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The International Taxation Project
Board of Taxation
c/- The Treasury
Langton Crescent
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REVIEW OF INTERNATIONAL TAX ARRANGEMENTS

The Australian Stock Exchange (ASX) is very pleased to be able to provide a submission to the Board of Taxation as part of the consultation process for the Government's Review of International Taxation Arrangements.

Australia's taxation system is an important element underpinning economic activity in Australia. ASX recognises the need for the Government to raise required revenue in a manner that is, as much as possible, consistent with the principles of good tax policy (efficiency, equity, simplicity and sustainability).

ASX is a member of the Business Coalition for Tax Reform (BCTR) and the Business Council of Australia (BCA) and has been involved in the preparation of their submissions.

We strongly endorse the eight key objectives for international tax arrangements identified in the BCTR's submission.

Achievement of these goals would leave Australia well placed to compete in global markets to attract mobile international capital to underpin economic growth well into the future.

THE ASX'S APPROACH TO THE REVIEW

As a participant in some broader business groupings ASX does not intend to provide a separate submission on the wide range of issues covered in the Treasury consultation paper.

Rather our submission will focus on one particular element of the consultation paper - those issues contained in *Chapter 2: Attracting Equity Capital for Offshore Expansion*. While we regard addressing the other issues raised in the consultation paper as important in sustaining Australia as an attractive investment destination, we think the issues are well covered in other submissions.

Our decision to focus in this one area reflects the importance that dividend imputation has played in the growth of Australian capital markets.

Imputation was an important reform in the late 1980's to remove the double taxation of income from equity investments of domestic investors. It has been a key element in helping to encourage growth in local capital markets and increasing shareholder numbers. The proportion Australian adults directly owning shares has increased from 10 per cent in 1991 to 40 per cent in 2000. The introduction of imputation has reduced the disincentive to save which came from double taxation of company profits as well as reducing the previous bias between debt and equity financing.

The imputation system is now well established and understood by investors. We support the continuation of imputation as a key part of our taxation system.

When the Government's Review of International Tax Arrangements was announced the ASX commissioned an analysis of international trends in dividend taxation and quantification of their implications for Australian tax policy by Ernst and Young. The research was financed from the Financial Industry Development Account (FIDA).

Given the developments in other countries, ASX thought it timely to reconsider the role of dividend imputation in Australia as there has been significant change in the Australian economy over the past 15 years, particularly the greater internationalisation of Australian business. The analysis was later expanded to model and quantify the impact of the options identified in the Treasury's consultation paper for shareholder effective tax rates and the cost of capital.

The results of this modelling and quantitative analysis is attached. We believe it provides a good overview of trends in this area of taxation and raises a number of important issues.

Some of these issues may go beyond the range of issues identified in the Treasury consultation paper – but they are issues of importance to ASX and many of our listed companies. We think they are issues the Board of Taxation needs to keep in mind when considering the longer term need to ensure Australia remains an attractive destination for foreign capital, a place where Australian companies can grow and prosper through offshore expansion, and one that does not force local companies to relocate offshore for tax reasons.

ASX recognises the important role played by dividend imputation and the distortions (disincentives to save and invest and a bias towards debt over equity finance) that could be re-introduced if there was a return the classical company taxation system. The quantitative analysis supports the view that any dilution of dividend imputation would adversely affect Australian companies and their shareholders.

Based on the analysis it is clear that there has been an international trend to reduce the taxation of capital. This reflects the

> *" ... increasing recognition of the significant 'deadweight' costs associated with taxing income from capital and that those costs are likely to be rising in view of the increasing international mobility of capital and the flexibility of international capital markets. As a result, most countries have been seeking to reduce the rates of tax imposed on income from capital, particularly dividend income."* [1]

This has been achieved through lowering corporate tax rates, providing broadly based tax relief for dividends received, and through the introduction of dual income/split rate tax systems that apply a lower flat rate of tax to income from capital.

