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

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Re:Think

Scrap imputation and lower corporate tax rates – an unambiguously bad idea.

This submission is focused around two aspects of corporate tax - the overall tax rate and imputation credits. In particular it addresses the idea that Australians would be better off if corporate tax rates were lowered and the imputation tax system was removed in order to finance the revenue loss.

This idea has been floated on the basis that

- High corporate tax rate discourages investment – particularly foreign investors upon whom Australia relies for capital
- The imputation system introduces distortions and no longer serves Australia well
- The imputation system encourages excessive investment in Australian companies by Australian investors
- A cut in the tax rate to 20% could be offset by repealing the imputation system

This proposal has superficial merit, however on closer examination we find it to be an unambiguously bad idea for Australians.

- It is likely to permanently reduce share prices by around 10%
- It will facilitate the transfer of some $6.2billion per year from Australian investors to international investors,
- The brunt of that transfer will be borne by superannuation funds, charities and low marginal tax payers. High marginal tax payers will be better off.
- It is unlikely to increase the amount of investment in Australia
- It could harm the efficiency of Australian business investment
- It will be a boon for senior corporate executives
- There will be second order costs such as such as reduced capital gains tax receipts and higher social security payments

Who pays what corporate tax, who receives the imputation credits? Who would benefit from a change?

The treasury papers outline the following facts from the 2012/3 tax year.

Corporate tax was $63billion.
Total franking credits paid were $41billion of which

- $12 billion were paid to overseas entities
- $19billion were paid to individuals, super funds and charities
- $10billion were intercompany transactions.

Hence a reduction in corporate tax from 30% to 20% would result in a loss of revenues of $21b, largely recovered by the $19b franking credits no longer reclaimed by individuals' super funds and charities.

Who would be the winners and losers in this situation?

The main winner would be international investors who would see their tax bill reduced by 33%. Given that they currently receive 39% of the $31 billion in credits non-intercompany credits, one can assume they will be the beneficiary of 39% of the $21billion tax reduction, a gain of $8.2billion.

That will be funded in part by the Treasury ($2 billion) with the remaining $6.2 billion being paid for by Australian taxpayers. (See appendix 1 for details.)

Hence this scheme would be an ongoing gift from the people of Australia to foreign investors to the tune of $6.7billion per annum.

Who is making the gift?

Analysis of the impact of such a change at an individual level reveals that the full burden of this change will fall on superannuation investors, charities and low income earners.

Impact of reducing corporate tax and abolishing imputation on various taxpayers

	Charity	Allocated pension	Super fund	Mid range tax payer	Top marginal tax payer	Foreign portfolio investor
Marginal tax rate	**0%**	**0%**	**15%**	**39%**	**47%**	**0%**
Look through tax rate on company profits - current system	11%	11%	23%	41%	47%	30%
Look through tax rate on company profits - 20% tax & no imputation	20%	20%	28%	41%	44%	20%
Reduction in net returns	-12%	-12%	-7%	-1%	4%	13%
Increase in Look through tax	90%	90%	22%	2%	-5%	-33%

Source: farrelly's. Note: Detailed calculations appear in the appendix.

The outcomes are very clear.

- Foreign investors will be substantially better off
- Top marginal taxpayers will be a little better off.
- Mid-level taxpayers will be marginally worse off.
- Charities, pensioners and superannuation investors will bear the full brunt of such a change.

In other words, this is actually a gift from Australian low income earners and superannuation investors to the rest of the world. High income earners, other than through their superannuation investments, sail through unscathed. It is difficult to see how this meets the fairness objective set out in the discussion paper.

What do Australian investors get in exchange for higher taxes?

Lower share prices.

While both earnings and dividends should increase by around 10% making shares 10% more valuable to foreign investors, the effect of removing the franking credits will be a reduction of 16% in the value of the income stream received by Australian shareholders. While it is not clear who are the marginal investors that effectively set prices of Australian equities, when looked at together we would expect the result would be a drop in the value of Australian shares of around 10%. We expect that this reduction would be permanent, in other words, that Australian shares would be permanently 10% lower under the mooted system than they would be under the current system.

Banks are a case in point, they make up a significant part of the Australian sharemarket (Financials, dominated by the bank currently comprise some 40% of the All Ordinaries index) and their dividends are largely fully franked. The banks are widely considered as expensive by international shareholders who do not receive the benefit of the imputation credits. On most measures international shareholders appear to be correct; based on price to book and price earnings multiples Australian banks do look expensive compared to their overseas counterparts.

