AUSTRALIAN FOUNDATION INVESTMENT COMPANY

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Financial System Inquiry,
GPO Box 89
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NSW 8001

via electronic submission

26th August 2014

Submission to the Financial System Inquiry regarding Corporate Financing

Dear Sir/Madam,

We are making this submission on behalf of the Board and shareholders of Australian Foundation Investment Company Limited ("AFIC"). AFIC is Australia's largest Listed Investment Company with over 100,000 primarily retail shareholders, many of whom rely on dividends as an important source of income.

As both a listed company that pays franked dividends to its shareholders and as an investor in listed equities, we have been strong supporters of the principle that corporate profits should not be taxed twice – once through the taxation of company profits and again when received by shareholders via dividends. Prior to the introduction of dividend imputation, property speculation gains, for instance, were only being taxed once whilst productive corporate activity was being taxed twice.

This important principle is behind the imputation system, including the refund of tax paid for lower-rate/nil taxpayers, including charities. This has ensured that the corporate tax system had fairness as one of its core strengths – the providers of capital were being taxed on their income from this investment at their marginal tax rate. The system does not (currently) seek to differentiate between different types of equity capital providers through the income tax system.

The principle of not having corporate earnings taxed twice has created a level playing field for Australian investors. An Australian holder of a domestic corporate bond receives income free of any tax withholding – as a company receives a tax deduction for interest payments, there is no double taxation. Similarly, an Australian holder of a share receives a franked dividend effectively free of any tax withholding. The decision of the investor then becomes one of risk/reward, as it should be in a properly functioning investment market.

This principle is as important today as it was when the system was introduced. **AFIC therefore strongly disagrees with the statement included on 2-58 of the Interim Report that 'the case for retaining imputation is now less clear than it was in the past.'**

The report acknowledges the fact that the removal of the double taxation of corporate earnings increased the ability to attract increased domestic equity. This was particularly evident during the GFC when well-supported capital raisings enabled Australian corporates to reduce their gearing levels.

Combined with compulsory superannuation the dividend imputation system has also widened the retail shareholding market amongst the Australian public to an enviable extent – this has led, we believe, to Australians being better informed about and better able to participate in the investment markets than in most, if not all, other countries.

The fact that distributed corporate profits are not taxed twice is an attractive feature for domestic investors. However, we believe that there are other important factors that account for the current strong interest of retail investors for domestic equities which include:

i. **The current low interest rate environment**. This means that the yield on equities is in most cases higher than that from fixed interest. Should Australia move into a higher interest rate environment that impacts on corporate earnings, this could change rapidly. We would argue that most Australian investors are fully aware of the risk differential between a fixed-interest investment (including those supporting annuity products) and an equity investment. Currently the higher dividend yield (whether franked or not) means that the risk assessment works in favour of domestic equities.

ii. **The current taxation of capital gains in Australia.** Due to the low yield from off-shore equities (which is frequently subject to withholding tax), investors in these instruments will need to sell in order to produce any meaningful income. In many other countries (for instance, New Zealand or the UK), capital gains receive favourable taxation treatment. In Australia, capital gains do not if the investment is held for less than a year, and even with a 50% discount on gains of more than one year, are still taxed at the investor's top marginal rate. This will cause many tax-paying investors to prefer higher-yielding domestic stocks, with the added benefit of not having to worry about exchange-rate risk. Dividend imputation is part of the system of Australian taxation and should not be viewed in isolation and without consideration of its interaction with the taxation of capital gains, superannuation, GST etc., all of which have features different from taxation frameworks elsewhere.

With regard to Australian corporates seeking debt financing, they are often able to borrow from domestic banks or, if larger, off-shore markets, at a lower rate than a domestic public bond issue would allow. Should liquidity from these sources become less available or attractive, a corporate bond market, if managed with reasonable disclosure requirements, might then prove more popular to companies. However, as noted above, the current low interest rates would be likely to dissuade investors from such fixed-interest investments.

The dividend imputation system has enabled a level playing field, and is an important cornerstone of the Australian market. Its benefits are widespread, and should be maintained in any future review of the tax system.

We would be happy to discuss the above with you at your convenience.

Yours faithfully,

Ross Barker
Managing Director

Andrew Porter
Chief Financial Officer