Investors will be the losers if imputation system goes

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Last Tuesday the Treasury announced in its discussion paper that the Abbott government was considering amending or abolishing Australia's tax imputation system.

Since 1987, Australian taxpayers have only been taxed once on corporate income, not the double taxation that investors in many other countries have had to put up with (New Zealand, Chile and Mexico remain the exception).

Our franking credit based tax system has undoubtedly given Australia one of the best and fairest systems of corporate taxation in the world, despite our still very high tax rates.

New Zealand, for example, with the same system as ours has maximum tax rates at about 33 per cent, compared with ours in excess of 47 per cent.

In the same discussion paper, the Treasury reports that \$19 billion in franking credits is distributed annually to Australian shareholders, with another \$10bn paid to companies for future distribution.

Annual dividends to the value of \$44.33bn, with grossed up value of \$63.33bn,[1] precisely generates the reported franking credits of \$19bn at the notional value of 42.86c per dollar of franked dividends.

If the relevant taxpayer is in the modest 37 per cent marginal tax bracket (\$80,000-\$180,000) category, the incremental tax currently paid is \$23.43bn on this income. Hence, for such taxpayers, the cost over and above franking is about \$4.43bn.[2]

[1] \$63.33bn. = \$44.33bn. + \$19bn of franking credit.

[2] \$4.43bn. = \$23.43 - \$19bn.

If double taxation were reintroduced, the after corporate tax dividend income on which personal tax would be payable is $44.33bn, yielding $16.4bn in incremental tax revenue.[3]

Thus, the total paid on dividend income rises from $23.43bn to $35.4bn ($16.4bn plus the $19bn of cancelled credits) which is an increase in the tax take of 51 per cent. The effective marginal tax rate on dividend income rises from 37 to 56 per cent, a staggering rise of 19 percentile points.

If a person were receiving $100,000 a year in franked dividends and 37 per cent is their marginal tax rate, they would be paying $37,000 per year in personal tax, leaving a modest after-tax dividend income of $63,000.

After the change, personal tax is levied on the $70,000 of after-corporate-tax income, leaving only $44,100 in after-tax dividend income as the marginal tax rate is still 56 per cent.[4]

If the investor is in the 47 per cent marginal tax bracket the devastation is even worse. Their current after-tax dividend income is $53,000 and with the loss of the corporate tax rebate of $30,000 (i.e., franking credit) on the gross income of $100,000 his after-tax income falls to only $37,100. The increase in tax is $15,900.[5]

Since his total tax paid is $62,900, the effective marginal rate has risen from 47 per cent to 63 per cent, comparable to France with the world's highest tax rate on distributions.[6]

In present value terms at the average corporate return of 12.77 per cent per annum, since July 2001 this $19bn annual loss to local shareholders amounts to a decline in value of $148.79bn for franking shares worth approximately $500bn, a potential massive hit to stock values.

The discussion paper points out, correctly, that imputation encourages Australian investors to invest more in Australian stocks and less in foreign stocks than they otherwise would in a world in which inefficient double taxation of dividends is universal. Given that information is vital for successful investment and that most information is local, the home bias means that both Australian firm and investor returns are higher when more Australians invest locally. Imputation, like aspirin, brings many benefits.

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[3] $16.4bn =$44.33*0.37

[4] $70k*(1-0.37) = $44.1k,

[5] Under the current imputation system: credit=$30K, dividend=$70k, taxable income=70+30=$100k, net tax after credit=$47-30=$17k (a). Under double taxation: tax=70*0.47=$32.9k (b). Increase in tax=(b)-(a)=$15.9k.

[6] Net increase in tax paid = (b) 32.9k + lost credit 30k = $62.9k.Includung the lost credit, tax rate increases to 63%.

The discussion paper is keen to bring about more foreign investment in Australia by lowering the corporate tax rate. Under imputation, Australian investors gain no benefit from any lowering and in general, imputation does little to encourage foreign investment.

Here the discussion paper is quite schizophrenic — while wanting more corporate investment in Australia, it would like to remove imputation as this would lower Australian investment in ourselves!

If any tax savings were used to lower the corporate tax rate such that the overall level of investment were preserved, all it has achieved is a worsening of Australian tax efficiency while making most Australian investors worse off.

Unfortunately for all those advocating a massive tax grab of $19bn, revenue gains would soon prove illusory. Australian companies would soon shift their corporate activities and tax base to tax havens. Imputation provides a strong motive to pay tax locally.

When imputation was introduced in 1987 there was a sizeable increase in dividends distributed so as to harness imputation credits. This would soon be reversed if the tax grab lobbyists have their way. Companies with poor investment prospects would invest more in a wasteful fashion, weakening Australia's investment performance.

Imputation means there is no tax benefit from taking on more debt. Reduced gearing that occurred with the introduction of imputation would be replaced by sizeable gearing-up.

If there is no, or limited, equity capital, there will be no or negligible dividends, but highly indebted companies become much more susceptible to collapse during recessions. Abolishing overtaxed dividends is perfectly legal, and we all pay the costs of corporate collapse.

That $19bn tax grab is soon converted into an additional $19bn in wasteful activities, while the entire corporate sector takes a significant hit from which recovery will be difficult indeed.

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