Australian bank valuations Feb 2015

	Australian Major banks	US major banks	UK banks	Singapore banks
Price / Earnings	14.7x	12.6x	10.3x	11.5x
Price /Book value	2.2x	1.2x	0.9x	1.3x

Source: Macquarie Equities

Of course, one main the reason for difference in valuations is that the banks pay high, fully franked dividends. As at the 5th May 2015 the average dividend yield across the four major Australian banks was 5.4% in cash terms but 7.8% after taking into account the value of the imputation credits.

For Australian investors removing franking credits while cutting corporate tax rates would increase the cash yield to 6.2% and while reducing the after tax yield from 7.8% to 6.2% – a 20% fall in the value of that income stream to domestic investors. It could be expected that such a move would generate a fall in the price of these stocks of at least 15% given the substantial holdings of domestic investors in these securities. Even at a 15% lower price these equities would not appear attractive to international investors based on traditional metrics. The price fall would be very likely to occur.

Farrelly Research & Management gives asset allocation advice to institutions and financial planners. Our modelling suggests that if this change were to take place we would advise a balanced superannuation fund to

- reduce its holdings in Australian equities from 28% to 15% in the event that prices did not fall in response to that change. That is to sell 47% of their Australian equity holdings.
- in the event prices fell the expected 10%, to reduce weights to Australian equities from 28% to 22%; that is a 21% reduction.

I would expect most asset consultants to take a similar approach. That being the case, a permanent fall in share prices of 10% does not seem difficult to envisage.

No change in capital flows to and investment by Australian companies.

In the short term it is axiomatically true that any reduction of holdings of Australian equities by domestic investors will have to be met by purchases from outside of Australia, as for every seller there must be a buyer. The scale of net selling by Australian investors is likely to drive prices lower.

More importantly, in the longer term, the question remains as to whether this change would cause Australian companies to raise more equity?

In terms of listed domestic companies raising capital two things are clear

- It will be easier to raise capital from foreign investors and harder to raise capital from domestic investors
- Overall, if prices do in fact fall, then the cost of equity capital will rise.

A higher cost of capital is hardly consistent with Australian domestically listed companies raising more capital over time. Raising the cost of capital makes it less attractive for domestic entities to raise capital either domestically or from abroad.

Increased foreign direct investment?

This appears to be on stronger ground. However, again it is mugged by reality. Other than resource investors, who have little choice but to operate in Australia and pay Australian taxes, it would appear that most direct foreign investors pay little if any tax at all. Dropping a tax rate to 20% is hardly likely to stimulate investment when there is a credible alternative to invest here without paying tax at all.

Lower dividend payout ratios and more reinvestment?

Lower dividend payout ratios will inevitably flow from a decision to scrap imputation. Companies not in an imputation environment tend to pay out 30 to 50% of earnings as dividends as opposed to Australian companies where payout ratios are closer to 75% on average.

Lower dividend payouts ratios have a number of consequences.

One is higher capital retention which, in theory, gives companies more capital to invest. In practice this has minimal effect on end investment. When faced with a capital investment decision companies without excess capital will still raise capital in the market to fund worthwhile projects.

Companies with excess capital will use that to fund the same worthwhile projects. If there is still excess capital after all worthwhile projects are funded companies will typically use that capital to buy back shares. Or, occasionally, invest in projects that do not return the cost of capital. The latter is the only – dubious – benefit of higher retention ratios.

On balance higher retained profits should have little impact on levels of investment.

Less efficient investment

A recent submission to the Financial Services Inquiry from Fidelity Worldwide Investments (Dividend Imputation Must Be Retained) has demonstrated that the imputation system makes Australian companies more efficient because it helps reduce the investment in non-viable projects. Because Australian companies do not hoard capital they need to go to the markets when investing in major projects. This provides a layer of discipline that is otherwise lacking.

Higher remuneration for senior management.

This proposal will lead to higher after tax profits. Higher after tax profits tend to lead to higher remuneration for senior executives. It is less clear that it leads to higher remuneration all the way down the line.

One of the key ways that senior executives are remunerated is via stock options. Stock options reward growth in share prices but options do not participate in dividends. When facing a choice between paying profits out as dividends or retaining them within the firm the board face a conflict; dividends are more tax effective than retention and hence are good for shareholders but retention is better for long term share price appreciation and therefore for the returns from stock options held by management. Removing imputation takes away that conflict. Now management can reduce dividends in the knowledge that it is more tax effective for shareholders and in so doing create a windfall for themselves.

