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Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

via electronic submission

27 May 2015

Submission to the March 2015 Tax discussion paper

Dear Sir/Madam,

We are making this submission on behalf of the Board and shareholders of Australian Foundation Investment Company Limited ("AFIC"). AFIC is Australia's largest Listed Investment Company with over 100,000 primarily retail shareholders, many of whom rely on dividends as an important source of income. As investors, we own shares in nearly 100 of Australia's largest companies.

We are responding specifically to a number of questions that directly affect our Company and our shareholders, namely dividend imputation and the CGT discount.

It is anticipated that this submission should take 25 to 30 minutes to read.

The main points are as follows:

1. Participation in the share market, and consequently the imputation system, is embedded in the Australian population. 38% of Australian adults own shares directly or through a self-managed superannuation fund. The figure is far higher when including industry and retail superannuation funds.

2. The principle that investment income, including income derived via shareholdings, is taxed at the marginal rate has led to charities and other low-rate tax-payers investing in shares. 22% of households with income below $50,000 in 2012 owned shares directly. Moves away from the imputation system would leave these sections of society more dependent on taxpayer funding.

3. The imputation system is well understood and appreciated – any changes to the system would have a significant impact on Australians and would be widely controversial. This could also have significant negative effects on confidence with impacts for the wider economy.

4. The imputation system prevents the double taxation of corporate profits.

5. It removes bias towards other forms of investment that would not include double-taxation – debt instruments, deposits, direct property etc.

6. Currently savings decisions are also impacted by the low interest-rate environment as investors seek yield, not the imputation system per se.

7. Imputation is now part of the valuation of Australian shares (c. 74% of the franking credit value is included according to recent research). Its removal would have an extremely damaging impact on share valuations and the ongoing wealth of Australian investors.

8. The domestic investor has proved extremely important to the stability of the Australian market. Any moves towards dismantling or partially removing the imputation system and the principles that underlie it could imperil this stability.

9. Imputation has contributed to lower gearing and less risk for Australian corporates compared to overseas competitors.

10. There is no evidence to indicate that Australian investors are reluctant to invest overseas because of the imputation system.

11. Conversely, there is no evidence to suggest that offshore investors are reluctant to invest in Australia because of the imputation system.

12. Any changes to the imputation system to encourage particular investment behaviours should not be at the expense of domestic shareholders, who understand, appreciate and value the current system.

13. The current CGT discount system mitigates the taxation of inflation and is simple to understand and to use.

Q. 20: To what extent does the dividend imputation system impact savings decisions?

38% of all Australian adults own shares

According to the 2012 ASX Share Ownership Survey, 6.7 million Australians, or 38% of the adult population, participated in the Australian share market either directly or through Self-Managed Superannuation Funds. This is a much higher percentage of investors than many other comparable countries – Germany 15%, UK 17%, and Switzerland 21%, for example. This has encouraged Australians to become engaged with and participate in the capital markets, leading to better informed retail investors and greater depth in the Australian capital market than would otherwise be the case. As most retail shareholders are long-term shareholders, this would have led to reduced volatility and turnover in the share market which is of benefit to both issuers and investors.

Removal or reduction of imputation would have an immediate and lasting impact on the Australian share market as the level of participation may drop to OECD averages as investors switch to alternative investments, in particular investments where there would be less risk of double taxation.

Valuation, wealth and CGT consequences of imputation changes

Data shows that c. 74% of the value of franking credits is included in share valuations (Goldman Sachs 2015). In this regard, an outright removal of imputation would have an immediate impact on the value of shares. This would lead to a:

- destruction of wealth for investors, particularly for older investors, placing more stress on the retirement savings of the ageing Australian population

- reduction in CGT receipts for Australia, from lower share prices and in the long term a reduction in participation from Australian individual investors in ASX listed shares.

