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Re: Not-for-Profit Sector Tax Concession Working Group Discussion Paper *Fairer, simpler and more effective tax concessions for the not-for-profit sector*

Thank you for the opportunity to comment on the above Discussion Paper.

Philanthropy Australia's purpose is to advance philanthropy. This submission accordingly focuses mainly on those measures which have the potential to affect giving in Australia, directly or indirectly. It is essential to a thriving not-for-profit sector that the regulatory and cultural environment remains conducive to giving at all levels, and that there are no unintended negative consequences from any proposed changes to the current system.

1. Income Tax Exemption and Refundable Franking Credits

Q6: Should the ability of tax income charities and DGRs to receive refunds for franking credits be limited?

Philanthropy Australia believes that there is no justification for effectively taxing the charitable sector by changing the current arrangements under which charities and income tax exempt DGRs can claim a refund of franking credits (being the tax already paid by companies the charities have invested in). This situation has not changed since the Henry Tax Review raised the issue of abolishing imputation credits in 2009, and Philanthropy Australia's technical paper in response to that review is attached to this submission. The question seems to suggest that the application of the franking credit rebate amongst Australian shareholders should in future discriminate against tax-exempt charities and DGR's. There are no good policy grounds for doing this. Why would tax-exempt charities and DGR's be less worthy than other investors? It is certainly not consistent with the Guiding Principle of fairness.

The current regime has increased the level of income being distributed to community organisations, as well as focusing investment portfolios on Australian companies paying Australian taxes. These outcomes help maximise community benefit in Australia both directly and indirectly. Dismantling the current system would impact heavily on dividend income flowing through foundations to the community. It has been suggested that the elimination of imputation and a simultaneous cut in the corporate tax rate while reducing cash in hands of shareholders, will be offset by an increase in the companies' share prices. For many philanthropic trusts, particularly those unable to distribute capital owing to restrictions in their deed, capital appreciation is irrelevant in determining distribution levels and the result will be a marked reduction in grants to the community. An educated guess would be in the order of a 20-30% reduction in the distribution level for many Australian foundations.

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Changes in this area may be particularly detrimental to Private and Public Ancillary Funds which must annually distribute the equivalent of 5% and 4% of the fund's assets annually. In a time of declining interest rates some funds may not be able to meet these targets without access to refunds of franking credits and as a result could face a substantial decrease in the value of the fund with some forced to distribute out of capital. This would result in a further decrease in funds available for the community benefit.

Charities which have investment portfolios built up over the years from bequests would face a similar reduction in income. This would reduce the financial capacity of charities at a time when the demand for their services continues to rise. It is especially significant for those charities which use the income from investments to fund their core activities which do not attract funds from the donating public and grantmakers, such as professional development of staff, maintenance, infrastructure replacement, administration and the other costs of running an organisation.

If the grantmaking capacity of philanthropic trusts and the financial capacity of service provision charities is reduced as a consequence of an inability to claim franking credits, the burden of responding to the unmet community needs would fall upon government.

While the Discussion Paper does show growth in tax expenditure on refundable franking credits, the figures are not disproportionately large. It should be noted that limiting the ability of charities to claim a refund is effectively a de facto reimposition of taxation on tax-exempt entities. It would also significantly reduce the capacity of philanthropic trusts to assist them through the reduction in income available to distribute. Any revenue recovered by Treasury would be offset by increased demands on the public purse from both charities and their clients.

2. Deductible Gift Recipients

Q11: Should all charities be DGRs?

The concept of extending DGR status to all charities is appealing in theory. Philanthropy Australia is certainly in favour of widening the criteria for DGR status, as lack of DGR prevents a great number of organisations from being eligible for philanthropic support, particularly from Private and Public Ancillary Funds. This is especially an issue for regional and remote Australia where there are often very few organisations with the capacity to apply for DGR status and to carry out programs and for social innovation whether through new organisations or innovative funding models such as social finance.

