IMPUTATION CREDIT SYSTEM

In 1987 the then Labor government in Australia handed out perhaps the largest tax break in the country's history. Australian taxpayers who received dividends from Australian companies were deemed to have already paid tax on those dividends.

In simple terms, if the company paid (say) $70 in dividends on which it had already paid $30 in company tax, the shareholder would be taxed on $100 at their marginal tax rate but were deemed to have already paid $30 of the tax due.

Where before, the government received $30 in company tax and (say) another $21 (30% of $70) in income tax from the shareholder, now it would receive just $30. In effect, the new system replaced company tax with a dividend withholding system. It ensured that shareholders who managed to avoid paying tax in Australia at least paid 30%. But the cost of doing this was to reduce tax on those who could not avoid it, by 30%.

The system is of course far more complex than it appears here. Payers, payees, and the ATO all have significant administrative workload in keeping track of, and reporting upon, the so called imputation or franking credits distributed and received.

The system also raised legal issues on how the Companies Act could view shareholders as separate legal entities from the company but the Taxation Act considered the company merely a conduit through which taxable profits are distributed to shareholders.

Interestingly, most countries that adopted similar systems have since abandoned them. Perhaps it is time for Australia to look at alternatives also.

Sadly, until it is either abandoned or significantly modified, Australia will continue to be seen as an expensive country in which to do business or in which to invest. To overseas investors, Australia has a company tax rate of 30% - which is seen to be uncompetitive. The fact that company tax paid is handed back to shareholders means nothing to foreign investors.

The question that the Tax Review has to answer is this. Is there a better way of doing this that would be cheaper and simpler to administer, that would enhance Australia's perceived competitiveness with overseas investors, that would remove the legal inconsistency between Company and Taxation law, and which would not be overly expensive in political capital to introduce.

It is suggested that these objectives could be largely achieved with a very simple change. Abandon the current system but, at the same time, make dividends deductible for company tax purposes, reduce company tax to (say) 20% (at least something less than our uncompetitive 30%), and require that companies withhold (say) 30% of dividends paid to non-Australian shareholders.

In our earlier example the $100 profit could now result in $100 dividend to shareholders on which they would pay tax at their marginal tax rate - the same as they do today. If the company decided not to distribute all after-tax profits, the shareholders would get less than they do today - but could hardly complain as the company does what the shareholders, collectively, direct that it should.

While making dividends deductible may sound somewhat radical, if interest paid on third party loans is allowed as a tax deduction, it is not unreasonable that dividends paid to shareholders for the use of their money should also be deductible.

Companies might complain that the effort to withhold from dividends paid to overseas investors is an additional administrative burden. But it would be significantly less effort than they currently face with imputation credits.

And the ATO could not complain. Where a company chooses to re-invest profits, it would get company tax that it does not get today.

Importantly, Australia would be seen internationally to have one of the most competitive tax rates in the world.