Corporate profits are part of the progressive tax system once distributed

As the Discussion Paper notes, ‘under imputation, company tax acts as a withholding tax on Australian shareholders.’ The introduction of the refundability of excess franking credits has meant that income from dividends that have been franked are taxed at the marginal rate of the investor – e.g. charities pay 0% whilst a high marginal-rate payer pays 49% (including the Medicare Levy and Budget Repair Levy).

Franking means tax neutrality for Australian investors

Income to an Australian domestic investor is currently tax neutral between a franked dividend and, for example, interest from a corporate bond. For instance, a payment of interest of $100 on a bond is received gross of any withholding tax, and is taxed at the marginal rate of the investor. Similarly, a dividend of $70 with a franking credit of $30 should lead to the full $100 being taxed at the marginal rate of the investor, with the difference that $30 of tax has already been paid.

It was an anomaly of the pre-imputation system that income from equities, which carries a higher risk than debt, should have been subject to double taxation and as such comparatively penalised in how such income was taxed through the Australian tax system.

Due to the timing differences arising from tax payments in the example above (the tax on the bond will be paid as part of the investors tax payments in the future whilst the franking represents tax that has (usually) been paid in the past), all other things being equal the investor would have marginal preference for debt income, from a tax timing perspective.

Therefore, the dividend imputation system has tended to reduce any tendency for Australian companies to rely on debt. Australia's debt to equity ratio of 62% is well below the world average of 74%.

Removal of imputation would reintroduce double taxation, reduce income and distort investment decisions

In terms of the taxation effect on income from savings, the removal of dividend imputation would tend to impact savings decisions away from dividend-yielding shares. The system as it currently stands has removed the distortions that had previously strongly favoured savings decisions against investments in equity and towards other forms of investment that produced income that was not subject to a non-refundable tax impost or double taxation prior to distribution.

Removal of imputation would slash investors' after-tax income by c. 25% if pay-outs remained constant (which would be unlikely). In this regard it is noted that 22% of households with income below $50,000 invested directly in shares in 2012. Any moves to reimpose double taxation of corporate profits would have a greater impact proportionately on these nil or lower rate tax-payers – charities that with the refundability of franking now pay no tax on the underlying income that their investments in Australian corporates produce would instead have a 30% tax rate on those earnings (the company tax paid on the underlying earnings) and a consequent loss of income.

Should investors choose to remain in the share market then, given the reduced after-tax dividend yield, investors would become far more likely to trade their investments:

a) to generate cash when required given the lower after-tax anticipated dividend flows,
b) to sell their investments in the short term (1 to 2 years, after the CGT discount became available).

This would lead to increased volatility in the share market, reducing the attractiveness for many investors, both foreign and domestic, and particularly for the listed companies themselves. The removal of the 45-day rule which would become unnecessary following any removal of imputation, would further increase volatility, particularly for options and financial services stocks. This rule was introduced to ensure that franking credits went to those who had borne the 'economic risks' of share ownership, i.e. held the shares 'at risk' for longer than 45 days.

The double taxation on corporate profits for the investor would lead to a preference for other forms of investment.

Various countries, identified in the discussion paper, have tax regimes to encourage investments in dividend-producing shares

The policy of tax relief for dividend income, to encourage savings in this form, is very common internationally.

The discussion paper notes, at page 85 (table 5.1) that various other countries have tax systems with no double taxation of dividends or exemptions for dividend income and other countries have partial double taxation with some shareholder relief.

That table confirms that relief for dividend income is a highly desirable tax policy. Such relief is achieved by the current imputation system. The UK, which removed its imputation system, replaced it with an alternative shareholder tax relief system. We submit that such a churn of policy would be most undesirable for Australia's capital markets, investments, savings and Australia's competitiveness.

As noted above, various other countries, even with limited favourable taxation of dividends still impose double taxation on corporate profits for the investor, leading to a bias towards other forms of investment. The UK, for example, has an array of complex measures to counter the bias to debt in its system.

