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The Argument for making franking credits available to Australians investing in foreign owned companies.

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Introduction

The Allen Consulting Group was commissioned by a group of New Zealand companies to develop their argument in support of franking credits being made available to residents investing in Australia via non–resident entities. To illustrate the arguments and points raised in this submission Lion Nathan has been used as a case study example, however the principles apply to a wide range of non–resident companies who choose to invest in Australia.

As a result of the current status of laws relating to dividends, foreign companies operating in Australia are seen as a less attractive investment option to potential Australian shareholders relative to their Australian resident competitors. As such, the foreign company's cost of raising capital is increased, reducing their competitiveness in their respective Australian industry.

In summary, dividend imputation should be extended to Australian shareholders in Lion Nathan (and other NZ companies) because it would:

- promote competitive neutrality within the beer industry (and other industries where NZ companies compete with Australian companies);
- eliminate the double taxation of dividends for Australian shareholders who indirectly hold interests in Australian companies via a foreign parent; and
- be consistent with the spirit of Closer Economic Relations between Australia and New Zealand.

Lion Nathan in Australia — Case Study

Lion Nathan has a long history, and expanded to Australia at the start of this decade. The company owns several major Australian breweries and a number of well–known beer brands. Lion Nathan is Australia's second largest brewer behind Fosters, with a 41.3 per cent market share. The company's activities generated over $800 million in Australian Government taxation revenue during its 1997–98 financial year. The beer industry is an important Australian industry, employing thousands of people and contributing significantly to national output.

The Anomaly

Australian investors require a certain after–tax return on investment to induce them to invest. As the laws currently stand, even though a large proportion of its revenues are earned in Australia, Lion Nathan (a New Zealand domiciled company), is unable to offer Australian share holders franked dividends, which raises the company's cost of capital. Therefore, franking credits on dividends should be extended to Australian investors in non–resident entities — particularly those that have a significant proportion of their operations located in Australia.

The Australian beer industry is effectively a duopoly between Lion Nathan and Carlton United Breweries. As such, competition between these two firms should be encouraged by the Government on the grounds of creating competitive neutrality in the beer industry. The existing tax law which denies Australian resident shareholders the benefit of franking credits arising from income tax paid by Lion Nathan in Australia is anti-competitive, and has unfairly disadvantaged Lion Nathan.

Additionally, Government policy has sought to integrate the goods and services markets of Australia and New Zealand via the Closer Economic Relations agreement, and so it would be logical for the capital markets between both countries to also be integrated.

While in the short term extending franking credits to shareholders in non–resident entities (New Zealand) might cause some revenue loss to the Australian Government, if it leads to more Australians investing in companies such as Lion Nathan (as would be expected), and hence result in an increased flow of dividends to Australians, and/or to increased investment in Australia by foreign companies, revenue to the Government might well increase over the longer term.

Recommendations and Conclusions

In order to rectify the anomaly identified by the Ralph Committee and discussed in this report, it is recommended that the Government remove the anomaly that currently makes it impossible for Australian shareholders in non–resident entities such as Lion Nathan to claim franking credits on their shares in companies. This should be done in the name of competitive neutrality and encouraging more competition within industries, as well as maintaining the spirit of the Closer Economic Relations Agreement with New Zealand.

1 Introduction

The Allen Consulting Group was commissioned by a group of New Zealand companies_. to develop their argument in support of franking credits being made available to residents investing in Australia via non–resident entities. The submission is made on behalf of the following companies each of which have substantial interest in Australian companies and large numbers of Australian shareholders.

- Lion Nathan Ltd
- Fletcher Challenge Ltd
- Ceramco Corporation Ltd
- Brierley Investments Ltd
- Nuplex Industries Ltd

To illustrate the arguments and points raised in this submission Lion Nathan has been used as a case study example, however the principles apply to a wide range of non resident companies who choose to invest in Australia.

The argument in support of franking credits is particularly relevant to companies which are New Zealand resident but currently have significant earnings derived in Australia, as well as a large number of Australian shareholders.

As a result of the current status of laws relating to dividends, foreign companies are seen as a less attractive investment option to potential Australian shareholders relative to their Australian resident competitors. As such, the foreign company’s cost of raising capital is increased, reducing their competitiveness in their respective Australian industry.