These international trends are ones that Australia, as a small, capital importing country, cannot ignore. As other key developed countries lower their effective tax rates, Australia will need to consider the impact this has on our ability to remain internationally competitive in attracting capital.

However in the context of the Government's current Review of International Taxation, we believe it is necessary to ensure that changes are made to our existing system to remove any unnecessary distortions to the investment decisions of companies or their shareholders.

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[1] Ernst and Young Report p10

THE ECONOMIC CASE FOR REFORM

The importance of inbound foreign investment to Australia's economic development is well known, but it is only more recently that the increase in outbound investment by Australian firms has been recognised and the economic benefits that this can bring acknowledged. The trend to a more outwards looking Australian corporate sector suggests that a re-examination of our international tax arrangements which were predicated on mainly inbound investment, is timely.

Much has been achieved through the period of economic reform since the early 1980s to make Australia a more attractive investment destination, including reforms to our tax system. The strong growth in foreign direct investment is testament to the fact that Australia is viewed as an attractive place to do business. However to maintain this position, in the face of an increasingly globalised world, all elements of our economic policy settings need to be examined to ensure they do not become impediments to attracting capital.

Australia needs a tax system that complements our regulatory and other attractions as a place to do business. A system that encourages the growth of local companies both domestically and internationally without pushing them to relocate offshore and which attracts new businesses and investment capital to Australia.

It is not only the overall tax burden on business and shareholders that is important but also the need to ensure that elements of the system that distort business decision making are minimised.

It has always been recognised that portfolio investment flows are sensitive to taxation arrangements but recent academic studies[2] suggest that foreign direct investment flows are becoming increasingly sensitive to host country tax arrangements as technological advances and the loosening of restrictions on trade and capital flows have increased the ease with which capital can cross borders.

The commissioned analysis, attached, highlights many of these international trends towards lower levels of capital taxation abroad. Many countries have fundamentally reformed their systems for taxing capital – with the overriding aim of reducing effective tax rates.

In contrast, Australia still maintains relatively high effective marginal tax rates on the dividend income of Australian shareholders.

In an environment where other countries are recognising these pressures and reducing taxes on capital, Australia cannot afford to fall behind if we are to continue to attract the capital necessary to underpin business investment and sustain economic and productivity growth into the future.

The Government's international tax review should ensure the overall tax burden on capital does not reduce incentives to save and invest in Australia, deter capital inflow or increase the cost of capital for Australian businesses.

In addition to these competitive pressures, the growth in outbound investment by Australian firms also poses challenges for the Australian tax system, which was largely developed prior to that trend emerging.

As the Productivity Commission noted earlier this year, in its report *Offshore Investment by Australian Firms: Survey Evidence*, outbound investment by Australian firms has grown significantly in the past decade. However, the level and growth has not been high in comparison to other developed countries. While many factors impact on decisions to invest

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[2] For example,
Altshuler R, Grubert H, and Newlon T (1998), *Has U.S. Investment Abroad Become More Sensitive to Tax Rates?*, NBER Working Paper no 6383; and
Hines JR (1996), *Tax Policy and the Activities of Multinational Corporations*, NBER Working Paper No 5589

abroad, the same report noted that companies ranked foreign and domestic tax considerations as relatively important factors influencing investment decisions.

The Government's international tax review needs to address any distortions that create biases against Australian firms investing abroad.

Large Australian companies are obviously most immediately affected by international tax issues, as they tend to have the most significant offshore investments as well as the highest proportion of foreign shareholders. However these are also important issues for medium sized businesses who are seeking access to foreign capital or who want to grow their business interests through offshore expansion, as inevitably they will, given the relatively small size of the domestic market.

In fact, it is this latter group, who may be most disadvantaged in accessing capital markets, that stand to gain most through changes to international tax arrangements that offers the potential to lower their cost of capital.

ASX acknowledges that significant changes have already put in place by the Government to improve the business taxation system.