Savings decisions are affected primarily by other factors

Savings decisions are impacted by a number of other factors, which would include :

a) The current low interest rate environment. The average yield on the ASX 200 was 4.24% before franking at 31 March 2015. At c. 76% franked this is equivalent to a gross rate of c. 5.5%. This compares to a 90 day BBSW rate of 2.23% at the same date (noting that the RBA in May reduced the base rate again to 2%). Many investors are currently willing to take the capital risk in order to obtain the higher yield – particularly when inflation is taken into account. This may not be the case in a higher interest rate environment. Any observations regarding current investor behaviour therefore needs to take this current situation into consideration.

b) Lack of bond issuance. The 2010 RBA bulletin on the 'Ownership of Australian Equities and Corporate Bonds' by Susan Black and Joshua Kirkwood indicated that retail investors' ownership of Australian bonds is less than 1%. This was down to two factors – firstly, that many household savings are invested via superannuation funds (which hold 10% of bonds) and secondly that disclosure requirements for issuers to retail investors mean that "it has usually been more cost effective to raise debt funding from institutional investors." Despite recent moves to ease these requirements, there is still a lack of a deep, liquid, Australian corporate bond market, exacerbated by the lower cost of being able to raise debt offshore for many of the larger corporates.

c) Currency risk. There is a natural bias towards Australian $ denominated investments in order to mitigate direct currency risk. However, investors are willing to take on some currency risk where growth opportunities are higher, and many Australian corporates derive much of their revenue from non-A$ sources, and even report in US$ (for example, the likes of BHP and Computershare).

Imputation has led to higher pay-outs but enhanced the depth of the equity market

Since the introduction of imputation, the pay-out ratio of the ASX 200 has increased from c. 50% to c. 70% (Source : Goldman Sachs April 2015). Over the past decade, the average payout of 65% has been c. 25% above the developed market average. Earnings that would otherwise have remained within the company are distributed and either reinvested by investors or used in consumption. Companies with a Dividend Reinvestment Plan enable shareholders to reinvest, or companies can come back to the equity markets for further capital for relevant growth opportunities.

The Discussion Paper notes that 'imputation reduces the bias that exists …towards companies retaining their profits, rather than distributing them' and then 'by encouraging greater use of equity financing, the imputation system may also improve the stability of the economy. This may have contributed to the strength of the Australian corporate sector through the recent financial crisis'.

As the Discussion Paper further noted, c. $12 billion or 30% of the imputation credits distributed each year are paid to non-resident shareholders, and therefore retained by the government. Of the $19 billion paid to individuals and institutions, a portion of this will be paid to higher rate taxpayers who have a tax rate of greater than 30% and will pay additional tax at their marginal rate.

Domestic investors prefer Australian corporates to pay tax in Australia

As domestic investors can access the benefits of franking credits for Australian tax paid by corporates, but not for offshore corporate tax paid, there is an incentive for companies that have large domestic shareholdings to structure their business to ensure that taxable activities are located within Australia. This is in addition to the reduced incentive 'for Australian companies with Australian shareholders to avoid Australian tax' (as noted in the Discussion Paper). This obviously has revenue benefits for the country.

The imputation system is simple and well-understood by retail shareholders

The Discussion Paper states that 'imputation has also increased the complexity of the tax system.' We would argue that this is not the case with regards to Australian retail shareholders.

The franking system insofar as the investor in listed companies is concerned is simple, transparent and well-understood as a form of 'withholding tax' in its interaction with personal tax rates.

It is at least arguable that other methodologies used in different jurisdictions to tax dividend income at different rates are more complex than the current dividend imputation system.

The integrity measures that are mentioned in the Discussion Paper are largely concerned with smaller private businesses and their interactions with their majority shareholders, rather than the listed companies in which most Australians invest. The integrity measures designed to minimise the trading of franking credits by larger institutional or professional investors do not concern typical retail investors and do not provide a deadweight or complexity overload affecting investment into Australian listed companies.

Any steps taken to address such integrity requirements should be carefully targeted at those types of businesses and individuals, and not detract from the system that is well-understood and utilised by millions of Australian domestic investors, superannuation funds and charities.

