SUBMISSION TO AUSTRALIAN GOVERNMENT TAX DISCUSSION PAPER

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This submission will be principally concerned with three broad areas dealt with in the Discussion Paper. These are:

1. The appropriate treatment of capital gains. (Discussion questions 19 and 23)
2. The appropriate response to negative gearing. (Discussion question 21)
3. The appropriate form of corporate-shareholder taxation for Australia. (Discussion questions 20, 24, 25, 32.

Rather than reviewing the points made in relation to these questions in the Discussion Paper this submission will argue for what I consider to be the most appropriate approach to dealing with these areas. It is submitted that the three areas are closely inter-related. The submission will also make reference to previous publication by the author for more detailed discussion of the proposals made in the submission. References to other literature supporting the statements in the submission have not been provided but can be supplied if requested. The submission at various points also has relevance for other issues raised in the Discussion Paper. These include: Discussion question 31, 33, 35, 36, 42, 43 and 58.

1. The Appropriate Treatment Of Capital Gains

Ideally in a comprehensive income tax all gains and losses on assets would be taken into account for tax purposes on an accruals basis. Australia, like most countries in the world, departs from this ideal for pragmatic reasons by generally adopting a realisation basis for the tax treatment of capital gains and losses on assets. The use of a realisation basis produces deferral advantages in an environment where rates of return on investments exceed the rate of inflation. Taxing capital gains in this manner amounts to giving capital gain preferential treatment when compared with an interest bearing investment with the same annual rate of return which is subject to tax as it accrues.

The preferential treatment produced by the use of a realisation basis is exacerbated under current Australian law by the availability of discounts for individuals, trusts and superannuation funds. Discounts were introduced following a recommendation by the Ralph Review of Business Taxation effectively as a substitute for the removal of inflation indexation and averaging provisions.

I have previously discussed problems associated with the use of a realisation basis and have suggested a solution to those problems in C John Taylor, 'CGT reform and the reduction of tax law complexity' (2008) 23 *Australian Tax Forum* 427.

Based on the analysis in that article the approach that I suggest in this submission for taxing capital gains is:

- Continuing to tax capital gains on all assets on a realisation basis, with an adjustment for inflation, but with no discount and with a compensatory tax on realisation to provide equal tax treatment with an investor who derived and was taxed on the same gain periodically over the same term as the owner held the asset;
- Prospective taxation of capital gains on all pre 20th September 1985 assets and main residences by allowing a cost of market value at the date of introduction of the changed system;
- Regarding death as a realisation event with a roll-over where the beneficiary is a spouse or dependant.

The approach suggested in my 2008 article for calculating the compensatory tax was as follows:

1. Determine the nominal gain on the asset on a realisation basis.
2. Calculate the average annual gain to the taxpayer on the asset by dividing the nominal gain by the number of years for which the taxpayer held the asset.
3. Add the average annual gain as determined in 2 to the taxpayer's taxable income for each year that the taxpayer owned the asset.
4. Apply the marginal rate that would have applied to the gain added in 3 on the assumption that the gain determined in 3 was derived after all of the taxpayer's other income.
5. Add an additional amount of tax for each year using the formula $[T(1+r)^n] - T$ where T is the tax that would be payable in a given year as calculated in 4, r is the relevant post tax rate of return on reinvestment, and n is the number of years from the year in which the tax is paid until the investment is realised.
6. The relevant post tax rate of return could either be the rate of return which, assuming a constant geometric return, produces the total gain or could be a rate of return determined by dividing the total gain by the average of A (the cost of the asset adjusted for inflation) and S (the sale price) and by then dividing the product of that calculation by the number of years in which the asset has been held. For the purposes of this presentation the latter value of r has been be used. This approach will produce a lower value of r and will tend to offset over taxation arising from the use of an averaging system.
7. In calculating the compensatory tax only adjust for changes in marginal rates using an average after tax rate of return (after taking into account changes in marginal rates).

Examples showing the calculation of the compensatory tax are contained in the article. The article also argues that imposing a compensatory tax in fact reduces the 'lock in' problem associated with capital gains taxation. The article also discusses the lock in problem in the context of the current exemption for pre CGT assets and the main residence exemption and discusses possible effects of the removal of the main residence exemption on workforce mobility. The article also discusses problems associated with the treatment of capital losses and the taxation of inflationary gains. That discussion will not be repeated here but it is submitted that the existing discount on realisation coupled with the exemption for gains on pre CGT assets and the main residence exemption significantly distorts investment decisions, narrows the tax base and adds significant complexity and textual bulk to the overall income tax system. In an appendix to my 2008 I identified provisions in Parts 3-1 and 3-3 of *Income Tax Assessment Act* 1997 which I considered would no longer be required if the approach I advocated then and advocate in this submission were adopted. The treatment of capital gains flowing through trusts would also be likely to be able to be simplified significantly with the removal of the CGT discount. Base broadening resulting from this approach should enable a reconfiguration of personal income tax rate scales with a possible overall lowering of rates.

