A response to the Federal Government's 2015 Tax Discussion Paper

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Re: D. Dividend imputation and the refunding of imputation credits (p.82 to p.87)

Discussion question 25 – Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?

The Tax Discussion Paper (TDP) states that high corporate taxes are having an impact on Corporate Australia's ability to compete globally, to grow and create jobs. However, the issue of what is an appropriate rate of corporate tax should be segregated from the question of whether or not the dividend imputation system continues to serve Australia well in light of globalisation.

A good tax system should reflect the design principles of: fiscal sustainability, equity and fairness and economic efficiency. In the main, Australia's imputation system addresses the principle of equity and fairness. It was first introduced in 1987 to relieve double taxation. In the early 2000's, the reform that allowed for imputation credits to be refundable for some taxpayers, further reinforced this principle.

Dividend imputation ensures that income is only taxed once and it effectively represents a collection of tax to be ultimately paid by the Australian resident shareholder. In this way, it ensures that the tax is borne by the taxpayer who derives ultimate enjoyment of the income. A company's assessable income is subjected to tax at the corporate rate of tax in the year it is derived. When that income is distributed to an Australian resident shareholder as a dividend from after-tax profits, the imputation credit that attaches to that dividend ensures that any additional tax is imposed at the incremental rate of tax only (that is, the difference between the shareholder's rate of tax and the corporate income tax rate.

In keeping with the principle of equity and fairness, individuals, superannuation funds and some tax-exempt entities, including charities are entitled to a refund of any excess tax paid at the company level. This ensures that the dividend income is taxed at the rate that applies to the shareholder who is effectively enjoying that dividend income. Consequently, assuming the dividend imputation system is retained, it would be inequitable to remove the right to a refund for excess imputation credits to shareholders whose marginal rate of tax is lower than the corporate rate of tax, or, that are in fact exempted from paying income tax. Australian Universities are generally income tax-exempt and entitled to a refund of imputation credits. The negative impact on the university sector of removing an entitlement to a refund of imputation credits, is detailed below under the heading Refundable Imputation Credits.

The TPD highlights that the dividend imputation system is not geared towards attracting foreign investment. Non-resident shareholders are not currently entitled to a foreign tax credit in respect of the tax paid at the Australian company level in respect of their franked dividend income. However, in the absence of a system of dividend imputation, a non-resident shareholder would be liable to pay withholding tax on that income. In the event that the shareholder is required to also pay tax in the

[1] KPMG Econtech 2010, "Economic modelling of improved funding and reform arrangements for universities"

country of residence, many foreign tax jurisdictions would allow the shareholder to claim a foreign tax credit equal to the withholding tax paid in Australia. Therefore, under the current system, a non-resident shareholder is no worse off by not receiving a foreign tax credit in respect of Australian franked dividend income.

Dividend withholding tax is currently imposed at a flat rate of 30% unless the dividends are paid to residents of countries with which Australia has a double taxation agreement (DTA), in which case the rate is generally limited to 15%. Therefore, assuming an Australian corporate tax rate of 30% and a dividend withholding tax rate of 15%, under the current system of dividend imputation, a non-resident shareholder may have a preference for unfranked dividends over franked dividends, as the rate of return on the investment would be greater.

In order to attract foreign investment, the dividend imputation system could be amended so that non-resident shareholders in receipt of franked dividend income would be entitled to foreign tax credit equal to the value of the imputation credits attaching to the dividend income. The ability to make use of that credit would require agreement via a DTA and would be dependent on the tax laws of the shareholder's country of residence, allowing such a credit.

Refundable Imputation Credits

Investment and reform in Australian universities has the potential to deliver growth and productivity gains that exceed many of the celebrated microeconomic reforms of the 1990s and 2000s. KPMG Econtech surveyed a large volume of literature to conclude the rates of return on investment in higher education average 15% for education and 25% for research.[1]

In addition to government funding, vital sources of other income for the universities are endowments and investment income. A removal of the right to refundable imputation credits would negatively impact earnings from investment in Australian shares, making investment in this asset class less attractive and reducing the funds available to universities for critical core activities and capital expenditure and also reduce employment in the sector. Additionally, this would negatively impact on the Australian university sector's global competitiveness and thereby potentially impact on the export of education and research.

The removal of refundable imputation credits for the dividend imputation regime would mean that franked dividend income is not taxed consistently across all classes of taxpayers. The current dividend imputation system ensures that the shareholder that derives the enjoyment from the dividend income, is ultimately liable for the tax on that income. Additionally, because imputation credits are refundable, the current system ensures that the rate that is imposed on that income is the shareholder's rate of tax. Therefore, to deny the refund of imputation credits to universities, other entities in the not-for-profit sector and other taxpayers generally, would not be in keeping with the good tax system design principle of equity and fairness.

[1] KPMG Econtech 2010, "Economic modelling of improved funding and reform arrangements for universities"