Q. 25: Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?

<u>Domestic investors continue to be crucial to the Australian market</u>

Domestic investors own c. 74% of financial stocks and 52% of non-financials (RBA 2010). During the early part of the financial crisis in 2007, capital raisings that were required were met almost entirely by domestic institutions – usually because the offerings were not open to retail investors.

The strong support for the Australian share market continued throughout the GFC. In 2009, Australian companies raised a then-record A$106 billion (9% of the value of the Australian market). As a percentage of the existing market, these new capital raisings were larger than those in New York, Hong Kong, London or Toronto. This is a proxy for growth in the overall market coming from the flow of new capital into companies, both new listings and existing companies, rather than changes in market capitalisation through price movements. As noted in the ASX publication in 2010 'Capital Raising in Australia : Experiences and Lessons from the Global Financial Crisis' - "The stress testing of the Australian financial system during the worst of the GFC provided a unique opportunity to assess the system's existing arrangements and the outcomes they deliver. It shows the system can respond quickly to external shocks and then move back into a more 'business as usual' mode when conditions recover.

The ability of companies to rapidly and flexibly tap public equity capital markets (largely from institutional funding sources) during the worst of the GFC, when equity values were sharply reducing, also played an important role, particularly for large companies in some of the most vulnerable sectors. A failure of an equity capital raising by a large Australian bank, for example, could have had serious systemic consequences."

Changes to the imputation system that would advantage foreign shareholders at the expense of domestic shareholders would be misguided, unnecessary and counter-productive. It would be extremely difficult to justify such changes to Australian share-holders (including those with shares in their superannuation funds).

<u>Valuation of stocks for foreign investors does not depend on franking</u>

Although imputation does have some impact on the valuation of stocks, the RBA also noted that 'foreign investors invest in Australian non-financial stocks to gain exposure to resource companies.' This highlights the fact that foreign investors are looking for relative value – either exposure to sectors such as iron ore and LNG that are difficult to obtain elsewhere or where factors such as economic growth, market position, A$ relative values and prospects combine such that an investor can see a value opportunity, such as agriculture.

This can be further illustrated in the increase in foreign investment during the Australian domestic banks' capital raisings of 2008 and 2009 when the strength of their credit ratings compared to many of their global peers highlighted their relative value.

A partial franking credit for foreign investors?

Franked dividends (i.e. dividends from tax-paid income, currently paid at 30% company tax) are currently not subject to Withholding Tax. That is a benefit for foreign portfolio investors. A trend of double tax agreements (eg US, UK) has been to offer dividend withholding tax exemptions for Australian subsidiaries of foreign groups (non-portfolio investors) so the franked dividend withholding tax exemption is unnecessary for such groups. However, foreign portfolio investors in Australian companies still generate an indirect imputation benefit.

Interest is subject to Withholding Tax, but usually at a lower rate. From a pure income perspective, therefore, foreign investors will be biased towards debt rather than equity unless there was full equality of tax treatment between overseas debt and equity investors as currently exists for Australian investors.

For completeness, one option for fine-tuning the imputation system to enhance its attractiveness for foreign investors might be to offer foreign investors receiving franked dividends some form of partial credit (not a full credit) for the underlying company tax paid by the paying company in respect of the dividend. Such a measure would involve revenue costs and would require integrity measures. In no case should such adjustments be made to the detriment of current Australian domestic investors.

The Discussion Paper states that it is suggested that 'the imputation system does not help attract new investment into Australia.'

We would argue that:

a) The evidence supporting foreign investment into Australia does not appear to suggest that the imputation system has reduced the level of foreign investment.
b) The 'side-effects' of the imputation regime have actually made Australian corporates more attractive through less gearing and greater capital discipline.

Foreign investment appetite for Australia has remained largely unchanged since imputation was introduced

The DFAT survey for 2013 of international direct investment into Australia (i.e. > 10% ownership interest) shows that in US$ terms, Australia has in the past 20 years fallen from the 8th largest destination in terms of volume for foreign direct investment to 14th. Three of the countries that have moved ahead of Australia are the fast-growing developing economies – China, Singapore and Brazil. Switzerland has also increased its openness to foreign direct investment.

