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AUSTRALIAN EQUITIES, ENHANCED YIELD

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Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES ACT 8001

via electronic submission

20 May 2015

**RE: Dividend Imputation – A critical piece of tax policy infrastructure
Dismantling the system would be folly**

Dear Sir/Madam

We are writing in response to the questions regarding the dividend imputation system posed in the Tax Discussion Paper issued by the Treasury in March 2015. "Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?"

Djerriwarrh Investments Limited is a publicly listed investment company. Our investment aims are to provide shareholders with attractive total returns including capital growth over the medium to long term and to pay an enhanced level of dividends. Our shareholder base of nineteen thousand investors is comprised of predominantly retail shareholders and self-managed superannuation funds and a number of charitable and not-for-profit organisations. The company has been operating since 1989. For all of that time the dividend imputation system has been in operation.

Because of the nature of our investment activities the Company and its shareholders are well placed to comment on the effectiveness and benefits of the dividend imputation system. We have a deep interest and strong commitment to its continuation. Any possibility that this system might be dropped or substantially changed is likely to be extremely detrimental. Accordingly, we believe it is essential to respond to the questions about Dividend Imputation in the Tax Discussion paper.

The Tax System should not penalise equity investment

The fundamental policy objective of the dividend imputation system is that shareholders receiving dividends from companies do not suffer double taxation on that income stream, that is once in the hands of the hands of the company and then a second time on the dividend received. The system results in Australian Investors being taxed at their marginal rate on the underlying company income by being given a tax credit for the company tax already paid by the company. It means that, to the extent that companies pay out their profits as dividends, for domestic investors, company tax on those profits is effectively a withholding tax integrated into Australia's progressive personal income tax regime. Some have argued that the system favours wealthy investors who receive a significant benefit. On the contrary, wealthy investors pay tax on the underlying income at their marginal rate of tax just as for any other type of income.

The effect of the system is that investors do not suffer a tax disadvantage from investing in equities that pay dividends, as compared with bonds that provide interest income, or property which is regularly held in trust structures where no tax is paid until income is distributed to unit holders. Given that equities are generally more risky than fixed investment securities, but preferable in providing a more stable capital structure for companies, it seems particularly inappropriate to propose that they should be taxed disadvantageously compared with other types of funding.

The Tax system should encourage as wide as possible participation in the Australian Economy

The consequences of the dividend imputation system for Australian Capital Markets have been profound. It has stimulated retail investors to have an interest in equity investments both directly and through Superannuation. This is obvious from the very large shareholder bases of our largest companies such as the four major banks, Wesfarmers, Woolworths, BHP Billiton and Telstra.

Equity investments are seen in the Australian community as not just an esoteric investment for the wealthy but an appropriate and sensible investment for many of the broader population, in particular, in preparation for their retirement. We believe that it would be an extremely retrograde step to make any policy changes that would reduce the appetite of the general retail investor for investing in equities.

The dividend imputation system has also meant that many not for profit and charitable entities can access refunds of the franking credits on their dividend income. The effect of this is that they have equivalent tax treatment across their investment asset classes whether their investments are in equity, debt or property.

The involvement of a large proportion of the population in the prosperity of the listed corporate sector has very important economic consequences for the nation. It means that the corporate sector is seen as being of significant benefit not just to employees but also to a wide ranging shareholder base in the general population. The financial health of the corporate sector is not seen as being at the expense of the general population but the prosperity of both are interdependent and grow together.

It was very obvious during the global financial crisis that Australian investors supported the large and urgent capital raisings by major Australian companies including the banks to bolster their capital position and reduce their gearing. This was a very significant factor in the Australian economy weathering the shock of the global financial crisis with considerable resilience. It is our view that this investor support was greatly assisted by the fact that these companies, in normal times, pay attractive dividends which are fully franked under the dividend imputation system.

The Tax system should encourage disciplined company behaviour that best rewards shareholders for the risks they take.

It is evident to us as an investor in sixty major listed companies in Australia that the existence of the dividend imputation system has had an equally important positive effect on the behaviour of Australian companies.

We observe that companies are motivated to structure their operations in ways that are subject to company tax in Australia knowing that the company tax they pay will be imputed to shareholders when the shareholders receive dividends. It is our view that the dividend imputation system has contributed to the willingness of companies to pay Australian tax rather than look for creative ways to reduce it as much as possible (or to transfer that liability offshore).

The second change in behaviour we note is that the boards of companies give more attention to the desire of shareholders to receive fully franked dividends.

