SUBMISSION TO THE AUSTRALIAN TAXATION REVIEW

By Peter Morgan

Date: April 2015

Dear Sirs,

I write to you as a passionate supporter of the Australian dividend imputation system.

PERSONAL BACKGROUND

I began my career in the Australian finance industry in 1987 as a stockbroker. In 1990 I became an active Australian equities fund manager and stayed in that role for the next 20 years (1990-2010). During that period i managed portfolio's with aggregate values of up to $ 12 billion on behalf of institutional and retail clients.

Prior to my roll as a fund manager i qualified as a Chartered Accountant having gained an Economics Degree majoring in accounting and taxation.

DIVIDEND IMPUTATION

In 1987 the then Treasurer Paul Keating removed the double taxation of dividends in Australia via the introduction of the dividend imputation system. Under the imputation system corporation tax is now paid by the company and the tax credited to the corporation is transferred to Australian shareholders on receipt of their dividends, so as to relieve their personal taxation on that income.

Dividend imputation was not introduced as a subsidy its was not introduced as a tax favour to the rich it was introduced to remove double taxation that might hit ANY taxpayer.

To quote Treasurer Keating,

" By introducing dividend imputation and capital gains tax i wanted equity taxed once, not twice and capital gains fully taxed. Thereby encouraging businesses to make more income and not lazy capital profits." (ALP Life Membership Acceptance Speech 1999).

In selling dividend imputation to the Labor caucus, Treasurer Keating sold its introduction by asking caucus to imagine two small shop keepers in a working class area.If the shop keepers formed a company their profits would be taxed twice, once at the company tax rate and then again at the full personal rate when those previously taxed profits were distributed to them as dividends.

" Is that fair ? If double taxation wasn't fair for shopkeepers it wasn't fair for any one." Keating argued.

PERSONAL OBSERVATIONS SUPPORTING IMPUTATION AND THE REFUTING THE ARGUMENTS USED FOR DIVIDEND IMPUTATION'S REMOVAL

As noted previously i was a fund manager specialising in Australian shares for over 20 years, as a fund manager i basically grew up and matured with the dividend imputation and superannuation systems. When i started superannuation assets were less than $ 50 billion today they are quickly approaching $ 2 trillion. Based upon my experience and knowledge i would like to make the following points to support the maintenance of dividend imputation and refute the arguments currently being used to support its removal:

1) It may sound simple but it is important to remember right up front that a consistent and recurring dividend and a consistent and recurring tax payment can only be paid out of a consistent and recurring income/profit.

2) In terms of investment valuation (not speculation) and with the exception of asset plays and turnaround situations a company is valued based upon its earnings expectations into the future. Not dividends.

3) Whilst there is some inherent value in franking credits attached to dividends which would be added to the valuation. It is ridiculous for some hysterical commentators to suggest that dividend imputation is the driving over investment in Australia equities.

4) Do these commentator's honestly believe an investor would prefer to invest in a mature local company like Telstra priced on 18 times earnings rather than a faster growing international company like Apple priced on 12x earnings and the reason is dividend imputation? Additionally News Corporation reached an index weight of 23% in the principal local equities benchmark in the year 2000. News Corporation's earnings were predominantly overseas sourced and the dividend yield was less than 1%, there was no way dividend imputation was driving this investment decision. In fact many Australian companies with high fully franked dividend yields were dumped.

5) It is also worth remembering at this point that the principal Australian equity benchmark upon which fund managers are benchmarked is capitalisation (size) and liquidity based. It is makes NO allowance for tax or after tax returns. In fact one of Australia's best consultants has tried to introduce an after tax return based benchmark and its acceptance has failed with clients.

6) I therefore strongly believe there are other factors at work that have contributed to the allocation to Australian equities and these include:

7) History, consultants planners and researchers, the fund manager and retail client gatekeepers are (perhaps wrongly) used to a 30-40% allocation to Australian equities despite a massive growth in the dollar value of Australian superannuation assets.

8) This local allocation has to date been supported by Australia not having a recession since 1991, the generally consistent operating performance of most Australian companies despite the GFC, Australia's corporate landscape having a major skew to banks (which have been major beneficiaries of low interest rates) and mining

companies (which have been major beneficiaries up until recently of the Chinese growth miracle).

9) Therefore based on the previous it is almost impossible to argue that dividend imputation is the only and even a major reason for the high allocation to Australian equities.