It is also regional and remote Australia which suffers most from the issue of the requirement for an entity to fit within a single DGR category. Many regional areas do not have the capacity to support a variety of community based organisations, and therefore one organisation will necessarily carry out multiple functions. Forcing these entities to restrict their activities and purposes to fit into a single DGR category is unnecessarily burdensome.

Social innovation is also constrained by the current DGR approach. Specifically, one natural pool of capital funders (Private Ancillary Funds) often cannot support those with the greatest demand for social finance owing to the recipients' lack of DGR status. Consideration should be given to extending the DGR intermediary model (the

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Foundation for Rural and Regional Renewal model) to other fields such as social finance and education, so that public schools can be supported by deductible donations as recommended in the Gonski Review, among others.

Philanthropy Australia is therefore supportive of a review of the DGR category system and favours an inclusive approach, where an entity is a DGR if the focus of its activities and purposes can be demonstrated to be to the greater community benefit in Australia or in developing countries.

However, Philanthropy Australia points out that the extension of DGR status to all charities would have unintended negative consequences for many charitable trusts and could prevent them from fulfilling their charitable purposes. Careful thought is required to ensure that any review of the system does not impede trusts from fulfilling their purposes, to ensure that grants from charitable trusts continue to be spent for community benefit.

One of the options presented in the Discussion Paper is to extend DGR status to all charities without requiring a charity to fit into one of the general DGR categories. However, the paper does not propose whether charities are to become item 1 or item 2 DGRs or even whether those categories are to be maintained. Any such scenario poses a number of dilemmas where charitable trusts are concerned.

For example, charitable trusts could be endorsed as item 2 DGRs. They would presumably therefore be limited to funding item 1 DGRs and would not be permitted to fund individuals. This would prevent some trusts from fulfilling their charitable purposes, such as those which were established to fund individuals for charitable purposes such as relief of poverty or advancement of education. There also arises the question of whether these trusts would be considered Public or Private Ancillary Funds – many will not fulfil the legal criteria for either of those entities (and cannot do so by the terms of the trust instrument).

Alternatively, charitable trusts could be endorsed as item 1 DGRs, or else given a special new DGR endorsement which did not limit them to funding only DGRs. However, this establishes a conflict with relation to the existing DGR structure and the restrictions that are currently placed on other types of trust such as private and public ancillary funds. Ancillary funds are not permitted to fund other ancillary funds. This is to ensure that gifts from ancillary funds are applied directly to community benefit, and that there is no loophole which could enable grants to move between funds without being spent on activities and purposes within the community. If existing private charitable trusts were endorsed as item 1 DGRs, a similar situation could arise where grants could potentially move from ancillary funds to these newly DGR charitable trusts – and possibly back again - without being spent on projects and activities.

There would also be little incentive for high net worth individuals to establish new Private Ancillary Funds (PAFs) if they could establish an item 1 DGR and thereby avoid the higher levels of reporting requirements and governance responsibilities that come with a PAF.

One potential solution would be to extend DGR status only to entities endorsed as charitable institutions, rather than charitable funds. However, Philanthropy Australia notes that the Australian Charities and Not-for-profits Commission Act 2012 proposes to omit the distinction between funds and institutions, registering entities simply in the overarching category of "charity" with further subtypes if an entity fulfils the criteria for a subtype.

Our conclusion is that neither of the above options is workable. Therefore should the extension of DGR to more charities be pursued , with Option 2.3 looking the most practical alternative, Philanthropy Australia believes that the best solution is to “carve out” those charitable funds which are not ancillary funds from the extension while the category of “charitable fund” is still valid (Ancillary funds should, of course, remain DGRs). This would also have the incidental benefit of providing some statistical data about the number of charitable trusts in Australia, which the Australian philanthropic sector has always lacked.

3. DGR versus fixed tax offset

Q15: Would a fixed tax offset deliver fairer outcomes? Would a fixed tax offset be more complex than the current system? Would a fixed tax offset be as effective as the current system in terms of recognising giving?