2. The Appropriate Response To Negative Gearing

I agree with the argument in the Discussion Paper (at) that the problem of negative gearing is not a product of the currently inadequate tax treatment of capital gains on the realization of assets. Currently negative gearing works as an investment strategy because the tax benefit of the deduction for interest and other expenses is received in each current year in which the income producing asset is held while tax on capital gains arising from holding the asset is deferred until realisation. The distortion arising from the use of a realisation basis is compounded in the case of gains by individuals, trusts and super funds by only recognising part of the gain for tax purposes. Removal of the discount alone would not produce neutrality between a negatively geared investment and an interest bearing investment with the same pre-tax annual rate of return. Neutral treatment, however, would be produced if the proposals suggested under Heading 1 of this submission were adopted.

3. The Appropriate Form Of Corporate-Shareholder Taxation For Australia

3.1 The History Of Systems Of Corporate-Shareholder Taxation At The Federal Level In Australia[1]

Since 1915 Australia has used several different systems of corporate-shareholder taxation. Between 1915 and 1922 dividends were deductible to the company and assessable to shareholders and a non-refundable rebate was available to shareholders when dividends were funded from profits that had been taxed at the company level. The dividend deduction system was abandoned in 1923 in favour of a form of dividend imputation which was regarded as being more consistent with the systems of corporate-shareholder taxation operating in State income taxes. Between 1934 and 1936, following recommendations of the Ferguson Royal Commission the imputation system was converted into a shareholder relief system under which credit was given at the shareholder level whether or not corporate tax had been paid. The credit in this period was at the lower of the corporate rate or the shareholder's rate on dividends. This effectively meant that the credit was not refundable. To raise additional revenue to prosecute World War II the imputation system was changed into a classical system in 1940. A dividend imputation was re-introduced in 1987 following a recommendation by the Asprey Committee in 1975 and as proposed in the 1985 Draft White Paper. The system adopted was a shareholder credit account system which tracked income minus tax paid at the corporate level. Credits were not refundable under that system. Under that system

[1] The Tax Discussion Pape at p.82 under Heading 5.2 r contains the slightly misleading statement that, 'Historically, Australia had a 'classical system' of dividend imputation that resulted double taxation of company profits when they were distributed to non-corporate shareholders'. As will be seen from the account above Australia at the Federal level has experimented with many different forms of corporate-shareholder taxation. In addition, some State income tax regimes adopted dividend exemption systems. The account at 3.1 is based on C John Taylor, 'Development of and Prospects for Corporate-Shareholder Taxation in Australia' (2003) 57 *Bulletin For International Fiscal Documentation* 346.

the portion of a dividend paid to funded from taxed profits a non-resident shareholder was exempt from withholding tax but did not generate a gross up and credit. Corporate tax preferences were 'washed out' on distribution. The present system was introduced in 2002 following recommendations of the Ralph Review of Business Taxation. For purposes of the present discussion the most significant changes implemented in 2002 were the tracking of tax paid rather than income minus tax paid and allowing excess credits to be refundable to certain taxpayers (most notably resident individuals and complying superannuation funds).

3.2 Advantages And Disadvantages Of Australia's Dividend Imputation System

Australia's current dividend imputation system has advantages some of which are identified in the Discussion Paper. The advantages of the current system include:

- A more neutral treatment of different forms of business organisation than exists in classical or dividend exemption systems;
- A close to neutral treatment of debt and equity financing by Australian resident investors;
- Ensuring that the total tax on income derived by a resident company and distributed to a resident shareholder represents tax at the resident shareholder's average rate (a result which, given the presence of a progressive rate scale, is consistent with vertical equity but is not produced by some other systems of corporate-shareholder taxation such as the classical system and dividend exemption systems);
- Incentive for Australian companies controlled by Australian residents to pay Australian corporate tax (this can also be seen as a distortion and consequently as a disadvantage);
- Ensuring that income retained at corporate level does not escape Australian tax; and
- Ensuring, through the corporate tax, that some tax is borne on distributions of corporate profits to non-resident investors.