While this move is likely to result in an initial hit of around 10% to share prices this should be recovered at around 3%pa due to the higher retention of earnings – that is extra capital growth due to lower dividends payments. For executives with more than a three year time horizon this is a gain. More importantly, any new options issued are much more valuable – issued at a lower price with higher capital gain prospects.

Note that this additional capital gain does not benefit all investors – the higher rate of gain is financed by lower dividends. It is only of benefit to those who don't receive dividends – stock option holders.

Higher social security payments and lower capital gains tax receipts.

Permanently lower share prices mean that capital gains tax receipts will necessarily be lower than would otherwise be the case. It also means that retirees' capital will be lower than was previously the case which will have an impact on the amount of aged pension paid to retirees. While these amounts may not be significant they should be factored into any cost benefit analysis.

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Appendix 1. Reducing corporate tax to 20% and ending imputation: winners and losers (Part 1)

	Australian entities	Overseas and other entities	Corporates	Total
Franking credits ($bill)	$19	$12	$10	$41
Ultimate share of profits[1]	61%	39%	-	
Corporate tax paid ($bill)	38.4	24.6		$63.0
Saving by reducing from 30 to 20% ($bill)	12.8	8.2		$21.0
Loss of franking credits ($bill)	-19	nil		-19.0
Gain /Loss ($bill)	-6.2	+8.2		$2.0[2]

Source: Data on franking credits and total corporate tax: ReThink page 83.

1. This is an estimate of the ultimate owners of profits and is assumed to be the same as the share of imputation credits. Intercompany earnings and franking credits are ignored as they ultimately flow through to end investors.
2. The overall gain to investors is a loss to the Treasury.

Appendix 2. Reducing corporate tax to 20% and ending imputation: winners and losers (Part 2)

		Charity	Pension fund	Super fund	Mid range tax payer	Top marginal tax payer	Foreign portfolio investor
Current system							
Tax rate		0.0%	0%	15%	39%	47%	0%
Pre tax profit		100	100	100	100	100	100
Tax paid by company	30%	30	30	30	30	30	30
Dividend paid -at payout rate[1]	65%	45.5	45.5	45.5	45.5	45.5	45.5
Franking Credit	100%	19.5	19.5	19.5	19.5	19.5	0
Capital gain[2]		24.5	24.5	24.5	24.5	24.5	24.5
Total return - pre tax		70	70	70	70	70	70
Total return - post tax		89.5	89.5	77.3	59.4	53.2	70.0
Average tax rate[3]		**11%**	**11%**	**23%**	**41%**	**47%**	**30%**
20% Corp tax - no imputation							
Tax rate		0.0%	0%	15%	39%	47%	0%
Pre tax profit		100	100	100	100	100	100
Tax paid by company	20%	20	20	20	20	20	20
Dividend paid -at payout rate[1]	30%	24	24	24	24	24	24
Franking Credit	0%	0	0	0	0	0	0
Capital gain[2]		56	56	56	56	56	56
Total return - pre tax		80	80	80	80	80	80
Total return - post tax		80.0	80.0	72.2	59.7	55.6	80.0
Average tax rate[3]		**20%**	**20%**	**28%**	**40%**	**44%**	**20%**
Reduction in earnings		**-12%**	**-12%**	**-7%**	**1%**	**4%**	**13%**
increase in tax rates		**90%**	**90%**	**22%**	**-1%**	**-5%**	**-33%**

1. Assumes Australian companies reduce dividend payout ratios
2. Assumes additional retained earnings increase value of company by the same amount.
3. Tax paid on undistributed earnings creates a tax burden even for non-taxpaying entities

About farrelly Research & Management Pty Ltd.

farrelly's is an Australian asset consultant with a particular focus on asset allocation strategies.

Tim Farrelly is the principal of farfrelly's. He is the author of the farrelly's Proactive Asset Allocation Handbook and is a member of the faculty at the Portfolio Construction Forum. Tim is a sought after speaker and a frequent presenter at FPA conferences on a range of topics including asset allocation, capital market history, risk management, and portfolio construction.

Prior to founding farrelly's in 2003, Tim was an Executive Director of Macquarie Bank Ltd, and a Director of Macquarie Investment Management Ltd.(MIML) At various times during his 14 years at Macquarie he sat on the MIML Asset Allocation and Risk Committees, and was responsible for distribution of the Bank's products through third party financial planners and stockbrokers.

Between 1981 and 1986 Tim was head of research for the Monitor Money Corporation, where he was responsible for asset allocation and manager selection.

Tim has a Bachelor of Engineering (Metallurgy) degree from the University of Melbourne and an MBA from the Harvard Business School.

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