This paper will consider this issue, and argues that the Government should change this law in line with the Ralph Review's recommendations. Section Two is the start of the case study and provides a background on Lion Nathan and the Australian beer industry, while Section Three considers the anomaly in more detail, presents the Ralph Review's argument for change, and explores the reasons for making the change. Section Four provides recommendations regarding the proposed change.

In summary, dividend imputation should be extended to Australian shareholders in Lion Nathan (and other NZ companies) because it would:

- promote competitive neutrality within the beer industry (and other industries where NZ companies compete with Australian companies);
- eliminate the double taxation of dividends for Australian shareholders who indirectly hold an interest in Australian companies via a foreign parent; and
- be consistent with the spirit of Closer Economic Relations between Australia and New Zealand.

2 Case Study: Lion Nathan in Australia

Key Points

- Lion Nathan has a long history, and expanded to Australia at the start of this decade. The company owns several major Australian breweries and a number of well–known beer brands.
- Lion Nathan is Australia's second largest brewer behind Fosters, with a 41.3 per cent market share.
- The company activities generated over $800 million in Australian Government taxation revenue during its 1997–98 financial year.
- The beer industry is an important Australian industry, employing thousands of people and contributing significantly to national output.

2.1 Lion Nathan's Australian Operations

History

Lion Nathan's origins date back to 1839, when Brown Campbell and Co, Auckland's first trading company, was established. Over the next 150 years, the company developed, through expansion and merger, into New Zealand's largest brewer and retailer. Between 1990 and 1993, this expansion broadened to Australia, when Lion Nathan purchased Bond Brewing (including Castlemaine Tooheys and Swan), Hahn Brewing and South Australian Breweries. The company also purchased the PepsiCo rights for Australia and New Zealand, making it the largest beverage company in Australia. In more recent years, Lion Nathan has moved into China, and has become partially owned by Kirin Brewery Company of Japan, creating the fourth largest brewing alliance in the world.

Lion Nathan is listed on the Australian stock market as a secondary listing of the New Zealand parent company.

Operations in Australia

Lion Nathan is Australia's second largest brewer, holding a market share of 41.3 per cent at the end of August 1998. Lion Nathan owns 5 breweries in Australia, employing 1,230 people, including sales and back–office staff. Its Australian operations produce a range of products in a variety of locations across the country. These products and operations are presented in Table 2.1 below.

Table 2.1

Lion Nathan's Australian Products

Brand:	**Locations:**
Hahn	Nation–wide
Tooheys	New South Wales and Victoria
XXXX	Queensland
Swan and Emu	Western Australia
West End and Southwark	South Australia

The company's end August 1998 financial year results are presented in Table 2.2, along with the company's Australian performance for the previous two years. As is evident from the table, Lion Nathan earns over 80 per cent of its annual earnings in Australia, making it in many respects, the equivalent of an Australian company.

Table 2.2

Lion Nathan's 3 Year Financial Performance — Australia

	1996	**1997**	**1998**
Volume (mls)			
Beer	714.3	699.7	709.9
Total	715.2	700.3	710.2
	$A'000	**$A'000**	**$A'000**
Revenue	1,503,145	1,508,689	1,579,421
Indirect Taxes	(577,851)	(578,829)	(733,288)
Net Sales Revenue	925,294	929,860	846,133
Operating profit	128,913	137,527	184,135
Add back interest	108,350	85,119	62,829
EBIT	237,263	222,646	246,964
Group EBIT	330,256	290,709	299,896
EBIT as % of Group EBIT	71.8%	76.6%	82.3%
Pre–Tax Earnings	128,913	106,367	184,135
Income Tax	61	(48,444)	(71,644)
NPAT	128,974	57,923	112,491

Source: Lion Nathan Corporate Relations

For its financial year ending August 1998, Lion Nathan's Australian operations generated almost $1.6 billion in revenue, up slightly from the previous two years, $247 million in earnings before interest and tax, and $112.5 million in after tax profit. This profit was higher than 1997, but still lower than that earned two years previously.

In terms of tax revenues, Lion Nathan's Australian operations contribute significantly to annual Government receipts. Lion Nathan's Australian subsidiaries paid income taxes of almost $72 million in 1998, as well as excise, sales tax and other duties of $733 million. This is a total contribution of $805 million to Australian Government revenues.