- The reduction in the company tax rate from 36 per cent to 30 per cent has helped narrow the gap with the headline marginal company tax rates of many our competitors.

- The recent negotiation of a protocol to amend elements of the Australia's Double Tax Agreement with the United States, which will lower withholding taxes facing Australian business operating in the US was another welcome development.

The Treasury consultation paper did not address the issue of the overall level of capital taxation given recent international trends. It did however identify a number of important issues that can distort business decisions.

As a general principle we need to minimise tax on the most mobile factors of production - such as capital – if we are to maximise economic growth prospects and maintain a sustainable tax base.

We also need to ensure that the system is not overly complex or biases investment decisions. Investment decisions made on purely commercial grounds are those most likely to enhance national welfare – when those decisions are distorted by tax arrangements the result can detract from national welfare.

For example, we have seen a handful of corporate relocations offshore. Usually this reflects the changing nature of the firm's business interests (as foreign operations become a more important element of the total group) and a desire to be closer to their main markets.

A few firms have also established Dual Listed Company (DLC) structures, with overseas based companies. One advantage of this structure is that it can allow the company to engage in a form of dividend streaming, which is not currently available to a wider range of Australian corporate entities.

We need to ensure that our tax arrangements are not pushing some firms to relocate or encouraging them to develop unnecessarily complex structures. The international tax system should not penalise companies for basing themselves in Australia – the existing conduit income arrangements may also be a significant impediment to foreign firms establishing regional headquarters in Australia.

Retaining large Australian corporate interests in Australia not only adds to local employment and economic activity, it also adds liquidity and depth to Australia's capital markets. While global funds managers allocate a large proportion of their funds under management on a geographical basis, the size of the Australian equity market will continue to be a significant determinant of the cost of capital for Australian firms. This, in turn, has flow-on effects for the attractiveness of Australia as an investment destination, providing benefits to a broad range of Australian companies seeking access to equity finance.

The market capitalisation of companies listed on the Australian Stock Exchange rose by around 325 per cent between December 1991 and December 2001. The number of listed companies rose by around 40 per cent over the same period. This can be compared with the experience in New Zealand where a few large corporates moved their listings offshore and which saw their market capitalisation rise by a more modest 60 per cent and the number of companies listed by 12 per cent over the same period.

QUANTITATIVE ANALYSIS

As noted above, the ASX commissioned Ernst and Young to prepare a report examining a range of issues related to dividend taxation.

After identifying trends and challenges in the taxation of dividend incomes the report uses their Tax Impact Model to assess the impact of a range of options on Australian and foreign shareholders effective tax rates and the cost of capital.

In our submission the focus is on the implications of those international trends that are likely to have the most relevance for Australian policymakers in understanding the impact on Australian companies and their shareholders. These include:

- reductions in company tax rates in Australia;
- the shift away from dividend imputation regimes, including the impact of returning to a classical tax regime, implementing a UK style modified dividend imputation regime, and implementing the options for reform proposed by the Australian Treasury, Option A (a tax credit for dividends paid out of foreign source income) and Option C (a tax credit for foreign dividend withholding taxes paid); and
- the clarification of the source of dividend income by allowing Australian multinationals to stream dividends paid out of foreign source income to foreign shareholders (option B).

ASX has commissioned analysis which quantifies the effect of these options on corporate cost of capital and shareholder effective tax rates in the context of three different corporate 'types':

- an Australian corporate group - with no offshore investments and few overseas shareholders;
- an emerging Australian multinational - with modest offshore investments and a small foreign shareholder base; and
- a mature Australian multinational - with more significant offshore investments and a larger foreign shareholder base.

By looking at the impacts across a broad cross section of corporate Australia it provides a guide to the general impact of options on different groups.

However it is important to stress that, given the significant assumptions that need to be made to undertake the modelling of the options, the results are more illustrative of the impacts than an attempt to measure accurately the impact on a ‘representative’ Australian company.

