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

John McLaren and Rhys Cormick

What shall we do with the company tax?

Tax and Transfer Policy Institute, Australian National University
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 manages 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

Capital Distortions - Company operations

- 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 1/3rd 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

Integration: international considerations

- 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

Variables	Corporation	Shareholder
Tax Base	- Dividend deduction - No Corporate tax	- exemption/concession to dividend
Tax Rate	- Lowered tax rate for distributed profits	- Redacted rate of tax on dividends
Tax Credit	- Credit for taxes that have been paid at the shareholder level	- Credit for taxes that have been paid at the corporate level - Non-refundable credit

- 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