2.2 The Industry

The Australian beer industry is dominated by two key players, Lion Nathan Pty Ltd (41.3 per cent of the market) and Carlton United Breweries Pty Ltd (56.1 per cent of the market), who together with a small number of middle sized breweries (such as Coopers Breweries), hold over 99 per cent of the market. Small pub breweries make up the remainder. In 1996/97, over 1.7 billion litres of beer were available for domestic consumption in Australia.

Table 2.3 provides a summary of the beer industry's contribution to the Australian economy (as well as that of the broader alcoholic beverage industry). A number of points to highlight from this table include the industry's contribution to employment, wages and salaries, and turnover. This emphasises that the industry is a significant contributor to the Australian economy.

Table 2.3
Size of Alcohol Beverage Industry — June 1997

	Beer & Malt	Wine	Spirits	TOTAL
• No. employees	2,948	6,966	355	10,269
— % of alcohol manufacturing	28.7%	67.8%	3.5%	100%
— % of total manufacturing	0.31%	0.74%	0.04%	1.08%
• Wages & Salaries ($m)	172.1	204.3	10.1	386.5
• Turnover ($m)	2,370.4	2,268.7	100.9	4740.0
— Wages and salaries as % of turnover	7.3	9.0	10.0	8.2
• Industry Gross Profit ($m)	846.6	768.2	45.0	1,659.8
• Turnover per person employed ($'000)	804.2	325.7	284.2	1,413.9
• Industry gross product per person employed ($'000)	287.2	110.3	126.7	161.6

Note: This table is drawn from ABS *estimates* of the size of the beer industry. As such, it is not directly comparable to actual statistics provided by Lion Nathan in Table 2.2. However, it does provide a good indication of the size and importance of the beer industry to the Australian economy.
Source: ABS Catalogue No: 8221.0

2.3 The Competition

As highlighted in Section 2.2, Lion Nathan's main Australian competition comes from Carlton United Breweries. Carlton United Breweries is the brewing arm of Foster's, an Australian firm with interests in beer, wine, hotels/pubs and gambling. Section Three of this report will consider the implications for competition of duopoly in the beer industry, and discusses the added impact on competition of current dividend imputation laws with regard to non–resident entities.

3 The Anomaly

Key Points

- Franking credits on dividends should be extended to Australian investors in non–resident entities — particularly those that have a significant proportion of their operations located in Australia.
- Australian investors require a certain after–tax return on investment to induce them to invest. As the laws currently stand, even though a large proportion of its revenues are earned in Australia, Lion Nathan (a New Zealand domiciled company), is unable to offer Australian share holders franked dividends, which raises the company's cost of capital.
- The Australian beer industry is effectively a duopoly between Lion Nathan and Fosters. As such, competition between these two firms should be encouraged by the Government. However, as it currently stands, Lion Nathan is at a competitive disadvantage to Fosters, which consequently affects market competition. Removing this anomaly should therefore be favoured on the grounds of creating competitive neutrality in the beer industry.
- For many years, Government policy has sought to integrate the goods and services markets of Australia and New Zealand via the Closer Economic Relations agreement. In addition, migration between the countries is also virtually unrestricted. Logic therefore suggests that under these circumstances, the capital markets between both countries should also be integrated — this proposal goes some way toward meeting that goal.
- While in the short term extending franking credits to shareholders in non–resident entities (New Zealand) might cause some revenue loss to the Australian Government, if it leads to more Australians investing in companies such as Lion Nathan (as would be expected), and hence result in an increased flow of dividends to Australians, and/or to increased investment in Australia by foreign companies, revenue to the Government might well increase over the longer term.

3.1 The Anomaly

The Australian beer industry can adequately be described as a duopoly. That is, it is dominated by two major players, Lion Nathan and Carlton United Breweries (Fosters), with a large number of small firms making up a fraction of the industry. Lion Nathan and Carlton United Breweries hold 41.3 per cent and 56.1 per cent of the Australian market respectively. Both are large employers, and each makes significant contributions to the Australian economy through direct employment, as well as significant taxation flows to the Government.

However, as the tax system currently stands, Lion Nathan is competitively disadvantaged compared with Fosters, to the detriment of stronger competition and the flow–on benefits to consumers and the economy. This anomaly is caused by the inability of Lion Nathan's Australian shareholders to obtain franking credits on their dividends. This arises because Lion Nathan is listed on the Australian share market as a non–resident entity — with its headquarters located in New Zealand.

