

THE AUSTRALIAN

Franking rule change will have big impact on wealthy investors

STIRLING LARKIN THE AUSTRALIAN SEPTEMBER 27, 2014 12:00AM



Ken Henry has called for changes to the dividend imputation system. Source: News Limited

THE most important rule when investing is to focus on making profits first and then worry about paying taxes second.

Australian ultra high net worth (UHNW) investors are naturally acutely aware of this guiding principle primarily because accumulating their affluent positions involved a high degree of concentration when transfiguring their entities' gross profits into personal net wealth.

Domestic UHNW investors naturally have sought the lowest, most advantageous tax vehicles for such wealth and, up until recent times, these have been found within the superannuation environment.

Significantly, since 1987, when the then treasurer Paul Keating introduced dividend imputation or "franking credits", double taxation of profits was no longer an ongoing concern and UHNW investors have refocused their efforts towards seeking out the most accommodative environment — which the advent of superannuation provided.

However, later this year, when the framework for the taxation white paper is released, it is likely to engage in a debate about the future of "franking credits" as we currently know them.

Buried deep within the appendix of the Murray inquiry's interim report is the critical comment: "The case for retaining dividend imputation is less clear than it was in the past" and, importantly, it goes on to highlight that "the benefits of dividend imputation, particularly in lowering the cost of capital, have arguably declined as Australia's economy has become more open".

The Murray interim report then states that the franking and other issues should be considered as part

of the taxation white paper process, unless they are already under active government consideration.

In recent times, prominent business leaders such as Ken Henry and David Gonski have called for changes to the imputation system on the grounds that the current tax system discourages offshore investment by large Australian corporates — an important factor for a free market economy such as ours.

Once the framework for the taxation white paper has been released for consultation in late 2014, the federal government will look to take the issue of tax imputation to the next federal election in 2016.

Australian UHNW investors are keen to participate in this debate and ensure that an important tax consideration within their investment process is represented during this critical national conversation.

Patrick Broughan, a tax partner at Deloitte, believes the mechanisms to lower the cost of capital today have changed since 25 years ago, when imputation was first introduced.

This is because capital is able to be sourced nowadays from international capital markets and there is less reliance on Australian investors through the domestic equities and corporate bond markets.

Broughan says: “The difficulty is that imputation is likely to bias Australian companies with Australian shareholders to invest in Australian income producing assets, rather than overseas assets.”

He goes on to add that “when capital is sourced from international capital markets, which is more obvious in the current environment, the original benefit of imputation lowering the cost of capital is less relevant, as this cost would be determined by the international capital markets”.

If the Murray inquiry is correct that the case for “retaining dividend imputation is less clear than it was in the past”, then what are the alternative systems for the taxation of company and shareholder income and if franking credits become a casualty of this process, what alternate frameworks make sense, not only for institutional markets but also individual investors as well?

In addressing this, Broughan thinks that in practice “there are very few pure shareholder taxation systems abroad and almost all OECD countries avoid double taxation to some degree coupled with the fact that none provide complete shareholder relief for all corporate taxes paid”.

It is clear that all systems for the taxation of corporate entities and their shareholders have advantages and disadvantages — no taxation system, either theoretical or practical, has nil disadvantages.

The taxation white paper will presumably have to weigh up the advantages and disadvantages of Australia’s dividend imputation system and decide if Australia should move to a different system or whether modifications can be made to the existing imputation system to ameliorate the deficiencies identified in both the Murray inquiry’s interim report and the earlier Australia’s Future Tax System Report.

These are obviously momentous decisions that will have direct implications for many Australian individual investors, within and outside of the superannuation environment.

An argument for the current imputation system is that listed companies like Telstra, BHP Billiton or the big four banks are economically important to the Australian economy, so taxing them is a means to regulate the behaviour of the people that govern and manage them.

The Murray interim report says that this then “creates a bias for individuals and institutional investors, including superannuation funds, to invest in domestic equities”.

Another advantage of this system is that there is only one level of taxation imposed on company earnings and no biases against corporate form, dividends or equity.

The disadvantages of an imputation system include revenue instability, double taxation on foreign earnings and the potential for a bias towards Australian companies only investing in Australian assets, rather than global assets.

On this, the Murray interim report is concerned that “dividend imputation may be affecting the development of the domestic corporate bond market” and also that “Mutuals cannot distribute franking credits, unlike institutions with more traditional company structures, which could be affecting competition in banking”.

No doubt Glenn Stevens and the Reserve Bank of Australia Board would like competition in banking addressed, especially after Treasurer Joe Hockey has made it crystal clear that his government won't be challenging the “Four Pillars policy”, which serves as a near perfect textbook example of an “oligopolistic” market.

“Macro-prudential” controls like those employed by the Bank of England may be considered at some point soon but until such time, the Murray interim report may serve to begin the much needed conversation surrounding these issues for regulators, government and investment communities.

Australian UHNW investors know that the profit motive is paramount but never forget that tax decisions made today have material and visible outcomes tomorrow.

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