Submission To Financial Services Inquiry
Response To Interim Report

July 2014

Submission on behalf of
Trustees the Hu and Lyons Superannuation Fund
Ling-chia Hu and Mark Lyons private investors

"There should be no fiddling with full imputation. Any trade-off between imputation credits and company tax is of no benefit to individual Australians." Peter Costello 2009

"This Bill will give effect to the most significant business taxation reform in this country in the post war years – the elimination of the double taxation of company dividends." Paul Keating 1987

"Recommendation 19: Superannuation funds should retain their access to imputation credits." Australia's Future Tax System 2009

This submission addresses only one matter raised in the Interim Report, the Australian taxation laws on imputation credits. This submission's primary purpose is to strongly represent the case for retaining the current system and taxation laws for imputation credits and strongly disagree with what is seen as ill-informed opinion on imputation credits and their effect. This submission argues that any removal or change to the imputation system is very unlikely to have the benefits that its proponents give and is likely to be a tax change of the like of the Mining Tax, politically destructive, earning the government no revenue or being revenue negative overall even before any trade-offs like the reduction of tax rates on company profits further reduce government revenue.

Question, ask yourself, do you support a company tax rate cut, two thirds the benefits of which will flow directly to overseas shareholders funded totally by double taxation of Australian Shareholders and Australians' Superannuation?

This submission makes 11 points against any changes to the current dividend imputation system in Australia.

Point 1. Double Taxation Relief Imputation Has Been Developed And Confirmed By The Most Reformist Treasurers / Governments Of Australia

Imputation credits provide double taxation relief, this was recognised by the Hawke / Keating in its government 1987 reforms and confirmed by the Howard / Costello government in the current simplified imputation system, effective from 1 July 2002.

"The classical taxation system, which applied before the introduction of imputation in 1987, resulted in double taxation of company profits." Australian Taxation Office

Point 2. Pension Phase Does Not Increase Imputation Double Taxation Relief

An unfortunate, piece of confused misinformation are statements that it will cost more in double taxation relief government revenue as more superannuation funds go into pension phase holding equities with imputation credits leading to more refunds of imputation franking credits.

This fallacious logical reasoning has appeared many times over the years and it is unfortunate indeed such a fundamental mistake in basic taxation reasoning has been made. It makes no difference in the

cost to the taxation revenues whether the imputation credits are applied to an income earner on a high tax rate to reduce their taxation or refunded as franking to a low income or low taxation rate holder, the amount of government revenue not collected will be the same. This was one of the major design premises for the system changes under the Howard / Costello Government, July 2000 and confirmed again in July 2002.

As examples (dividend figures are not actual for simplification)

Example 1. Superannuation Fund in Accumulation
The Lyons and Hu Superannuation Fund
Accumulation Account 1
Holding NAB: 3,500 shares
Dividends: $7,000
Company Tax Paid On Dividends From Profits, Imputation Credits: $3,000
Total Profit Income Attributable To Shareholder: $10,000
Total Tax Payable By Shareholder on Dividend Profits Without Imputation System: 10,000 @ 15% = $1,500
Tax Payable After Imputation Reduction: $0
Refunded Imputation, Franking Credits: Imputation - Tax Reduced By Imputation: 3,000 - 1,500 = $1,500
Amount Of Less Government Revenue: Tax Not Paid + Refunded Imputation 1,500 + 1,500 = $3,000

Example 2. Superannuation Fund in Pension
Mr Lyons and Ms Hu both turn 60 and retire on July 1
Pension Account 1 is opened with the balance of Accumulation Account 1
Holding NAB: 3,500 shares
Dividends: $7,000
Company Tax Paid On Dividends From Profits, Imputation Credits: $3,000
Total Profit Income Attributable To Shareholder: $10,000
Total Tax Payable By Shareholder on Dividend Profits Without Imputation System: 10,000 @ 0% = $0
Tax Payable After Imputation Reduction: $0
Refunded Imputation, Franking Credits: Imputation - Tax Reduced By Imputation: 3,000 - 0 = $3,000
Amount Of Less Government Revenue: Tax Not Paid + Refunded Imputation 0 + 3,000 = $3,000

Example 3. PAYE Taxpayer
Ms Hu aged 39
Top Tax Rate: 45%
Holding NAB: 3,500 shares
Dividends: $7,000
Company Tax Paid On Dividends From Profits, Imputation Credits: $3,000
Total Profit Income Attributable To Shareholder: $10,000
Total Tax Payable By Shareholder on Dividend Profits Without Imputation System: 10,000 @ 45% = $4,500
Tax Payable After Imputation Reduction : $1,500
Refunded Imputation, Franking Credits: Imputation - Tax Reduced By Imputation: 3,000 - 3,000 = $0
Amount Of Less Government Revenue: Tax Not Paid + Refunded Imputation 3,000 + 0 = $3,000

It is clear that in all three cases the amount of Government revenue foregone under double taxation relief is the same at $3,000 regardless of the shareholders tax rate, it therefore clearly does not matter that more funds are going into pension phase in regards to their access to imputation and franking credit refunds, what clearly matters is, the rate of tax.