Philanthropy Australia does not support the introduction of a fixed tax offset because it is likely to reduce total giving, particularly because of its negative effects on philanthropy, and therefore is contrary to Guiding Principle 3, which is to recognise giving in Australia.

A fixed tax offset would fulfil some criteria of “fairness” by providing the same level of tax benefit to all regardless of income. However, it does not follow that implementing a greater tax incentive for lower income earners will lead to an increase in donations from low income earners. While Philanthropy Australia appreciates the logic of a scheme whereby everyone receives an identical benefit from their gifts, it seems far more rational in a system where wealth is unevenly distributed to provide the greatest incentive to those with the most capacity to give. Increasing the incentives for those with less wealth will not increase their capacity to give. Changing the effective tax benefit for donors to a flat rate at a lower level than the highest marginal tax rate would result in a disincentive for higher income earners – the very people who are in a position to give at higher levels. This may in fact result in a decrease in giving at the high net worth end which would be a negative consequence for the continued growth of giving and the philanthropic sector.

Since the taxation statistics continually show that the largest donations are made by those with taxable incomes of over $1 million, and also that “the more one earns, the more one claims as a tax deductible donation”. It seems logical that if the Government wishes to promote donations to DGRs, it should not curtail the benefit which results for those with the most capacity to give. Philanthropy Australia’s understanding is that currently it is at the higher income levels that Australia’s giving levels lag the most behind countries such as the USA.

Philanthropy Australia welcomes the acknowledgement that sometimes structured philanthropy (in this case Ancillary Funds) can have specific issues which are different from other charities that need careful consideration in order to preserve and build a deeper culture of giving in Australia. While the hybrid system with deductions for Private Ancillary Funds seems at first glance to provide a reasonable compromise which would continue to encourage high net worth individuals to establish and give to Private Ancillary Funds, irrevocably sequestering those funds for future community benefit, there may well be some disadvantage to other types of DGR from this scheme. Public Ancillary Funds such as community foundations, which provide an important mechanism for smaller scale, rural and regional donors would be disadvantaged in comparison to Private Ancillary Funds. Furthermore, DGRs which might expect to receive large gifts from major donors may find the size of those gifts dropping.

Furthermore, Philanthropy Australia believes that the introduction of an alternative system, whether a fixed tax offset system or a hybrid, would at this stage be unnecessarily onerous and complicated for the not-for-profit sector which is already dealing with extensive and unprecedented change. This is particularly important since charities and not-for-profits, like any organisation which manages finances, are dependent on the accounting and auditing profession as well as upon the good services of a myriad of volunteers. Changes to the system would add to auditing and accounting costs both directly and indirectly.

The current system of tax deductions is, as the Discussion Paper states, simple, transparent and effective. It has also resulted in large gifts to DGRs. Philanthropy Australia sees no reason to make any changes to a system which is working as intended, for the sake of recovering a relatively small amount of foregone tax revenue.

It also needs to be recognised that there is always a danger in making changes in this space, particularly such complex changes as suggested here, as there are often unintended consequences in future years which require yet , requiring even more changes. This creates significant uncertainty and caution on the part of donors and potential donors and so can work against the desired outcome. The policy outcome of encouraging more giving is therefore more likely to be achieved through greater education and promotion of giving, which is a key objective of Philanthropy Australia and an area in which it is keen to work with government and others.

4. Clearing House

Q19: Would a clearing house linked to the ACN Register be beneficial for the sector and public?

Philanthropy Australia considers the development of payment mechanisms are better left to the private sector rather than have either the ACNC or ATO develop a consumer transactional role. Facilitating appropriate access to ACNC search functions from third party sites that host payment functionality would probably be a significantly more cost effective option.

5. Workplace Giving

Q20 Are there any barriers which could prohibit the wider adoption of workplace giving programs in Australia?