However, the introduction of dividend imputation itself does not appear to have resulted in a material fall in foreign investment as a proportion of total global investment. Foreign investment in stocks represented 39.4% of GDP – above both the OECD figure of 35.4% and the G20 figure of 29.6%.

Imputation has reduced risk of Australian corporates, making them more attractive

By making the taxation on the yield on equity tax neutral with regards to the yield on debt via the imputation system, Australia reduced the cost of equity for Australian investors. This lowering of the cost of equity has led to Australian corporates becoming less geared, and thus less risky, further increasing their relative value to both foreign and domestic investors. Assuming the same MSCI sector weights for other economies relative to Australia (to allow for specific industries being more highly geared than others), Australian corporates have a debt to equity percentage of 62% compared to the world average of 76% (US on 95% and Europe on 70%). Even without this weighting, Australia still ranks below the world average of 74% (US 82% and Europe 75%).

The Discussion paper acknowledges this effect – 'by encouraging greater use of equity financing, the imputation system may also improve the stability of the economy. This may have contributed to the strength of the Australian corporate sector through the recent financial crisis.'

Imputation has imposed greater capital discipline on Australian corporates, making them more attractive

Franking credits have no value to companies themselves – only to shareholders. This in part explains the higher pay-out ratio for Australian companies.

Australian corporates therefore need to be able to demonstrate that retaining taxed profits rather than distributing them has produced more favourable outcomes than returning profits to shareholders. Alternatively, in seeking further funds from shareholders, the arguments for investing for acquisition need to be well-presented and meet a required cost of shareholders capital.

Again, this capital discipline is, in our view, a sign of a well-run company.

Distribution of foreign shareholdings not a direct result of imputation

As noted above, foreign investors are often seeking access to sectors of the market that are not readily available to them in their own jurisdictions, or where growth prospects seem high and valuations relatively low.

In the current low interest-rate environment investors are seeking yield as a corollary to or even instead of capital growth (for foreign investors, this depends in part on the differential tax treatment of capital gains and income in their own jurisdictions).

Investors that seek yield will be disproportionately attracted to higher-yielding stocks, regardless of imputation, albeit at lower levels.

This explains why households and domestic institutions, particularly in the current interest rate environment, are attracted to the higher yielding financial stocks (65% of household equity investments are in financials – 33% of the total equity in this sector) and stocks such as Telstra whilst foreign investors who can find exposure to such sectors elsewhere are under-represented – 26% of financials vs 48% of non-financials. Retail investors own only 8% of the non-financial stocks.

Another reason for the higher concentration of retail investors in these stocks is a result of flotations and demutualisations which have largely been in the financial services sector, plus Telstra and Qantas.

Dividend imputation does not prevent Australian investors seeking to invest offshore

Due to the growth in superannuation assets outstripping the growth in the market capitalisation of Australian companies, the percentage of the ASX owned by superannuation funds is estimated to be c. 37%, an increase of 11% over the last 10 years. However, in aggregate the weighting to Australian shares has reduced from 28% to 26% (Goldman Sachs 2015).

As at 30 June 2014, 1/3rd of funds in the managed funds industry were invested offshore (Morningstar/ABS). It should also be noted that Australia's own Future Fund only has 8.2% of its assets in Australian equities (as at 31 March 2015) (as opposed to 20.8% in other developed markets and 9.5% in emerging markets).

Australian companies are increasingly seeking growth opportunities off-shore. This has not affected their valuation by Australian investors such as ourselves. Companies like Computershare, CSL, Cochlear, Brambles and Amcor are unable to fully frank their dividend, but the growth opportunities off-shore compensate for the absence of franked returns and any underlying non-creditable foreign tax paid by those entities.

To reintroduce double taxation on companies that are predominately domestically focussed would act as a disincentive to invest in those companies, with consequent effects on investment into the local economy.