The precise impact on companies will depend heavily on their particular circumstances including the extent and location of the offshore investments and shareholders; and their dividend distribution policies.

The results of the analysis on the impact on effective tax rates is somewhat more straightforward than that applying to the impact on the cost of capital. The later is very sensitive to assumptions about the marginal source of finance - whether it is sourced domestically or offshore. The analysis attempts to look at the issue under both assumptions.

IMPACT ON EFFECTIVE TAX RATES OF AUSTRALIAN SHAREHOLDERS

A key conclusion from the international comparison study is that international trends are placing increasing pressure on Australia to lower effective tax rates on capital.

The analysis in Section 4 of the report looks at the impact of Australian and foreign taxes on the effective tax rates facing Australian and foreign shareholders. We will focus here on the impact on Australian shareholders.

The results clearly demonstrate that a return to the classical system of corporate taxation would significantly increase effective tax rates for all types of companies to varying degrees – and these disincentives would rise as the company increased its dividend distributions.

It is for this reason we continue to support the retention of the imputation system.

Further reductions in Australia’s corporate tax rate would provide some relief for Australian shareholders, although the interaction with our relatively high personal income tax rates would see much of the benefit lost as dividend distributions increase.

The option to achieve a reduction in effective tax rates on capital through the replacement of imputation with a UK style tax credit system would need considerable thought before receiving serious consideration. It would be a major change to a system that is well established and while it would reduce complexity there would be a significant transition cost. Moreover, the analysis shows that the notional credit level would need to approach 30 per cent before the effect of the removal of imputation on effective tax rates of companies paying franked dividends would be fully offset.

Treasury Option A provides more limited relief only for dividends paid out of foreign source income. This option seems worthy of serious consideration to complement the existing imputation system and as a way to reduce the bias at the shareholder level against offshore investment through an Australian multinational. However, the analysis shows that a credit set at around 10 per cent, as flagged in the Treasury consultation paper, is likely to provide very limited relief but this effect would rise in line with the size of the credit provided.

Option B (dividend streaming) and Option C (a tax credit for dividend withholding tax paid) would provide even more limited relief given their relatively narrow application. In fact, under the assumptions in the analysis the impacts are very small.

However, this is not to say that for particular companies (i.e. those with significant offshore earnings and a large numbers of foreign shareholders or those who have investments in countries which applied high levels of dividend withholding tax) there may not be significant benefits.

IMPACT ON THE COST OF CAPITAL

As noted above, the estimated impact on the cost of capital is very sensitive to assumptions about who sets the cost of capital for Australian companies. The Treasury consultation paper notes that the standard assumption is that as a small, capital importing country, the marginal source of capital for Australia is offshore. Under such an assumption a reduction in effective tax rates for Australian shareholders would have no impact on the cost of capital.

However, the Treasury consultation paper (p16) also acknowledges that this simple assumption is unlikely to apply in all cases and that:

> *For smaller Australian multinationals and companies considering offshore expansion, access to international capital markets may be more restricted, and the domestic capital market may be a more important source of funds. For these companies, often in the process of rapid expansion, the effect of any shareholder level tax bias against direct investment offshore may be more significant.*

There is an extensive economic literature[3] on rigidities in capital movements across borders. While some of this can be traced back to regulatory or tax differences amongst countries that have been reducing over time, there remains a significant element which reflects the so-called 'home bias' of investors, which is harder to break down.

So, in practice, while there may be a small number of large Australian corporates with a significant international profile who can normally access global capital markets relatively freely, the vast majority of Australian companies will rely heavily on local markets (and hence a domestically determined cost of capital) for their financing.

We think the academic literature combined with anecdotal evidence from Australian corporates indicates that a simple blanket assumption of perfect capital mobility is unrealistic.

In Section Five of their report, Ernst and Young calculate the impact on the cost of capital of the various reform options on the basis that the marginal capital is supplied by an Australian.