In addition to its capacity to mobilise gifts, workplace giving also can play a significant role at the early phases of individual's journey to more structured philanthropy and should therefore be made simple to implement and attractive to both employees and employers. Philanthropy Australia observes the research by the Australian Charities Fund into workplace giving which indicates that the major barriers to wider adoption of workplace giving are limited awareness, perceived complexity, limited time and resources, and the need for visible and vocal senior management support. Philanthropy Australia supports a coordinated, government-funded campaign to promote workplace giving and recommends that consideration be given to other recommendations made by the Australian Charities Fund in their submission to this paper.

6. Raising the threshold for deductible gifts

Q21 Do valuation requirements and costs restrict the donation of property? What could be done to improve the requirements?

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Yes. In particular the need to have an ATO valuation certificate for shares listed on the ASX when a simple rule such as the closing price on the day the transfer was registered at the share registry would reduce red tape.

7. Raising the threshold for deductible gifts

Q26: Should the threshold for deductible gifts be increased from $2 to $25 (or to some other amount?)

Philanthropy Australia believes that the threshold for deductible gifts should be raised and that there should also be a mechanism introduced to increase it at fixed intervals roughly in line with CPI. It is well over 80 years since the $2 (then 1 pound) threshold was introduced and what was once a substantial amount is clearly now miniscule. Anecdotally many donors do not bother to claim small donation amounts, while others claim deductions for small amounts which are not actually tax deductible (such as raffle tickets and purchase of small items of fundraising merchandise). Many charities also find that there are administrative problems with recording, processing and receipting small donations.

Philanthropy Australia therefore supports the proposal to raise the threshold for deductible gifts from $2 to $25 then adjusted every 5 years or so to an appropriate CPI adjusted round number.

8. Fringe Benefits Tax

Philanthropy Australia does not intend to comment on this section in detail. We recommend a principles approach should be followed and cautiously support the further exploration of some of the ideas in the Discussion Paper. While the FBT regime does enhance not-for-profit organisations ability to attract and retain quality staff who might otherwise choose better paying jobs in the private or public sectors, there are clearly some significant issues including inappropriate use (e.g., for wedding costs), individuals' capacity to claim from multiple employers, which adds to the casualization of the workforce, and the 'dead-weight' administrative burden. These are all detrimental to the efficiency of policy outcomes and therefore the FBT exemption framework does require further review and improvement. Any changes to the Fringe Benefits Tax Concessions should then include an appropriate transition strategy to allow not-for-profit organisations time to adjust.

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Appendix 1

PROPOSAL TO ABOLISH COMPANY TAX IMPUTATION IN ORDER TO FINANCE A REDUCTION IN COMPANY TAX RATE

Prepared by Dr Ian McKenzie[1]
April 2009

These notes analyse the proposal to abolish Australia's company tax imputation system in order to finance a revenue-neutral reduction in the company tax rate to 19%.

1. Key Weaknesses of a Non-imputation System of Company Taxation

A basic objective of taxation system design is neutrality: to tax even-handedly all classes of income. A classical company tax system (i.e. no imputation) violates this principle by taxing twice income from companies: firstly, at the company tax rate in the hands of the company and, secondly, at the shareholder's marginal tax rate when company income is distributed. Such a system taxes more heavily income earned within company structures vis-a-vis income earned from all other sources.

Thus, under a classical company tax system, the tax-exempt status of the tax-exempt sector (e.g. non-profit charitable bodies) is undermined because these entities' dividend income from investments in companies is still taxed at the company tax rate, even though it is exempt from tax at the shareholder level.

In addition, because company financing in the form of borrowings is not subject to such double taxation, non-imputation biases the financing decision of companies to favour debt vis-a-vis equity. Recent upheavals in the global financial system underline that this is a bias to be avoided!

Non-imputation also biases the decision of the company concerning the use of earned income in favour of its retention by the company rather than its distribution to shareholders as dividends, since the latter choice triggers double taxation of the income, unlike the first.