I will not comment on whether the 0% tax rate on superannuation is appropriate in pension phase, but I clearly and strongly point out that the tax rate results in reduction of the revenue from share dividend income and clearly not the access to imputation and franking credits. But this would also be the case for any other class of investment, reduced tax rates in pension phase will mean there will be a reduction in tax paid on any investment.

Point 3. Australian Corporate Bond Market Extremely Limited For Individual Investors and Listed Bonds Virtually Non Existent

Another point that is made by advocates of removing double taxation relief on Australian shareholders is that it would increase funding into the Australian corporate bond market. Firstly, it is not reasonable to state that there is any comparison in the taxation of debt and equity, because debt and fixed interest returns are only ever taxed once and there is no double taxation to the investor on debt investment, the investor chooses these instruments solely because they are considered safer and fixed. Secondly, quality large corporate direct listed debt on the ASX is virtually non-existent and there is a trend towards even bypassing Australian banks and placing large corporate debt directly in international debt markets. To somehow suggest that companies such as BHP, RIO, the major listed banks, Wesfarmers, Woolworths, Westfield or any of the top ASX 50 companies would prefer to issue their direct funding debt through listed debt on the ASX to a large number of small retail investors who would demand a higher yield rather than go through large wholesale and international debt markets is laughable, and why should Australian investors want to invest only in small unstable companies through their debt, rather than the larger more stable companies that represent 90% of the taxation and profitability of the Australian corporate economy which they can do through equity investment in shares. Even smaller Australian companies are reluctant to place listed debt on the ASX or in any way publicly to small Australian investors and I can only concur with the NAB in their commissioned assessment from the Australian Centre for Financial Studies:

“However, limited use of bond financing was apparent before the introduction of the imputation system in 1987, while the heavy reliance on bank loan finance relative to bond finance suggests that this is, at best, only a part of the story. Financing and issuance cost. The relative cost of bonds compared to accessing bank loans may also be a determinant. This has several aspects. First, because banks may have better knowledge about a corporate’s financial health, they may be better able to assess the risk involved. Investors, without that knowledge may require a higher rate of return. Notably it is typically companies with strong name recognition and high ratings which are the main issuers of bonds…” 2014, Australian Debt Securities and Corporate Bonds Trends and prospects An independent report prepared for National Australia Bank by the Australian Centre for Financial Studies. The principal authors of this report are Professor Kevin Davis, Research Director and Martin Jenkinson, Research Officer at the Australian Centre for Financial Studies.

Again, this seems to be another spurious excuse from the advocates of removing double taxation relief for Australian Shareholders.

Point 4. Greater Australian Company Profits Overseas Unlikely

It is assumed by proponents of the removal of double taxation relief that imputation has a measurable effect on reducing greater investment overseas and rates of global profits from Australian companies.

Far more likely reasons include the lack of size, particularly of Australian Banks in overseas markets, which is why New Zealand banks are all Australian owned. In fact the New Zealand government call for streaming of imputation between the two countries because they perceive our system leads to more New Zealand companies being controlled by Australian capital and needing to set up their headquarters in Australia. It would therefore be foolish indeed to remove our double taxation relief given that other larger jurisdiction and trading partners have double taxation relief in their jurisdictions. The assets under management and profit size of for example the Chinese major 4 banks dwarf those of the Australian big 4 banks.

Chinese largest bank, Industrial and Commercial Bank of China made 55 Billion USD in last financial

year, Commonwealth Bank, Australia's largest made about 8 Billion USD. Assets under management of China's largest bank are just over 3 Trillion USD with Commonwealth Bank having under 1 Trillion USD. With Chinese bank profits being 292 Billion USD last year and Australian bank profits 39 Billion USD. http://www.reuters.com/article/2014/06/29/us-banks-rankings-china-idUSKBN0F411520140629

It is further obviously incorrect when looking at the two largest, largely held, actually global companies operating in Australia, namely, BHP Billiton and RIO Tinto. Both these companies earn a large amount of profits in offshore jurisdictions. They have a large number or Australian and international shareholders and they pay imputation credits at 100% on dividends to Australian shareholders. I would put it to the major banks that BHP Billiton and RIO Tinto already produce profits overseas that the banks would envy, but they still manage to comfortably 100% impute dividends to their Australian shareholders. It would be farcical indeed to suggest that BHP and RIO operate their iron ore operations in the Pilbara only in order to 100% impute their dividends to their Australian shareholders.