10) Let me now move to the important material benefits (other than the removal of double taxation) that dividend imputation has brought to Australia's corporate and economic performance

i) Corporate discipline which has boosted company strength and profits

In 1987 prior to the introduction of the dividend imputation system the Australian share market was predominantly made up of banks, sleepy traditional industrial manufacturing/mining companies and a growing list of entrepreneurial pirates. As dividends were taxed, most companies (including the banks ) of the time had the choice of retaining a lot of surplus capital on balance sheet or using it to diversify via acquisition. On many more occasions than not the diversifications via acquisitions materially destroyed shareholder value and led to tax write-offs. Almost concurrently as the blue chip companies of the time were building up lazy balance sheets with surplus capital or making poor diversification decisions the entrepreneurial pirates (eg: Bond Corporation, Qintex and Adsteam) took advantage of the situation and made numerous (bank) debt funded acquisitions. The non taxing of capital gains also helped promote the business strategy of the entrepreneurs. As history has shown all the entrepreneurs went broke and the major banks Westpac and ANZ were on the brink of collapsing in the early 1990's. As an aside it was quite common for the entrepreneurs and many industrial companies of these times to have many pages in their annual reports for subsidiaries many of which were established for tax minimisation purposes overseas.

Since the introduction of dividend imputation corporate discipline has improved materially, individual company board and management teams are far more shareholder return focused and generally now have to weigh up the risks and returns of the allocation of capital to expansion against returning capital to shareholders via dividends. Having said that, It is also worth noting that since the introduction of dividend imputation a number of Australian companies have still tried to expand overseas and many have failed miserably (eg: AMP, IAG,NAB and QBE). One can only speculate whether multi billion dollar losses (including tax write offs) would of been far greater with other unchecked expansions if dividend imputation was not introduced.

ii) Dividends and a dividend history help confidence in downturns and times of financial crisis

> " In the wipeout of 1987, the high dividend payers fared better and suffered less than half the decline of the general market. "
>
> Peter Lynch (one the world's best investors) - One Up On Wall Street.

In my 25 plus years of investing large amounts money on behalf of other people the confidence that a consistent and prudent dividend brings cannot be underestimated particularly in hard times. As an example just go back and look at the worst performing fund managers in Australia after the 1987 crash and through the recession of the early 1990's. Many of them had aggressively sold their past performance which was based upon speculative gains. The losses to investors were huge and many never recovered. One of Australia's best fund managers that has stood the test of Perpetual Trustee's actually branded itself out of this period with the " dividend income story ", via which it subtly sold to financial planners the benefits of companies paying and growing their income stream. It boosted investor confidence in terrible times and gave them hope.

More recently during the GFC all Australia's major banks were able to raise capital and rebuild their liability base away from a heavy reliance on potentially " flighty " local and overseas deposits. A few former politicians have taken credit for saving Australia from the GFC my firm belief is that it had nothing to do with their efforts but more to do with a once in a life time boom in China and dividend imputation which allowed the local banks to more easily raise capital.

Again let me quote Peter Lynch (from One Up On Wall Street page 285) .

" Sadly it is true America has one of the lowest savings rates in the developed world.Part of the blame goes to the government which continues to punish capital gains and dividends. While rewarding debt with tax deductions and interest payments. The Individual Retirement Account was one of the most beneficial inventions of the last decade-finally American's were encouraged to save something free of tax-so what does the government do ? It cancels the deduction.."

CONCLUDING COMMENTS

The world is currently flush full of easy money through the manipulative policies of central banks. Global interest rates have never been lower and some are actually negative for reasonable durations. Conversely asset prices are booming and risk has been materially under priced.

Australia is a cyclical economy with a heavy reliance on mining,housing and farming. Some may waffle on about Australia having the ability to attract investment away from these sectors, well let me just say good luck, Australia is currently a very expensive place to do business and has an inflexible wage system.

For the last 25 years Australia has boomed, there is a generation that hasn't seen a recession, despite record low interest rates total debt has never been higher here and globally. China's best growth is behind it and booming commodity prices have collapsed. Put simply these are very dangerous times.

This is not the time for quick illogical budget fixes like the removal of dividend imputation. There is almost currently $ 2 trillion in superannuation assets seriously what do you think will happen to the value of those superannuation assets if imputation is removed ?

Finally it is often said Australia has one of the best retirement saving systems in the world, and there is an old saying " if something is not broken don't try and fix it ."

My advice (as strongly as i can say it) leave dividend imputation alone.

Yours sincerely

Peter Morgan