These and other drawbacks of the classical company tax system are expanded upon in the 1985 Draft White Paper on Tax Reform.

2. Key Features of an Imputation System

An imputation system means that the company tax regime is effectively just a withholding tax structure in respect of Australian resident shareholders. This is because the tax collected at the

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company level is (by virtue of the imputation credits attached to franked dividends) subsequently credited against Australian shareholders' individual tax liabilities when such income is distributed. Imputation credits are refundable in cash where an individual shareholder's marginal tax rate is less than the company tax rate. This feature ensures that all income distributed by companies to Australian shareholders is effectively taxed only once at the shareholder's marginal tax rate. Accordingly, apart from the timing disadvantage that income retained by Australian companies is taxed at the time that is **earned** -- rather than when it is **distributed** to shareholders – Australia's imputation system achieves for Australian investors the highly desirable attribute of neutrality of taxation treatment of company income vis-a-vis income from other sources.

Thus, for example, the tax-exempt status of the tax-exempt sector is preserved by Australia's imputation system since the tax-exempt sector receives a refund for the underlying company tax paid on its dividend receipts, as illustrated in Table 1.

Table 1. Taxation of Dividend Income in Hands of Tax-exempt Australian Investor.

	(a) Current imputation system	**(b) Imputation abolished & Australian company tax rate reduced**
Company taxation	A$	A$
Company income	100	100
Less Company tax paid	(30)	(19)
After-company-tax income (assumed to be fully distributed)	70	81
Shareholder taxation		
Dividend receipt (1)	70	81
Taxable income	100 (= Dividend receipt + attached imputation credit, which equals amount of company tax paid)	81 (= Dividend receipt)
Shareholder tax liability at rate of 0%	nil	nil
Plus Imputation credit (2)	30	nil
Net after-tax return to shareholder [= (1) + (2)]	**100**	**81**

A revenue-neutral abolition of imputation would thus reduce the dividend investment income of charities and other tax-exempt entities by 19%.

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Because an imputation company tax system is basically just a withholding tax structure for Australian resident shareholders, its revenue-raising impact is essentially upon foreign shareholders. The Australian company tax regime represents the core mechanism by which the Australian nation shares in the profits earned by foreign investors from Australian sources. This arises because foreign investors do not receive the full benefit of imputation credits - only the lesser benefit of abolition of Australian dividend withholding tax in respect of franked dividends (such dividends would generally otherwise be taxed at a dividend withholding tax rate of 15% if the foreign investor were resident in a country with which Australia has a double tax agreement and 30% otherwise.)

The impact of the recent commodities boom on company tax revenue illustrates the importance of the company tax system as a mechanism by which Australians generally share in the profits realised by foreign investors in exploiting Australia's resource base. At a company tax rate of 19% rather than 30%, much of this benefit would have been given away to foreigners.

3. Impact of a Revenue-neutral Reduction in the Company Tax Rate Financed by the Abolition of Imputation

(i) Distributional Effects
A revenue-neutral reduction in the company tax rate financed by the abolition of imputation would increase taxation of Australia residents' dividend income and, correspondingly, reduce taxation of foreign residents' Australian-source dividend income. Specifically, it would:

- double tax company income distributions received by Australian resident shareholders. Instead of being taxed only once at the shareholder's marginal tax rate, this income would, in addition, bear company tax at 19%.

- reduce the Australian company tax paid by foreign investors.
  In most circumstances, this would largely represent a loss of Australian income tax revenue for the benefit of revenue in the foreign shareholder's country of residence. This is because of foreign tax credit arrangements whereby a foreign investor typically receives a credit against his tax liability in his country of residence for the underlying company tax he has paid in the foreign country from which the income was sourced.

  This is illustrated in the following examples which consider the distribution of $100 of Australian-source income as dividends to a foreign investor, firstly, under the existing imputation system (Table 2) and, secondly, with abolition of imputation (Table 3).