It has also been widely recognised that Australia's current dividend imputation system has several disadvantages some of which are identified in the Discussion Paper. The disadvantages of the current system include:

- The failure to extend imputation benefits to non-resident investors combined with the level of Australia's corporate tax and the form of relief from international double taxation in the investor's country of residence means that Australia is a less attractive destination for foreign portfolio and non-portfolio investors than it otherwise would be;
- The failure to extend imputation benefits to non-resident investors means that debt financing of resident companies controlled by non-residents can be more beneficial than equity financing;
- A consequence of the previous bullet point and the fact that imputation credits provide benefits to resident shareholders means that the current treatment of dividends discriminates in favour of resident shareholders;
- The combination of refundable credits and the discounts on capital gains on shares means that investing by residents in domestic shares is more favourable than the investment of an equivalent amount assets producing the same pre-tax interest returns;
- The combination of the relationship between the progressive individual income tax rate scale and the corporate rate, the current treatment of capital gains on shares and the taxation of corporate distributions only on realisation can produce a retention bias in closely held companies controlled by Australian resident natural persons;

- The failure to give credit at the corporate level in the imputation system for payments of foreign tax creates a bias against offshore investment by Australian companies and results in attempts to reduce foreign tax payable through complex tax planning;
- The failure give credit for payments of foreign tax in the imputation system produces a bias for resident investors in favour of Australian tax paying equities against foreign equities and Australian equities that are not tax paying;
- Many of the complex provisions in *Income Tax Assessment Act* 1997 and *Income Tax Assessment Act* 1936 can be analysed as being products of one or more of the distortions identified above. These include: the benchmark franking rule; anti dividend streaming rules; anti franking credit trading rules; the debt and equity rules; and the thin capitalisation rules.

3.3 Suggested Solution To Problems With Australia's Dividend Imputation System

It is submitted that most of the problems associated with Australia's dividend imputation system are the cross border aspects of the operation of the system. Technical changes to the cross border operation of the system are available which would mitigate those problems significantly.

3.3.1 Problems Associated With The Failure To Extend Imputation Benefits To Non-Resident Investors

Turning first to the failure to extend imputation benefits to non-resident shareholders it is worth noting that the Discussion Paper, along with many commentators, properly discusses this as a problem in the context of the relatively high level of Australian corporate tax as compared with both the OECD average and, more particularly, with regional competitors like Singapore and Hong Kong. As the Discussion Paper recognises, for Australian resident investors the corporate tax functions as a withholding tax so in that context the headline rate overstates the level of corporate tax. The key issue then is the effective rate of Australian corporate tax that applies to non-resident investors. The assumption in the Draft While Paper is that the current effective rate of Australian corporate tax deters foreign investors with consequent adverse effects on capital deepening, productivity and real wages.

One solution would be a general lowering of the Australian corporate rate. Cutting the corporate tax rate across the board to be anything like competitive with Singapore or Hong Kong would be very expensive although the cost may dissipate over time if the rate cut produced greater economic activity. Importantly the cut in the rate would apply not only to companies which had non-resident shareholders but to all companies. The revenue cost would be mitigated by a change back to a classical system of corporate-shareholder taxation featuring double taxation of corporate profits but this would be at the expense increased tax planning through incorporation. For closely held domestic companies a cut in the rate would exacerbate a tendency toward tax planning via retention of profits in these companies as would a more away from dividend imputation towards a classical system or other forms of corporate-shareholder taxation. Again the revenue cost would be mitigated if, as also canvassed in the Tax Discussion Paper, the 50% discount on capital gains were eliminated, but this too would exacerbate the tendency towards profit retention unless capital gains were to be taxed more heavily than ordinary gains to compensate for the advantages of deferral.

If the problem is seen as having a competitive tax rate for non-resident investors in Australian companies then why not have a solution that is targeted at those investors. Here it is important to realise that the current treatment of non-resident investors in Australia's dividend imputation system are just a design choice made at the time of its introduction and amendment. There is no set in stone reason why Australia could not extend tax offsets on franked dividends to non-resident investors. In fact, doing so would enable many complex provisions in the dividend imputation system aimed at preventing a technique known as dividend streaming, to be repealed. Why don't we allow non-residents tax offsets on franked dividends? The technical reason is that, for many but not all resident taxpayers, tax offsets on franked dividends are refundable. There is no technical reason, however, why Australia could not allow a proportion of the franking credit on a dividend to generate a tax offset for non-resident investors.