It can be further proven that this is a fallacy by looking at the composition of the ownership of Australian banks, their current percentage of profits earned overseas and the way imputation works under the ITAA.

Partial List of Overseas Intermediaries Ownership of "4 pillars" 2013

	Company	Combined HSBC (Nominees)	JP Morgan Nominees	Combined Citicorp
1	Commonwealth Bank	14.10%	11.13%	4.18%
2	National Australia Bank	16.94%	14.47%	3.33%
3	Westpac Bank	15.10%	12.27%	4.60%
4	ANZ Bank	18.88%	15.65%	5.41%

It can be reasoned from figures above that the amount of imputation on profits as INCOME TAX ASSESSMENT ACT 1997 - SECT 202.60 states that imputation credits are available at the rate of company tax paid in Australia on profits, given that payout ratios of companies in Australia hardly ever exceed 100% of after tax profits, it can be seen that there is currently an excess ability to impute at 100% created by the fact that foreign investors are not entitled to imputation. This means that Australian banks being more than 50% foreign owned could increase their profits earned from overseas operations to over 50% and still provide 100% imputation to Australian shareholders. Given that none of the Australian banks currently earn anywhere near 50% of their profits from overseas the argument that they are being held back by double taxation relief for their Australian shareholders requiring tax to be paid predominantly in Australia cannot logically be made. Much more likely is that they are simply not capable of making large profits in overseas markets for other reasons such as already mentioned, their size or other cultural or national reasons.

Finally, another obvious reason why this assertion is a fallacy, the banks could simply not fully impute their dividends, in the unlikely event they ever managed to exceed the limits of their imputation. This is clearly shown by looking at another widely held Australian company, Macquarie Group, despite not fully franking their dividends at 100% their share price soared in recent years.

Point 5. International Shares Are Not Avoided Because Of Imputation Double Taxation Relief

The report assumes there is a bias for Australian shares amongst individual and SMSF investors caused by the Imputation system, this assumption is unlikely the cause, six reasons that are far likelier causes are i) risk aversion and ii) difficultly of repatriation of returns iii) widely used bank offered share trading platforms that have far higher compliance checks and rates for international trades, or do not offer international equities at all iv) taxation v) the funds in SMSF are predominately in pension phase vi) Australians like to invest in Australia, comparison of proportion of holdings of international and domestic real estate, the largest asset holdings of Australian.

i) This is also supported by the risk aversion shown in the high rate of cash held by SMSF's. It may be very unlikely to change the pattern of risk averse investment if double taxation relief through

imputation is removed, it may simply drive risks averse investors further into non performing cash assets. This point is also related to foreign currency risk and risk from other points.

ii) In many international jurisdictions, repatriating returns exacerbates risk aversion, for example the steps required in investing in overseas shares coupled with currency risk this brings in the related thoughts in the investor of uncontrolled sovereign risk which is not the exclusive of any jurisdiction with a recent example being the US government requiring Citigroup to pay a whole current year profit of 7 billion USD fine for reselling loans written by government run Freddie Mac and Fannie Mae, a confused and unreasonable piece of compensation where the sovereign originating the bad loans compensated themselves through a globally privately held intermediary.

iii) An initiative would be to legislate lower rates for trading international shares equivalent to rates for Australian equities and require all major bank backed trading sites to provide international shares. Another initiative would be to negotiate listing of global corporation direct shares on the ASX, however it is doubtful large international corporates or sovereigns would look favourably on doing this. In fact Exchange Traded Funds of international shares are readily available for direct investment by Australian superannuation funds already, but the reason they do not invest in them is unlikely to be imputation of Australian shares, but rather that they do not want to pay the cost of funds managers or be under their control, obviously the reason for setting up an SMSF or direct investment in the first place.

iv) Another obvious reason international shares are less held is taxation, obviously given that there is 0% taxation in pension phase for superannuation it would be difficult to see how an investor could take advantage of this rate of taxation and hold investments in another tax jurisdiction even under Australian jurisdictional double taxation arrangements as these only limit the amount of tax paid to not paying any more than the Australian rate. The obvious problem is that the rate of 0% will always be exceeded in the foreign jurisdiction meaning that the effective tax rate in Australian investments for pension superannuation funds is always lower than for international investments. Ironically, the only effective change here would be to change Australian jurisdictional double taxation legislation, for the Australian Tax Office to refund the difference between the tax over paid in the foreign jurisdictions and the Australian tax payers tax rate.