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Table 2. Taxation of Australian-source dividend income by foreign investor.
Case A: Foreign shareholder's marginal tax rate in his home country is at least as high as Australia's company tax rate

	(a) Current imputation system	**(b) Imputation abolished & Australian company tax rate reduced**
Australian taxation	A$	A$
Australian income	100	100
Less Company tax liability	(30)	(19)
Less Dividend withholding tax	nil (since assume all income distributed as franked dividend)	nil
Equals Cash dividend income after Australian tax (1)	**70**	**81**
Foreign country taxation		
Income	100	100
Less Foreign income tax liability (assume 35% marginal tax rate)	(35)	(35)
Plus Foreign tax credit	30	19
Net foreign tax paid (2)	**5**	**16**
Foreign investor's cash receipt after Australian and home tax liabilities [= (1) – (2)]	**65**	**65**

Under the example, Australia gives up $11 of revenue which represents a dollar-for-dollar transfer to the foreign treasury. The net-of-all-taxes return received by the foreign investor is unchanged. Accordingly, foreign investment in Australia has NOT been made more attractive by the abolition of imputation. This conclusion holds true provided the foreign shareholder's marginal tax rate in his home country is at least as high as Australia's company tax rate.

Where the foreign shareholder's marginal tax rate in his home country is *lower* than Australia's company tax rate, then the revenue forgone by Australia is split between a transfer to the foreign treasury and a genuine reduction in the net-of-all-taxes return received by the foreign investor, as illustrated in Table 3:

Table 3. Taxation of Australian-source dividend income by foreign investor.
Case B: Foreign shareholder's marginal tax rate in his home country is lower than Australia's company tax rate

	(a) Current imputation system	**(b) Imputation abolished & Australian company tax rate reduced**
Australian taxation	A$	A$
Australian income	100	100
Less Company tax liability	(30)	(19)
Less Dividend withholding tax	nil (since assume all income distributed as franked dividend)	nil
Equals Cash dividend income after Australian tax (1)	**70**	**81**
Foreign country taxation		
Income	100	100
Foreign income tax liability (assume 25% marginal tax rate)	(25)	(25)
Foreign tax credit	25 (assume credit capped at amount of foreign tax liability)	19
Net foreign tax paid (2)	**nil**	**6**
Foreign investor's cash receipt after Australian and home tax liabilities [= (1) – (2)]	**70**	**75**

In this example, the Australian revenue again forgoes $11, of which the amount corresponding to the excess of the Australian company tax rate above the foreign shareholder's home marginal tax rate ($6 in this example) is simply a transfer to the benefit of the foreign treasury. Only the balance ($5 in this example) goes to the foreign shareholder.

Thus, the benefit of the Australian revenue forgone in respect of foreign-source income will go either wholly (Case A) or partly (Case B) to the foreign treasury. Therefore the "bang per buck"

in the translation of the revenue forgone by Australia into a higher after-tax return to foreign investors is weak.

(ii) Overseas practice
By virtue of the 1985 Australian tax reforms and the replacement of the wholesale sales tax by GST, Australia's tax system would be ranked highly by tax policy professionals on the criteria of efficiency, neutrality and fairness relative to overseas tax systems. The fact that most OECD countries retain double taxation of company income is a poor argument for Australia to "go backwards" and would surely not be an argument accepted by Australian Treasury in respect of other proposals for adoption by Australia of defects of foreign tax systems e.g. erosion of tax bases due to widespread tax concessions.

(iii) Implications for double tax agreements
Abolition of imputation would likely require Australia to renegotiate its double tax agreements. In order to obtain foreign country agreement, Australia would likely be required to make new concessions in respect of the division of taxation rights between Australia and its foreign partners. This would likely represent a further loss of revenue by Australia.