Where the non-resident shareholder resides in a country Australia has a double tax agreement (DTA) we could provide a targeted reduction in the effective Australian corporate tax rate that applied to the non-resident shareholder by allowing a proportion of the franking credit to generate a tax offset for the shareholder. Because of withholding tax rates in DTAs, to produce an even effective Australian corporate tax rate for investors from all DTA countries the proportion of the credit allowed would need to fall with the withholding tax rate. Where a shareholder resides in a non DTA country I would favour continuing our present policy of exempting the franked portion of the dividend from withholding tax and not allowing tax offsets. Generally we do not have DTAs with very low taxed countries or with countries that are not significant trading and investment partners.

If the Australian corporate rate remained at 30% extending a proportion of tax offsets for franking credits to non-resident shareholders would reduce their effective Australian corporate tax rate except in the case where the shareholder resides in a non-DTA country. The following Table shows how this would occur.

Australian Company	***Category One*** DTA 15% Withholding Tax	***Category Two*** DTA 5% Withholding Tax	***Category Three*** DTA 0% Withholding Tax
Income	100	100	100
Corporate Tax & Franking Credits	30	30	30
After Tax Dividend	70	70	70
Gross Up For Franking Credits	30	30	30
Grossed Up Dividend	100	100	100
Withholding Tax	15	5	0
Tax Offset for Franking Credit	30 100% tax offset	20 Ie 30 x 20/30 66.66% tax offset	15 ie 30 x 15/30 50% tax offset
Net Australian Tax/Refund/ Conversion to tax loss	15 refund	15 refund	15 refund

The example shows that, to produce a very competitive 15% effective corporate rate for non-resident investors Australia could, while maintaining its corporate rate at 30%, provide a full tax offset of where a 15% withholding tax applied, a 2/3 credit where 5% withholding tax applied and a 1/2 credit where a 0% withholding tax applied.

In all cases the effective Australian corporate tax rate for a non-resident shareholder would be a very competitive 15% at a lower revenue cost than under an across the board cut in the corporate tax rate and the benefits of dividend imputation would be preserved for resident shareholders. Other rates could, of course, be chosen although it is worth pointing out that a rate of 15% would be equivalent to the rate that currently applies to complying superannuation funds.

Extending imputation credits to non-resident investors from DTA countries in this manner would reduce the current bias in favour of debt financing over equity financing for foreign controlled companies and may mean that thin capitalisation and debt and equity rules would no longer be necessary.

3.3.2 Problems Associated With The Failure To Give Credit For Payments Of Foreign Tax

Again the point can be made that there is no set in stone technical reason why Australia could not give credit in its imputation system for payments of foreign tax by Australian corporates. Foreign tax paid is already tracked through the conduit foreign source income provisions. There would be an additional compliance burden on Australian corporates but they may well consider that the benefits of obtaining credit for payments of foreign tax would make the burden worth bearing.

As a payment of foreign tax does not directly benefit Australian it may be thought to be objectionable in principal to grant refundable imputation credits for payments of foreign tax.

I have previously discussed alternative treatments for foreign source income in Australia's dividend imputation system in C John Taylor, 'Alternative treatments for foreign source income in Australia's dividend imputation system' (2005) 20 *Australian Tax Forum* 189. Without repeating the analysis and arguments in that article I reiterate the conclusion that I reached then, that the 'limited exemption approach' that I proposed in that article and in an earlier article (C John Taylor, "Approximating Capital-Export Neutrality in Imputation Systems: Proposal for a Limited Exemption Approach" (2003) 57 Bulletin For International Fiscal Documentation 135) can produce capital export neutrality in many the cases discussed in the article and capital import neutrality in all cases.

In outline the 'limited exemption approach' would require an Australian company to track foreign corporate tax paid on profits repatriated to Australia (this could be either all repatriated profits or, depending on what was conceived to be the real nature of the problem, foreign income which was non-assessable non-exempt income for Australian tax purposes). The account could be called the 'limited exemption account' or 'LEA' account. To the extent that a dividend paid by a company was funded from the LEA account a portion of it would be exempt on redistribution. The exempt portion would be:

$$T[(1-m)/m]$$

where

t = foreign tax paid

m = the shareholder's marginal rate

The taxable portion of the distribution would be:

$$F – t – [(t – tm)/m]$$

where

F = foreign income

This would mean that the after tax dividend that the shareholder received would be:

F – Fm

This would mean that the total tax borne on the dividend funded from foreign source income had represented tax at the shareholder's marginal rate.