As with the impacts on effective tax rates of Australian shareholders, discussed above, a return to the classical taxation of dividends would significantly increase the cost of capital – particularly for companies with a large domestic presence. In contrast, a reduction in Australia's corporate tax rate would see some fall in the cost of capital. Replacing imputation with UK style tax credit would see the cost of capital only fall if the notional credit were set at a level approaching 30 per cent.

Treasury Options A, B, and C would lead to a slight fall in the cost of capital under the modelled scenarios. A notional credit for Option A above the $^1/_9{}^{th}$ identified in the Treasury paper would be necessary to generate a reasonable reduction in the cost of capital.

CONCLUSION

In the context of the specific options raised in the Treasury consultation paper, it would seem that Options A, B, and C all offer scope to provide a more efficient tax system and potentially reduce the cost of capital for a significant group of Australian companies.

Given that companies at different stages in their development (and depending on the extent and nature of their offshore arrangements) would be affected to different extents by the options we suggest the Board of Taxation may wish to give consideration to a package, involving elements of all three options.

As the analysis notes:

- the implementation of Option A (a tax credit on dividend paid out of foreign source income) would provide the scope to:
  - enable the current dividend imputation regime to be retained for those companies that have no foreign source income;
  - reduce the effective marginal tax rate imposed on that foreign source income, thereby reducing the disincentive for Australian investors to invest offshore through Australian multinational companies;

[3] For example,
Obstfeld M and Rogoff K (2000), *The Six Major Puzzles in International Macroeconomics: Is There a Common Cause?* NBER Working Paper No 7777;
Feldstein M (1994), *Tax Policy and International Capital Flows*, NBER Working Paper No 4851; and
Gordon R and Bovenburg A (1994), *Why is Capital so Immobile Internationally? Possible Explanations and Implications for Capital Income Taxation*, NBER Working Paper No 4796.

- reduce the cost of capital for those Australian companies with restricted access to international capital markets; and
- involve a lower revenue cost than replacing the current dividend imputation regime with a UK style notion credit regime.

- the implementation of Option B (dividend streaming) would provide the scope to:
  - reduce the effective marginal tax rates imposed on the foreign source income that foreign shareholders earn through Australian multinational companies;
  - reduce the cost of capital for mature Australian multinational companies with significant offshore investments and numbers of foreign shareholders;
  - improve national welfare by reducing the current disincentive for foreign shareholders to invest in other countries via Australia and reduce the incentive for mature Australian multinationals to shift their operations offshore thereby helping to add depth and liquidity to domestic capital markets; and
  - reduce the disincentive for foreign multinationals to establish their regional headquarters in Australia.
- the implementation of Option C (a tax credit for dividend withholding taxes paid) would provide the scope to:
  - reduce the effective marginal tax rate imposed on that foreign source income, thereby reducing the disincentive for Australian investors to invest offshore through Australian multinational companies;
  - reduce the cost of capital for those Australian companies with restricted access to international capital markets;
  - encourage the repatriation of profits back to Australia; and
  - potentially involve a lower revenue cost than option A, since no credit would be provided for the underlying company tax paid.

Option A certainly provides the clearest assistance to the broadest range of Australian firms, providing relief to all firms paying dividends out of foreign source income, and should be the centrepiece of any package.

Option C also offers some relief to companies operating in jurisdictions with high rates of dividend withholding tax, however this issue is maybe best addressed through the negotiation of tax treaties designed to reduce this impost (such as that recently negotiated with the US).

Option B can complement either Option A or Option C by ensuring that foreign source income that flows through Australian multinationals to foreign shareholders does not reduce the value of franking credits paid out of Australian income to their Australian shareholders.

We believe the current Review of International Tax Arrangements can be a useful mechanism for reform of our existing system, reducing a number of distortions in the existing system. We wish the Board well in its work advising the Government on these issues – and hope the attached report is helpful in its deliberations.

Yours sincerely,

Richard G Humphry
MANAGING DIRECTOR AND CHIEF EXECUTIVE OFFICER