(iv) Rationale for measures to encourage foreign investment
Analysis fails to demonstrate that Australia's ability to attract foreign investment is a policy problem and therefore that measures to lower taxes on foreign investment in Australia are a policy priority.

As a nation that is well endowed with attractive investment opportunities, Australia has traditionally run a current account deficit financed by foreign capital inflow. The exchange rate is the primary variable that adjusts to ensure that Australia maintains external balance over time. While there are inevitably swings in international investor sentiment, the historical record seems inconsistent with the proposition that Australia has difficulty in attracting foreign investment inflows because our company tax regime affords inadequate returns to foreigners. This view is further supported by the current bidding for natural gas assets by players such as BG Group and Shell, and the interest of various Chinese parties in acquiring iron ore and other mineral assets in Australia.

4. Arguments Advanced in Favour of a Revenue-neutral Reduction in the Company Tax Rate Financed by the Abolition of Imputation[2]

(i) "Imputation is not valued by investors"
In advocating the abolition of imputation, Nicholas Gruen is reported to conclude that he is "unable to reject the hypothesis that companies with dividend imputation do not attract any share price premium". It is unclear what this means. The introduction of imputation would be expected to have resulted in a **one-time** upward revaluation of the shares of Australian companies at around the time of announcement/implementation of the policy change and this effect is generally considered to have occurred.

[2] Obviously, these arguments apply similarly to a revenue-neutral **partial** abolition of imputation and reduction in the company tax rate – only the magnitude of the effects changes.

Gruen's claim is contradicted by the finding of a variety of academic studies. For example, academic analyses of so-called "dividend drop-off" effects indicate a heavy factoring in of the benefits of imputation into Australian share prices. These analyses examine the magnitude of the fall in the share prices of Australian companies at the point in time when shares go "ex dividend", specifically when shares lose their right to receive a franked dividend. These typically show that the size of the share price drop is not just the cash amount of the dividend but also an additional amount equal to approximately 70% of the face value of the franking credits attached to the dividend. In other words, these share price movements suggest that investors factor approximately 70% of the face value of franking credits into share prices[3].

An academic study which compare the trading prices of shares that differ only in the right of the holder to receive a one-off franked dividend have suggested an even higher franking credit valuation close to 100%.

(ii) "The (pre-tax) rate of return on Australia assets is determined by foreigners and, accordingly, reducing the Australian company tax rate would induce a significant increase in foreign investment"

This argument starts from the proposition that in a small capital-open economy like Australia's the return on investment on Australian assets is determined in a global market because capital flows work to arbitrage away asset return differences. There are various reasons why international capital flows, while an important influence, do not arbitrage away all differentials in asset returns across countries:

- It is a well established proposition in macroeconomics (associated with Robert Mundell) that a small capital-open economy is unable to conduct an independent monetary policy (i.e. determine the level of domestic interest rates) if its exchange rate is fixed but that a flexible exchange rate restores independence. Under a flexible exchange rate, the expected movement in the value of the domestic currency breaks the rigid nexus between the domestic interest rate and the global interest rate.
- Risk – countries with higher investment risk due to say political, industrial or legal uncertainties must offer a premium return in order to attract investment (investors will require a higher return in Pakistan compared with Norway)

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[3] The fact that the valuation is less than 100% can be attributed to:

(i) the loss of time value due to the fact that an Australian investor receiving a franked dividend receives the cash benefit of the attached imputation credit only with a lag of up to two years i.e. when it comes time for the investor to pay his net tax liability in respect of the tax year in which the dividend was received: and

(ii) the presence of foreign shareholders on Australian company share registers - for these holders, franking credits may be of little or no value.

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- Tax – domestic and foreign investors are subject to different to tax rules and so will require different pre-tax returns in order to obtain an acceptable after-tax return. (This is why the abolition of imputation in Australia would have the potential to change the relative attractiveness of Australian-versus-foreign investment for both foreign and Australian investors.)

