6.2 Page 137)

Dividend imputation and offshore investments

Many submissions support dividend imputation, indicating it is well understood by Australian investors, generally avoids the double taxation of company profits and lowers the cost of funding for Australian firms. However, submissions suggest there is scope to review aspects of the imputation system to improve how it operates for Australian firms investing offshore.

A number of submissions argue that the denial of imputation credits for foreign taxes paid on foreign income distributed to resident shareholders limits their ability to access capital for offshore investment. This impairs their international competitiveness. In effect, under the imputation system, resident shareholders are provided with a deduction, rather than a credit, for foreign taxes paid by the company. To redress this situation, submissions propose a credit or some recognition for foreign tax paid.

However, paying foreign tax does not benefit Australians, whereas Australian tax funds public services. The absence of a foreign tax credit then aligns an investor's private return from investing overseas with the national return and provides a counter-balance to incentives for Australian companies to shift investments to low-tax countries. This view is consistent with maximising Australian (rather than global) welfare, but assumes no spillover benefits from offshore investment and disregards any costs of biasing the saving portfolio choices of residents (see Section 6.7). Providing a credit for foreign tax paid might also reduce the integrity benefits associated with imputation.

(Section 6.3 Page 140)

While there may be some benefits, mainly in terms of offshore investment by Australian companies from the removal of imputation, **generally our Members support the retention of dividend imputation.** The main reasons for this support are:

- 1. Overseas investors ought not be the focus.** No Government devises its tax structure on the basis of overseas investor interests. The consideration of tax treatment of overseas investors is tied up with bi-and-multi lateral tax treaties, i.e., equal treatment in both countries. In any event, overseas ownership of Australian companies is already around 32%. This shows that Australia is already very attractive to foreign investors, based on factors including the quality of companies, higher dividends, and the integrity of markets.
- 2. Removal Not Good for Sharemarket.** The proposition that the removal of imputation will be "good for the share market" is misguided. In fact, its removal may even lead to a reduction in share prices. The largest single investor group in the domestic equity market is the Australian working public and retirees, either directly or through some form of superannuation structure. This outweighs overseas equity investments by a factor of 2-3 times. There is no evidence that the millions of Australians who are living off their savings / superannuation, and those who are working towards their eventual retirement by contributing to superannuation will be better off with the removal of imputation. Given the large proportion of companies listed on the ASX that pay franked dividends, imputation is a significant wealth-enhancing issue.
- 3. Savings incentive.** The importance of imputation has increased as other savings incentives have diminished. Without superannuation there would be a negative savings rate, and greater burden on the Federal Government to fund retirees' existence.
- 4. Overseas investment based on commodity cycles.** Offshore investing in Australia has shown itself to be driven by commodity cycles, as witnessed by correlation between the A\$ and hard commodity prices. A number of Australian businesses that have been bought by overseas companies in the last 5 - 10 years have been reconstructed and resold to Australian investors a few years later, rarely in better shape as they are loaded with debt, and stripped of earnings that could have flowed to Australians. The profits are already flowing out of the country, without any corporate tax being paid. Note that those Australian companies that do take their expertise offshore are already penalised by the domestic tax regime by not being able to pass the profits derived offshore to domestic shareholders in the form of franked earnings/dividends. It is perverse that such discouragement exists.
- 5. Equity: Double taxation unfair.** The principle of not taxing end shareholders twice is widely recognised as fair. It encourages longer term investment decision-making in Australian businesses (which in turn assists employment of Australians, etc). It also encourages Australian companies to meet their local tax obligations, in the knowledge that domestic shareholders will benefit accordingly.
- 6. Revenue Leakage a separate issue.** If there is concern with the leakage of revenue because of how surplus franking credits are dealt with, then that issue can be dealt with separately.

7. **Not Middle Class Welfare.** The 2006 ASX shareholder survey² said 46% of Australians (or 7.3 million people) own shares, including 38% who own shares directly. For most, share investments are their second largest investment after the family home. This does not suggest that imputation is solely the preserve of high net worth individuals, but forms a key component of the savings and investments of a large proportion of the Australian people.
8. **Importance for SMSF's.** More than a decade, there has been extraordinary growth in Self-Managed Superannuation Funds. Figures compiled by APRA and the ATO for the 12 years to 2008³ show that the value of assets held in SMSFs has grown more than twelve-fold, from \$28.2bn (in June 96) to \$347.5bn (in September 08). There are now almost 400,000 SMSFs in Australia, representing the interests of almost 800,000 individuals, more than half of which are at or nearing retirement age. Enhanced levels of income via franked dividends is an important consideration for people's long-term plans for retirement income. This should not have to be put at risk by short term fiscal considerations. The interests of patient investors in SMSF's – and in superannuation generally – ought to have priority over short term fiscal imperatives.
9. **Deterrence to Dividends?** The removal of the imputation system may discourage companies from paying dividends altogether, or lowering the dividend pay-out rate, which would put downward pressure on share prices.

The Dividend Imputation system has served Australia and its investors well for over 20 years, and has been a key reason for the market's success over that period. The system works well and long-term investment decisions have been made on the assumption that it is to continue. With that in mind, there needs to be compelling reasons for its removal.

Thank-you for the opportunity to contribute to this very important inquiry into the Australian tax system. Should you require further information, please contact me, or Doug Clark, Policy Executive on dclark@sdia.org.au.

Yours Sincerely,



David W Horsfield
Managing Director/CEO

² Link to Report is: www.asx.com.au/about/pdf/shareownership_study_2006.pdf

³ Statistics in this submission are taken from the following references: APRA *Insight* February 2007; ATO *Speeches by Ian Read, Assistant Deputy Commissioner for Taxation, ICAA SMSF Conference* 22 February 2008 & *Taxation Institute WA State Convention* 28 August 2008; and ATO *Self-Managed Super Fund Statistical Report* 15 October 2008. (Available at www.ato.gov.au.)