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5 June 2015

The Manager
Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam,

Submission to the Tax Discussion Paper released 30 March 2015

Wilson Asset Management is of the strong view that the existing dividend imputation arrangements should be retained as it leads to:

- robust capital formation in Australia
- efficient capital distribution
- a more stable economy with reduced cyclicality
- greater financial support for Australian charities.

Please find enclosed our submission in response to the Tax Discussion Paper, which supports this position.

Should representatives of the Treasury wish to speak with the matters raised in this submission, please contact me on (02) 9247 6755.

Yours faithfully

Geoff Wilson

Chairman

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In general, Australian companies have a mixed track record of generating returns on overseas investment. The Australian banking sector provides sufficient anecdotal evidence of this fact. Westpac Banking Corporation and National Australia Bank Limited destroyed shareholder value in their expansions into the United States and the United Kingdom. In contrast, Commonwealth Bank of Australia has focused on investing in Australia and is currently the nation's best performing bank.

Efficient capital distribution

Dividend imputation incentivises Australian companies to distribute significant portions of tax paid earnings. A review of company data between 1995 and 2009 found firms distributing franking credits had a higher dividend payout ratio than non-franking credit firms (Abraham, 2013).

Academic literature has shown that companies with high payout ratios outperform those with lower payout ratios. Research conducted by Arnott and Asness found companies with high payout ratios generated the best earnings growth over a 130-year sample period (2003). We support the argument put forward by Fidelity Worldwide Investment in its submission to the Financial System Inquiry, which provides additional detail about the relationship between high payout ratios and efficient capital distribution (2015).

A more stable economy with reduced cyclicality

In lowering the costs of equity relative to debt, dividend imputation limits the imperative for companies to gear. As a result, Australian firms holding relatively low levels of gearing compared to other countries. Goldman Sachs Investment Research found that Australia has the lowest level of gearing when adjusted for its sector mix (2015).

Modigliani and Miller's seminal paper on capital structure demonstrated that the corporate tax shield serves to lower the cost of debt relative to equity, which would not be the case under a 'free market' system (1958). The authors also showed financial distress costs and bankruptcy risk have a real and significant impact on the welfare of companies and are increased in leveraged firms.

Leverage is a key indicator of the financial health of companies and the economy in general. Leverage exacerbates the cyclicality of financial markets as it drives companies' performance during bull markets and intensifies companies' losses during financial downturns. Leverage was a key factor in the magnitude of the global financial crisis. As a result, the capital discipline dividend imputation has driven in Australia is a crucial defence against cyclicality and debt-related systemic risk.

Greater financial support for Australian charities

Australian philanthropic trusts and foundations are excluded from income tax exemptions on all forms of investment due to their charitable purpose. The availability of refundable franking credits on dividend income is consistent with this exemption. Reintroducing double taxation would offend the principle that funds applied for charitable purposes should be income tax exempt. This issue is effectively described by Philanthropy Australia in its response to the Discussion Paper (2015).

Conclusion

We believe dividend imputation has significantly benefitted Australia's financial system. Dividend imputation leads to robust capital formation in Australia, efficient capital distribution, a more stable economy with reduced cyclicality and greater financial support for Australian charities. The removal or adjustment of dividend imputation would therefore be detrimental to the Australian financial system.

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Wilson Asset Management – Tax Discussion Paper submission

About Wilson Asset Management

Wilson Asset Management is an independently owned leading boutique funds management business established in 1997 and based in Sydney. Wilson Asset Management manages more than $1 billion across three ASX-listed investment companies: WAM Capital Limited (WAM), WAM Research Limited (WAX), WAM Active Limited (WAA); and recently created Future Generation Investment Company (FGX), which provides access to 16 prominent fund managers while supporting Australia charities with a focus on children at risk.

Our shareholders are at the forefront of everything we do. Wilson Asset Management respects the rights of all shareholders and advocates for a fairer, more effective Australian financial system. Last year we lodged two separate submissions to the Financial System Inquiry (FSI) arguing retail investors should be on a 'level playing field' with institutional investors by participating in primary capital raisings without the requirement of a prospectus.

We serve more than 21,000 shareholders across our three listed investment companies and approximately 60% are self-managed superannuation funds. Our investment team comprises of five professionals with more than 70 years' combined experience in financial markets.

We are therefore well positioned to provide views to the Federal Government on its review of the taxation system, particularly in regard to dividend imputation.

Dividend imputation background and current debate

As outlined in Tax Discussion Paper (Discussion Paper) dividend imputation was introduced in 1987 to relieve double taxation. The paper states "dividend imputation ensures there is no double taxation on income from Australian shares owned by Australian resident shareholders and supports the integrity of the business tax system" (2015, pg. 73).

The application of this fundamentally sound principle has provided Australia with a competitive advantage for nearly three decades. Australian corporations have made all capital investment or dividend decisions based on the existing system. As a result, recent questions about its future have alarmed businesses and shareholders alike.

The case for retaining dividend imputation

We commend the government for its review of the tax system in its entirety, however dividend imputation has served the country well and will continue to do so should it remain unaltered. The existing system is fair and equitable and encourages the effective allocation of capital and efficient distribution of profits.

We believe dividend imputation enables:

- robust capital formation in Australia
- efficient capital distribution
- a more stable economy with reduced cyclicality
- greater financial support for Australian charities.

<u>Robust capital formulation in Australia</u>

Dividend imputation leads to efficient capital allocation by directing capital towards Australia companies. Further, dividend imputation encourages Australian companies to invest in Australian projects as they do not earn franking credits on foreign-earned revenue (Abraham, 2013). Increased local investment is a boon for the Australian economy in general, but particularly for shareholders.

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