In the 2005 article I proposed that to avoid payments of foreign tax being either refunded (either directly or in tandem with the dividend imputation system) or offset against domestic tax liabilities the exemption have an upper limit of F-t. The article also discusses ways of easing the compliance burden at both the corporate and shareholder level and rules for determining what the shareholder's marginal rate was. The approach could be applied to distributions to non-resident shareholders and consideration could be given to whether in that respect it could replace the current conduit foreign source income regime.

It is submitted that implementation of this system would significantly mitigate the bias against offshore investment by Australian companies and the bias in favour of investing in domestic equities for Australian residents.

3.3.3 Problems Associated With The More Favourable Treatment Given To Investing In Domestic Equities Over Investing In Interest Bearing Securities

Chart 4.1 in the Discussion Paper and the associated text at pp.60-61 argue that the effective marginal rate on investing in domestic shares is significantly lower than an equivalent interest bearing investment. While agreeing with that general conclusion I would argue that the assumptions illustrated in Chart 4.1 are flawed in that the analysis assumes a 6% return on shares after company tax and a 6% notional return in other cases. When analysing returns for resident shareholders in an imputation system this does not appear to be a valid assumption to me. If a 6% return pre company tax is assumed consistently with the assumption made for other assets then investment in domestic shares should be equivalent to investment in domestic income producing real estate.

I agree with the substantive analysis at p.61 of the reasons why 'The tax system may encourage Australian households to invest more of their savings in companies, particular Australian companies, than they would otherwise'. The reasons given are: the CGT discount; the limitation of the benefits of the dividend imputation system to Australian shareholders; and the extra layer of tax borne on investing in foreign equities due to the failure to credit payments of foreign tax in the imputation system. I would submit that each of these problems has been addressed in earlier portions of this submission. The treatment of capital gains was addressed under Heading 1. Problems associated with the failure to extend imputation benefits to non-residents were addressed under 3.3.1. Problems associated with the failure to credit payments of foreign tax in the imputation system were addressed under 3.3.2.

3.3.4 Problems Associated With The Retention Bias In The Imputation System

First it should be noted that this problem also exists to a greater extent in other systems of corporate-shareholder taxation and is particularly problematic in classical systems or variants on them. Second it should be noted that the problem is partially a product of the relationship between the corporate rate and the progressive individual rate scale. The problem could be mitigated by reform of the progressive rate scale. Third the problem would also be mitigated by taxation of capital gains on shares in the manner suggested under Heading 1. The problem would appear to be confined to closely held companies.

A more radical solution to problems associated with retentions in closely held companies could be to consider applying a different system of corporate-shareholder taxation for closely held companies. One alternative is partnership equivalent taxation in which income is attributed to shareholders independently of actual distribution and where tax is only paid at the shareholder level. Difficulties in collecting tax from non-resident shareholders would mean that this system would have to be confined to closely held companies which did not have non-resident shareholders. Under this system some tax preferences at the corporate level which are currently washed out on distribution would be available to shareholders. This would have a revenue cost and, while appropriate in the case of tax preferences that are available through other forms of business organisation might be thought to be not appropriate in the case of preferences (such as the treatment of foreign branch profits under *Income Tax Assessment Act* 1936 s23AH) which are only available to companies. If this were thought to be undesirable it would be necessary to identify preferences fitting into this category and then expressly exclude the application of those preferences to companies to which partnership equivalent taxation applied. This approach would mean that profits were taxed at the shareholder level as they arose and that deferral at the corporate level was not possible. A difficulty with this approach would be that, if it were made mandatory for closely held companies with no foreign shareholders, the mandatory classification could simply be avoided by having foreign shareholders. If it were made optional then presumably companies where controlling individuals wanted to retained taxed income at the corporate level would not elect for partnership equivalent taxation.