Can the taxation of dividends be improved ?

The dividend imputation system has enabled a level playing field, and is an important cornerstone of the Australian market. Its benefits are widespread, and should be maintained in any future review of the tax system. Any changes need to maintain its integrity as enabling the earnings of an investor to be taxed at that investor's marginal rate.

Potential opportunities for fine-tuning the imputation system might include:

- **a)** Consideration of a system to allow for some recognition of corporate tax paid offshore by Australian corporates as such profits are returned to the investor. The revenue costs and the level of recognition would be a matter for the tax reform process. **In no case should such adjustments be made to the detriment of current Australian domestic investors.**
- **b)** As mentioned earlier, a potential overlay providing a partial imputation credit to foreign investors in Australian companies, where the Australian company pays franked dividends. **In no case should such adjustments be made to the detriment of current Australian domestic investors.**

Q. 26 : To what extent would Australia benefit from the mutual recognition of imputation credits between Australia and New Zealand ?

Such a recognition would encourage Australian investors to invest in NZ companies, and vice versa. Due to the relative size of the two markets, it would appear that Australian government revenues would be impacted by such an arrangement to a far greater extent than New Zealand's.

Again, it would be counter-productive to seek such an arrangement at the price of compromising the integrity of the current Australian imputation system.

Australian companies can currently distribute NZ imputation credits to shareholders. Only NZ taxpayers benefit, and this mirrors the current successful Australian system.

Q. 19 : To what extent is the rationale for the CGT discount, and the size of the discount, still appropriate ?

The vast majority of taxation jurisdictions tax capital gains preferentially to other forms of income from savings (and until 1985, capital gains in Australia were free from any tax).

This is for two reasons:

a) To allow for the effects of inflation and the time value of money. This removes the disincentive for investors to lose access to their capital for a prolonged period of time.
b) To allow for the risk element in investing. Bank deposits should carry little or no risk, and hence do not usually attract concessional taxation treatment. The Discussion paper notes that the CGT treatment 'discourages saving in instruments such as bank deposits.' We would argue that this in fact is largely the result of continued strength in the share market (and property market) and the comparatively low yield on bank deposits, which in some cases is below the level of inflation. Should the share and/or property market go through a period of prolonged turbulence, then it is likely that many Australian investors would again seek the security of bank deposits, regardless of the lack of any CGT discount which may be available.

Both of these reasons remain valid for Australian investors

We are concerned that the discussion paper does not highlight that, before the current CGT discount of 50% was introduced, Australia's CGT regime, when introduced by the Hawke-Keating government, provided for an annual inflation adjustment by way of indexation at the consumer price index (CPI) rate ('indexation'). This fact seems to have received little attention in recent media and tax advocacy materials. The next stage in this tax reform process, and public discussion materials, should highlight that fact. Indexation addressed the problem of inflation but was complicated and difficult to administer. A discounted rate is far simpler as a method of preventing the taxation of inflation.

The previously used indexation methodology, which was also available to corporate taxpayers (unlike the CGT discount), is still available for assets purchased between 1985 and 1999, and involved calculating for each asset its indexed cost price by reference to historical CPI tables. The indexation adjustment might be more or less than 50% depending on the duration and dates of holding the asset. The previous methodology also contributed to a reluctance of investors to sell CGT assets, whilst they waited to achieve better indexation. The current CGT discount is simple to use and to understand, reducing the complexity of investment decisions for many Australian investors. The CGT discount was introduced following the Ralph Review of Business Taxation after a time of high inflation to enhance both the tax compliance and risk-recognition of the CGT.

It should also be noted that the current discussion is being held in the context of low inflation rates. A sustained period of higher inflation would reduce the attractiveness to an investor of the 50% CGT discount in favour of an indexation methodology and a return to such a methodology in these circumstances would reduce government revenue.

We would be happy to discuss the above with you at your convenience.

Yours faithfully,

Ross Barker
Managing Director

Andrew Porter
Chief Financial Officer