v) This has been largely covered above, it is quite obvious that the proportion of SMSF superannuation holdings is far larger in pension phase, so clearly the issues of risk aversion, tax advantage, repatriation of returns are all amplified in this stage as pensions are more risk adverse, taxed at 0% in Australian investments while unlikely to be in international jurisdictions and reluctant to go through the risks and difficulties of repatriation of returns.

vi) In comparison to privately held real estate, the holding profile of international vs domestic is very similar, given that Australians largest and most commonly held wealth is in residential property some roughly 5 trillion AUD I believe, it is clear that most Australians simply don't like to hold international real estate privately, as there is no similar imputation of residential Australian property causing this almost exclusive holding of domestic real estate. In fact New Zealand has no capital gains tax at all for investments or private residence so one would assume if imputation of shares was the only reason holding the private Australian investor back from rushing into investment in international shares then one would expect to see a large amount of international real estate held privately by Australians to a percentage of at least 25% or more to be an effective amount. This is obviously not the case and yet we do not see any reviews identifying this as a concern for the Australian economy given it is three times the asset holding of superannuation one would think it would be three times as worrying.

Point 6. Double Taxation Relief For Domestic Company Owners Is Widely Practiced In Other Jurisdictions Particularly Amongst Major Trading Partners

Most other major trading partners taxing jurisdictions also have double taxation relief for the domestic owners of domestic companies, sadly, it is a widely, incorrectly held view propagated by those that should know better that only Australia and New Zealand have systems for double taxation relief for

the domestic shareholder owners of domestic companies. This was recognised in the Henry Review which gives a partial listing of the countries below.

HK, Singapore full relief
Japan, UK and US lower rates of taxation or full relief for lower and middle income earners
China 50% relief
NZ and AUS Imputation Credits

In fact the New Zealand government call for streaming of imputation between the two countries because they perceive our system leads to more New Zealand companies being controlled by Australian capital and needing to set up their headquarters in Australia. It would therefore be foolish indeed to remove our double taxation relief given that other larger jurisdiction and trading partners have double taxation relief in their jurisdictions

Point 7. Double Taxation Relief For Australian Shareholders Encourages Australian Companies To Pay Australian Tax And Invest In Australian Infrastructure And Services

As stated in Point 3, shareholding by Australians of large Australian companies as a proportion is on the decline particularly in our major corporations and banks, figures dated 2013 tabled below show the growing trend towards overseas ownership with just 3 foreign financial intermediaries alone representing high proportions of foreign ownership,

	Company	Combined HSBC (Nominees)	JP Morgan Nominees	Combined Citicorp
1	Commonwealth Bank	14.10%	11.13%	4.18%
2	National Australia Bank	16.94%	14.47%	3.33%
3	Westpac Bank	15.10%	12.27%	4.60%
4	ANZ Bank	18.88%	15.65%	5.41%

	Company	Combined HSBC (Nominees)	JP Morgan Nominees	Combined Citicorp
1	AMP	19.23%	13.88%	4.6%
2	BHP Billiton	17.36%	13.29	10.75
3	Brambles	25,85%	21.73%	8,77%
4	CSL	24.39%	17.43%	6.1%
5	Fosters Group	23.29%	21.23%	6.31%
6	Macquarie bank	19.06%	19.96%	6.08%
7	Newcrest Mining	37.83%	16.57%	4.94%
8	Origin Energy	15.83%	14.10%	5.17%
9	Rio Tinto	19.59%	16.68%	4.89%
10	Suncorp	20.23%	17.09%	7.1%
11	Telstra	18.49%	12.5%	1.36%
12	Westfield	31.44%	25.0%	7.03%
12	Westfarmers	16.31%	13.77%	6.43%
13	Woolworths	16.50%	11.34%	4.025
14	Woodside	16.19%	11.97%	2.25%

This and not the rate of the tax payer as discussed above is the one thing that does decrease the amount of double taxation relief revenue “cost” to the Australian Government. But it would be fantastical indeed for Mr Murray, bank CEO's or management to believe they have the right to dictate policy on the composition of nationality of ownership of all Australian companies or whether overseas shareholders should enjoy higher rates of return at cost to Australian shareholders being on potential top effective marginal rates of 75% plus Medicare levy.

This is further more than compensated to the Australian government, when it is considered what the actual effect of encouraging further increase of international ownership of Australian companies would

mean. At the moment as mention Australian ownership in our largest banks and miners is under 50%, if foreign ownership trend continues and goes to 90% which it could easily do given the size of international investors, then three obvious things happen that make removal of imputation double taxation relief for Australian shareholders farcical.

