Dividend Imputation:
A critical review of the future of the system

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What shall we do with the company tax?

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24 July 2017
Agenda

• Australia’s Dividend Imputation System
• Policy Problems
  • Equity, Efficiency and Simplicity
  • Neutrality
• Capital distortions
  • Superannuation investors
  • Company operations
  • Foreign investors
• The aim of integration
  • Overview
  • International considerations
• Forms of integration
  • Key variables
  • International comparison
• The future for Australia?
Australia’s Dividend Imputation System

- 1 July 1987 – imputation system partially based on the Asprey Committee report
- To eliminate double taxation under the classical system
- End result is that the total tax burden for Australian resident shareholders is their marginal rate of tax
- The payment of Australian corporate tax by the company results in the accumulation of a franking account
- The payment of distribution may be franked. Set at the franking percentage.
- Australian resident shareholder’s include the distribution amount plus the franking credit amount in their assessable income. The franking credit is then applied as a tax credit against tax liability
- Refund of unused franking credits
Australia’s Dividend Imputation System

- The total tax burden will be the shareholder’s marginal tax rate
  - Where marginal rate is lower, a refund may arise
  - This makes franked dividends desirable for low rate shareholders
    - Superannuation accounts
    - Charities
  - Non-resident shareholder’s do not receive the benefit of the imputation credit
  - In order to create a franking account, there must be Australian taxes paid
  - What about the impact of a lower corporate income tax rate?
  - What about the budget deficit and the saving of $4 billion per year?
Equity, Efficiency, Simplicity, Neutrality

• Equity
  • Resident and non-resident investors not treated the same
  • Wealthiest receive 48% of franking credits
  • Excess credits a tax refund – over $4 billion
• Efficiency – discrimination towards non-resident shareholders
• Simplicity
  • Franking account
• Neutrality
• National Neutrality
Capital Distortions - Superannuation

- Superannuation investors receive large benefits from imputation – particularly when in the pension phase
- Large number of individuals effected by any change and vast amount of retirement savings invested and growing each year
- Superannuation fund managers are highly influential on both government agenda and corporate markets
  - Superannuation funds make up approximately 1/3rd of total investors in Australian domestic equities
  - Imputation provides an after tax return for domestic members 8% in accumulation and 9.2% in pension phase
  - Adds an extra 1.3% in accumulation and 1.5% in pension phase

Capture theory - The superannuation industry has captured both government and the listed Australian corporations
• In order to pay franked dividends Corporations must pay income tax in Australia
• This discourages Australian companies from deriving exempt foreign earnings and expanding their operations overseas in order to take advantage of opportunities
• Australia may struggle to ever become a headquarters for large MNEs with this disincentive
• Perennial dilemma over debt or equity financing – and the cost of financing
• Need to pay sufficient income tax to generate the level of franking credits required
• Impact on retained earnings
• Impact on the share price – evidence that higher with imputation
Foreign Investors

- Foreign investors comprise approximately 1/3 of Australia’s investors in domestic equities.

- Foreign investment could be higher if the non-resident discrimination did not exist – Australian companies over distribute.

- Foreign investors do not receive the benefit of franking credits.

- Prefer tax exempt capital gains. The potential for capital gains are reduced by the high dividend distributions by Australian listed companies.

- Reduces investment in R&D and other tax effective programs with Australian investment in R&D being at a very low level by world standards.
Integration: overview

• Aim of integration is to have the shareholder taxed the same if earnings are direct or via an entity
  • e.g. a partnership
• Achievable in closely held companies
• Widely held and publicly listed companies are more difficult
  • Broader classes of shareholders
  • Greater liquidity of interest
  • Greater degree of retained income
International double taxation on dividends

Relief of double taxation at the:

- Corporate level; or
- Both the corporate and shareholder level.

Must consider where the integration relief is provided in each country

- Imputation considered against EU law
  - Resulted in the abandonment of imputation in Europe
- May be resolved via tax treaties
  - Reciprocal agreements e.g. Australia and New Zealand

Will foreign earnings be treated the same?
Forms of Integration: international

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<thead>
<tr>
<th>Variables</th>
<th>Corporation</th>
<th>Shareholder</th>
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<tbody>
<tr>
<td>Tax Base</td>
<td>- Dividend deduction</td>
<td>- exemption/concession to dividend</td>
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<tr>
<td></td>
<td>- No Corporate tax</td>
<td></td>
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<tr>
<td>Tax Rate</td>
<td>- Lowered tax rate for distributed profits</td>
<td>- Redacted rate of tax on dividends</td>
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<tr>
<td>Tax Credit</td>
<td>- Credit for taxes that have been paid at the shareholder level</td>
<td>- Credit for taxes that have been paid at the corporate level</td>
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<td></td>
<td></td>
<td>- Non-refundable credit</td>
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- Consider impact on superannuation, foreign investors, foreign earnings
- Other aspects
  - Shareholder differentiation
  - Non-refundable credits
  - washout
International comparison

- Dividend exclusion system
  - Germany and Singapore

- Shareholder differentiation
  - United Kingdom

- Imputation but allows credit for foreign taxes paid
  - Canada

If dividend imputation met all the objectives of a good tax system then why only Australia and New Zealand
The future of Imputation

- Henry Review recommended Imputation be scrapped as the Australian economy opens up
- Growing push for a review of options
- The ideal options have the following effect:
  - No distortion on capital markets
  - No discouragement of foreign investors
  - Not erode retiree’s income
  - No discouragement of Australian listed companies to derive foreign earnings - consider interaction with rest of system
  - Equity, efficiency, implication and neutrality
  - No washout of corporate concessions

This is not found in the current system in Australia