The dividend imputation system has led to an increase in the level of dividend payout ratios for many Australian Companies. As a long term investor we regard this as a very desirable outcome. For a long term investor that is unwilling to sell their investment, the primary way of benefitting in the prosperity of a Company is by receipt of increasing dividends.

We see that fund managers with a shorter term investment horizon are much more willing to sell their shares to crystallize value for their investors rather than focus on dividends. Long term investment has entirely the opposite view namely, that the best value that companies can create is by increasing their flow of dividends. We think the dividend imputation system has been important in enabling companies to encourage their long term investors through attractive growing dividend streams.

It is sometimes argued that the dividend imputation system discourages companies from reinvesting their profit in the growth of the business. As investors we do not observe this. However, it has meant that companies are more disciplined in their use of retained profit. Companies should only retain profit if it can be deployed in a way that adds value for shareholders by earning an attractive rate of return as with any capital allocation decision that covers their cost of equity. Otherwise, in our view, it should be returned to shareholders.

Companies that are in need of additional equity for new investment can promptly and readily tap their shareholder bases through Dividend Reinvestment Plans, Share

Purchase Plans or Short Form Rights Issues. Our experience is that shareholders will strongly support companies that have a sound track record of performance.

The economic environment in Australia in recent years has been such that many companies have found it difficult to grow their businesses organically in a way that would provide attractive returns on additional equity that add to shareholder wealth by covering their cost of equity. This may well be another factor behind recent decisions by companies to pay out a higher level of dividends rather than retain earnings.

Another line of argument about company behaviour under the dividend imputation system is that it discourages companies from investing offshore. In the case of the companies in which we invest we do not see evidence that supports this view. In fact, there are many listed Australian companies that have undertaken very significant investment in the growth and development of businesses offshore, examples would include AMCOR, ANZ Banking Group, ALS Limited, BHP Billiton, Brambles, Coca Cola Amatil, Computershare, CSL Limited, James Hardie Industries, Ramsay Health Care, Sonic Healthcare, Toll Holdings, and many more.

As an example, an Australian Company with a 60% dividend payout ratio from its profits could theoretically expand to the point where 40% of its business is offshore before its ability to fully frank its dividends might be affected.

We are not aware of instances where the dividend imputation system has substantially inhibited companies from investing offshore. However we can understand the reticence of some companies to do so. Investing offshore significantly increases the risk and complexity of operating and managing a business. Success usually takes much longer than is initially anticipated and the record of Australian companies in investing overseas has been patchy.

The attitude of foreign Investors towards Australian equity.

Another argument about the dividend imputation system is that it may discourage foreign investors from investing in equity in Australia because they cannot obtain credits for the underlying Australian Company Tax. We do not observe from their behaviour that this is a significant issue.

The attitude of foreign investors towards Australia is a complex issue. It involves judgments by them about many general and specific issues. These include the state of the Australian economy, the level of the Australian dollar, the levels of interest rates and inflation expectations, fiscal and monetary policy settings and directions and the political situation. Most importantly the strength and vigour of industries in which we have a particular competitive advantage such as resources and agriculture for example, attract considerable investment from overseas investors and particularly Asia.

In respect of particular companies, there are a whole host of specific issues which would be influencing foreign investors such as future prospects, risks, competitive position, and quality of management and so on. While tax rates and dividend yields will, of course, be two of the issues in their thinking, given all the factors involved we do not believe that the dividend imputation system looms as a significant issue for them.

We should note in passing that foreign investors do benefit from the dividend imputation system, in that fully franked dividends are not subject to dividend withholding tax when paid to foreign shareholders. Equally important for them will be the incidence of taxation on them in their home jurisdiction when dividends are repatriated from Australia or the shares sold. Regard would also need to be taken to the terms of any applicable double tax treaties between Australia and their home or other operating jurisdictions.

Conclusion

It is our view that the dividend imputation system has been one of the key policy settings that has supported both the health and robustness of the Australian equity markets in the years since its introduction. We believe that the case for retaining the dividend imputation system is now stronger and more important than it has ever been in the past. Any move to eliminate or substantially weaken the dividend imputation system could have a significant negative effect on the willingness of Australian investors to put their capital at risk in Australian corporates. We would strongly urge the Treasury to recognize the central significance of the dividend imputation system in the strength of the Australian Economy.

Yours sincerely

John Paterson
Chairman
Djerriwarrh Investments Limited