A) Because there would be practically no Australians being paid dividends as a proportion of total dividends, there could be hardly any perceived “cost” to Australian Government to provide double taxation relief to them.

B) None of the recipients of profit dividends from Australian companies will pay any personal Australian tax including, obviously GST, if consumption and other broader based tax is not to be further eroded it makes sense not to further erode payments to Australian owners of Australian companies who are also consumers and broad based tax payers in Australia.

C) Corporates may see it as commercially necessary to join the growing global trend to set up in a low tax jurisdiction as a multinational and pay the lowest rate of corporate tax possible, seeing Australia receive no tax from the individual shareholders nor the company, this may be an unfortunate natural outcome of fully globalising our companies.

Point 8. Direct Ownership Of Small Companies And Trust Investments Would Be Favoured

Direct owners of companies can avoid double taxation without access to imputation by simply drawing salary and bonuses before company profits are declared, currently this cannot be done by the owners of large companies, the shareholders.

Trusts not taxed as companies, with trusts nearly all profits are passed through to the shareholder in the trust without company taxation being paid. This is not a trivial amount of investment in Australia with many notable large listed Real Estate Investment Trusts with $10 Billion plus market capitalisation appearing in the ASX50.

Point 9. Gearing

‘The Financial System Inquiry warned gearing could “create vulnerabilities” for the financial system “if allowed to grow”, adding it should not be a core focus of “any superannuation fund” and is “inconsistent with Australia’s retirement income policy”.’ The Financial Services Enquiry 2014

Superannuation cannot gear to purchase equities but can do so to purchase real estate, removal of imputation to superannuation will further skew investment into over invested property markets and risky geared super investments.

Delayed capital gains, negatively geared investment will also be even more favoured if imputation is removed, seeing an immediate loss of government tax revenue. For example in superannuation running 0 return or lost making investments in accumulation to realise capital asset gains in pension phase at 0% tax rates seems a logical consequential strategy.

Outside of superannuation, it is obvious because of Australians' preference for domestic investments and risk aversion, the removal of imputation for equity investment will simply lead to greater investment in property and loss making ones at that in order to delay capital gains and taxation. An obvious example of buying rental property to retire into and doing this more than once to move through them and reduce capital gain as owner occupied residence at lower later life tax rates and reduced capital gains based on partial owner occupied periods before disposal.

Point 10. Unlikely To Produce Any Government Revenue

As has been previously clearly shown on Point 2 the transfer of imputed holdings into pension phase is revenue neutral, any change to imputation will not reduce the amount of lost revenue by superannuation funds transitioning from accumulation to pension phase. If the government wants to save money form tax discounting to superannuation pensions then obviously the rate of 0% is the place to start.

Secondly, altering rules to imputation will drive more regular profits offshore attracting no Australian taxation, through GST and other domestic based taxes on residents economic activity.

Thirdly, it will actually be avoided through particularly changes of investment into assets that can defer taxation through capital gains most obviously, the already over heating real estate markets which are making it difficult for the RBA to maintain necessary lower interest rates to encourage private consumption.

Fourthly, if companies do get their stated wish to invest and earn far more profits in other jurisdictions they will pay far less Australian corporate tax from investing capital in these jurisdictions. They may even more readily move profits into other jurisdictions that were actually earns in Australia to pay lower rates of tax.

These 4 things combined will lead to any change to imputation being a tax change of the like of the Mining Tax, politically destructive earning the government no revenue or being revenue negative overall even before any trade-offs like the reduction of tax rates on company profits further reduce government revenue.

Further, in the current political climate it would be impossible to explain to the Australian public that company tax was being cut by 10% or more while the budget deficit requires large public spending cuts to be made.

Point 11. Scope Of Inquiry

The Australian banking and financial industry is the custodian of assets and not the actual owner of the great majority of assets, and superannuation is no longer the domain of just bankers even as custodian, self managed super funds represent 31% of superannuation with over 1 million trustees, retail funds which banks only control a part of is 23%. I was particularly disappointed by the lack of representation of the SMSF industry and individual actual owners of shareholdings or their representative organisations on a panel making mention of the imputation system, the panel seems to have mainly comprised members who have performed in positions as custodial officers, not owners of the actual assets and investments. It's always easier to make decisions about other people's money, far harder when it's your own money and livelihood on the line, this is the representation that needs to be on the panel to make mention of something as all-encompassing as the future of double taxation relief for the actual owners of assets, in this case the actual shareholder asset owners of Australian companies.
http://www.superannuation.asn.au/ArticleDocuments/129/SuperStats-May2014.pdf.aspx