The key flaw in the much of the analysis, however, is ignoring that, for the investment decision of foreign investors, the relevant return on Australian investment is after **all** taxes – both Australian and in the foreigner's home country –not just the return after Australian taxes. It is for this reason that analysis neglects the revenue transfer effects to foreign treasuries, described above, which undermine his arguments that imputation abolition would lead to a significant increase in foreign investment and uplift in Australian asset values.

(iii) "Imputation abolition would lead to an uplift of Australian asset values"
Australian investors face a tax bias in favour of investing in Australian companies vis-à-vis offshore companies because Australia has eliminated double taxation of company income whereas most foreign jurisdictions have not. (Australian investors effectively receive a refund of Australian, but not foreign, company tax paid by their investee companies.) Abolition of imputation could therefore be expected to induce Australian investors to undertake some portfolio switching away from Australian, in favour of, foreign assets. Since the Australian share market is traditionally considered to be owned roughly one-third by Australian retail investors, one-third by Australian institutions and one-third by foreigners[4], such switching could exert a significant one-off downward force on Australian asset prices. This would offset any offsetting upward influence from imputation abolition in attracting additional foreign investment, an effect which – as noted above – would be muted because of the high leakage of revenue forgone by Australia to foreign treasuries.

(iv) "A reduction on the company tax rate would stimulate growth"
The appeal to academic studies that claim that a reduction in the company tax rate produces an increase in growth needs to be discounted since these studies refer to a **genuine** reduction in the company tax rate, not a "sham" reduction via imputation abolition which increases the tax burden on Australian residents' investment in Australian companies and dissipates the reduction in tax burden on foreign investors by transferring most of the revenue forgone to foreign treasuries[5].

(v) Imputation abolition would simplify the Australian tax system"
It is true that the Australian tax system would be simplified by imputation abolition, just as it could be simplified by dispensing with other features, such as the foreign tax credit system or capital gains tax, that would be widely considered to be indispensable in improving the fairness

[4] In this context, it is not clear that Gruen's assumption that the foreigner is the marginal investor is correct.
[5] In addition, such studies need to be treated carefully since the assumption that they make about the financing of the company tax rate cut is usually crucial to the results obtained. For example, it is easy to generate the finding that a company tax rate cut stimulates growth if the financing of the revenue loss is ignored. On the other hand, if the revenue is raised by increasing other taxes, it is far from velar that a net benefit for growth would result.

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and efficiency of the tax system. Having been in place for over twenty years, imputation is now well understood and accepted in Australia, its implementation problems have been ironed out and its compliance appears to arouse little complaint.

(vi) Beneficial optics of a lower company tax rate
It is hard to accept the assertion that the optics of a reduction in the "headline" Australian company tax rate from 30% to 19% would delude Australian investors into favouring such a change when the reality would be that double taxation of company income was being reintroduced. Almost anyone with practical experience of financial markets would attest that, in reality, professional investors do analyse returns on a "net of all taxes" basis and would quickly see through the sham.

In like vein, international rankings of Australia's company tax rate need to be discounted since these rankings do not compare like with like. The real-world burden of company tax is clearly lower in countries like Australia, where company tax is an imputation system, compared with the majority of other countries where company tax is a genuine double tier of taxation.

5. Summary
Abolition of imputation to finance a reduction in the company tax rate would be contrary to Australian residents' interests by reintroducing a distortionary second tier of tax on company income in order to finance the provision of a benefit primarily to foreigners. It would be an ineffective policy in making returns on Australian assets more attractive to foreigners because of the high leakage of Australian company tax revenue forgone to foreign treasures. Proponents of imputation abolition do not demonstrate that Australia has difficulty in attracting foreign investment inflows because our company tax regime allows inadequate returns to foreigners. Accordingly, policy measures such as imputation abolition which tax Australian investors more heavily in order to "subsidise" foreign investment in Australia (thus encouraging foreigners, rather than Australians, to own our companies and develop our resources) would be counter to the national interest.