Another alternative would be to revert to 1915 and apply a dividend deduction system to closely held companies. Again revenue considerations at current levels of withholding tax in DTAs would be likely to mean that the system would need to be confined to closely held companies with companies with non-resident shareholders not being permitted to elect to be taxed as dividend deduction companies. In contrast to the system that applied in Australia between 1915 and 1922 I would not favour marrying a dividend deduction system with an imputation system. While several alternative approaches are possible depending on the overall objectives sought to be achieved[2] one that would be appropriate to achieve an objective of preventing retentions at the corporate level would be to limit the deduction in any year to the company's taxable income for that year and to no allow corporate losses produced by the deduction to be carried either forward or backward. Under this system corporate tax preferences would be washed out on distribution and there would be no need for provisions excluding them from dividend deduction companies. The same difficulties would be associated with making the approach mandatory for certain companies and if the approach were made optional then presumably companies that wanted to retain corporate profits would not elect for dividend deduction treatment. However, the likely compliance cost benefits of an optional dividend deduction system over an imputation system would also presumably be taken into account in determining whether the elect for dividend deduction treatment. A further difficulty with this approach is that restricting its application to companies with no non-resident shareholders might infringe the non-discrimination article in several of Australia's DTAs. I have previously discussed this issue in Taylor C J, "An Old Tax Is A Simple Tax: A Back To The Future Suggestion For The Simplification Of Australian Corporate-Shareholder Taxation" (2006) 2 Journal of the Australasian Tax Teachers Association 30 to 57. The conclusion reached in that discussion was that the non-discrimination article would not be likely to be infringed if, in addition to excluding non-residents

[2] I have previously discussed the 1915 – 1922 system and an approach that would produce equivalent results to the current Australian dividend imputation system in Taylor C J, "An Old Tax Is A Simple Tax: A Back To The Future Suggestion For The Simplification Of Australian Corporate-Shareholder Taxation" (2006) 2 Journal of the Australasian Tax Teachers Association 30 to 57

from being shareholders in optional dividend deduction companies, tax exempts (and possibly other entities such as superannuation funds and listed companies) were also excluded from being shareholders in dividend deduction companies.

3.3.5 Problems Associated With The Complexity Of The Dividend Imputation System And Associated Rules

The main point to be made here is that most of the admittedly complex provisions in the current Australian system are the product of the choice to not extend imputation credits to non-resident shareholders. At 3.3.2 I already submitted that granting proportional credits to non-resident shareholders from DTA countries would reduce or even eliminate the need for both Thin Capitalisation rules and Debt and Equity rules. As under some DTAs unfranked dividends would still be more valuable to non-resident non-portfolio corporate shareholders than franked dividends it would still be necessary to have some rules to prevent dividend streaming and franking credit trading although the advantages accruing to those strategies would be lessened by the granting of proportional credits to non-residents. In addition eliminating the exemption for capital gains on pre-CGT assets (as suggested under Heading 1) and using the limited exemption system for dividends funded from foreign source income would mean that the problems of dividend streaming and franking credit trading would be reduced in significance because there would be fewer instances of unfranked dividends.

Assuming that the problems of dividend streaming and franking credit trading, while reduced in significance, would continue to exist they could be dealt with more simply than at present by changing the rules for attaching franking credits to a dividend. In a previous article, C J Taylor, 'Resolving Inequities in Australia's Dividend Imputation System' (1995) 12 *Australian Tax Forum* 1 I argued that the opportunity for dividend streaming (and for that matter franking credit trading) would be virtually eliminated if franking credits were attached to a dividend using the following formula:

F[D/P-Yc]

where F was the credit balance in the company's franking account, D was the amount of the dividend, P was the company's after tax distributable profit, Y was the company's taxable income for tax purposes, and c was the corporate tax rate.

Under this approach, except where the company's taxable income was equal to its distributable profits, all dividends would be partially franked. Where the dividends were partially franked the approach would mean that where distributable profit exceeded the company's taxable income credits would be retained in the franking account to the extent that the company retained profits. This would be counterbalanced in periods where the company's taxable income exceeded its distributable profit. Dividend streaming between resident and non-resident shareholders in one period would not be possible. It is submitted that streaming between periods would not be possible either. Nor would franking credit trading.

It is likely that listed companies would determine the level of dividend they paid that was necessary for them to attract investors and maintain their share price taking into account the total after tax effect for shareholders of receipt of the partially franked. It is probable that the after tax result of distributions for shareholders would closely approximate the result under the present system (on the assumption that the complex anti dividend streaming rules are working effectively).

The behavioural effects that a rule of this nature would have on closely held companies would be likely to vary according the circumstances of the particular company. Closely held companies with shareholders who are otherwise on a marginal rate lower than the corporate rate might be likely to be biased in favour of increased distributions. Closely held companies with shareholders on marginal rates above the corporate rate who are approaching retirement would not have their existing bias in favour of retention of franking credits curtailed by the rule and, indeed, the rule might even facilitate the bias. As discussed at 3.3.4, that bias would be likely to be reduced by taxation of capital gains in the manner suggested at 1. Adopting one of the types of optional alternative systems of corporate-shareholder taxation for closely held companies would be another way of dealing with the bias.