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**Submission in response to the Tax White Paper from Balanced Equity Management Pty Limited, a Franklin Templeton Investments Company**

**Imputation Key to a Flexible, Efficient Financial System**

Discussion Question 25.

Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?

We agree with the view in the Tax Discussion Paper that the imputation system “provides a more neutral tax treatment of incorporated and unincorporated businesses and reduces the bias towards debt (rather than equity) in company financing choices.” We believe that the contrary opinion that it generates a bias in favour of investing in shares over other saving vehicles stems from considering the tax collected only at the investor level; when tax on corporate entities and their investors is examined in totality, the perception of bias is dispelled.

In our opinion the principal reason to retain the imputation system is to assist the optimal allocation of capital. Financial markets channel savings from individuals, particularly through the superannuation system, into productive companies. The efficiency of this capital allocation system is critical to the long-term growth in productivity and ultimately to increased living standards.

Efficiency in capital allocation requires that money can be moved from companies that are generating extra capital into those that can put that capital to good use. It is in no one's interest that barriers are placed in the way of this process and a poorly designed tax system can act as just such a barrier.

Balanced Equity Management generally encourages the management and boards of the companies in which it invests to pay out capital that is surplus to immediate needs, confident in the knowledge that the market will support an equity raising when capital is required for investment. The discipline imposed by this process reduces the risk of companies committing to suboptimal investment propositions.

However it is only the imputation system that allows money to move freely without detriment to the owners of the business. If the tax system taxes profits as they are earned, and again as they are passed to shareholders before they are put back to work, the financial incentive is to leave profits in the company rather than pass them to shareholders for reallocation. The franking system removes the grit out of the capital pipes and allows money to flow to where it is best utilised.

The classical tax system incentivises gearing so interest payments can serve as a tax shield. The incentive in favour of higher gearing, combined with the disincentive to pay dividends leads to suboptimal capital allocation decisions (such as takeovers driven by tax considerations rather than economic logic) and tax planning structures.

We agree that imputation provides Australian investors with an incentive to invest more of their savings in Australian companies which pay tax in Australia rather than other investments. However it does not follow that this introduces an elevated level of risk for Australian savers, in particular with their superannuation savings. The imputation system fosters a flexible equity market as profits are paid to investors when generated allowing capital to be raised where and when needed. The effectiveness of the system was shown in 2008 and 2009 when very substantial amounts of equity were raised.

The current system provides a modest incentive to invest in Australia while still allowing Australians the freedom to invest in the global economy. It certainly hasn't raised an insuperable barrier to overseas investment, as superannuation funds’ international equities weighting has been steadily rising over many years, driven by considerations such as industry and currency diversification. Companies also have the flexibility to invest overseas provided the prospective returns warrant it and companies such as CSL, Amcor and Brambles are world leaders in their respective fields.

A related argument is that the imputation system does not materially reduce the cost of capital for Australian companies as the pool of international capital (which derives no benefit from franking) is so much larger than the pool of Australian capital (which benefits from franking) that the marginal cost of capital is set by the international investors. No one would doubt that abolition of the franking system would cause a withdrawal of Australian capital (in the absence of a very large price correction) but the argument is made that it would be replaced by international capital at only a very small price differential given the relatively large size of that pool. This is an academic argument that misunderstands the importance of locally based capital. Apart from the fact that Australian investors own such a large part of the Australian market, their commitment to the Australian market means they are a far more stable source of capital. To be nearly totally reliant on overseas investors to set the price of our local shares would lead to a more volatile market. In practice it would not happen; share prices would reset to a materially lower level to retain a very large Australian ownership of the market. The cost of capital would indeed rise.

Finally the benefit of imputation in fostering a compliant culture should not be underestimated. For an Australian company with predominantly Australian shareholders there is no reason to try to reduce tax; indeed it is more advantageous to the shareholders for the company to pay tax in Australia than to pay it to an overseas taxing authority, even if the Australian rate is higher. While the abolition of the franking system would lead to higher Australian tax collection if all stayed the same, in practice it would not stay the same. The integrity benefits of the current system would be lost. Dividend income would drop, there would be an incentive to pay tax overseas rather than in Australia and core funding would rely less on equity and more on debt to generate tax deductible interest payments.

We would strongly support retention of the key components of the current imputation system.

Andrew Sisson

Managing Director

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