As franking credits are not available to Australian shareholders in Lion Nathan, Lion Nathan becomes a less attractive investment option relative to other companies listed on the Australian stock exchange, and particularly Lion Nathan's competitors, such as Fosters. Investors require a certain after–tax return to induce them to invest in a particular company, and given that Lion Nathan dividends currently confer no tax advantages, investors are less likely to decide to invest in the company — unless Lion Nathan raises its pre–tax dividend payout to compensate shareholders for a lack of franking credits. The implications of this anomaly for Lion Nathan are presented in Section 3.3.

Table 3.1 below provides an example of the returns to an Australian shareholder investing in a New Zealand company that earns $1,563 profit in Australia (example one), versus the same shareholder investing in an Australian company earning $1,563 (example two). It also illustrates the outcomes for an Australian shareholder in a New Zealand company if the proposal made in this paper were accepted, and franking credits were extended to Australian investors in non–resident entities (example three). The table is followed by a more detailed explanation of each case.

Table 3.1

Net Dividends received by an Australian Shareholder — 3 Examples

	CURRENT POSITION		AFTER PROPOSED CHANGE
	(1)	(2)	(3)
	Aust. Shareholder in NZ parent Co which holds shares in an Aust. subsidiary	Aust. Shareholder in an Aust. Company	Aust. Shareholder in NZ parent Co which holds shares in an Aust. subsidiary
Pre–tax Profit	$1,563	$1,563	$1,563
Tax @ 36%	$563	$563	$563
Available for Distribution	**$1,000**	**$1,000**	**$1,000**
Dividend to NZ Company	$1,000		$1,000
Aust DWT	0[1]		0[1]
FDWP Liability in NZ	0[2]		0[2]
Received by NZ Company	**$1,000**		**$1,000**
NZ Company tax on dividend income	0[3]		0[3]
Dividend paid to Australian Shareholders	$1,000		$1,000
Less: NRWT paid in NZ @ 15%	($150)		($150)
Cash received from NZ	**$850**		**$850**
Tax Credit:			
NZ	$150		$150
Australia		$563	$563
Taxable income of Australian Shareholders	**$1,000**	**$1,563**	**$1,563**
Tax @48.5%	$485	$758	$758
Less tax credit	($150)	($563)	($713)
Australian tax payable	**$335**	**$195**	**$45**
Net cash in hand	**$515**	**$805**	**$805**

1 *There is no Australian Dividend Withholding tax (DWT) payable because the dividends are fully franked*

2 *There is no NZ Foreign Dividend Withholding Payment (FDWP) liability because there is a deemed underlying foreign tax credit.*

3 *This is Nil because dividends derived from foreign companies are exempt from tax in NZ*

Example one illustrates the situation where an Australian individual shareholder invests in a New Zealand parent company, such as Lion Nathan, under current taxation laws.

In this case, if the NZ parent company's Australian subsidiary were to earn a pre–tax profit of $1,563, it would forward $563 to the Australian Government as company tax (at 36 per cent). The remaining $1,000 would be forwarded to the New Zealand company for distribution. Assuming Australian shareholders receive in dividends an amount equal to the contribution made by the Australian subsidiary, the shareholder receives the $1,000 as a dividend (after taking into account withholding tax paid and tax credit received). Assuming the shareholder is taxed at the highest Australian marginal tax rate of 48.5 per cent, he or she will be liable, for $485 in tax, less the $150 tax credit, leaving a tax liability of $335. The shareholders net post–tax dividend will therefore be $515.

This is contrasted for the same investor in an Australian company that is able to offer franked dividends. This company also earns a pre–tax profit of $1,563, and pays tax of $563, leaving $1,000 for distribution. After being grossed up by the tax paid of $563, the Australian shareholder is subject to tax on $1,563. At the top marginal rate this equates to $758, less dividend imputation credit of $563. This leaves tax payable by the shareholder of $195, and net cash in hand after tax of $805.

All else being equal, under these circumstances, a rational Australian investor will always prefer to invest in an Australian company, thereby earning higher after tax profits. This means that the New Zealand Company will have to generate higher before–tax returns to attract capital — ie, its cost of capital will be higher.

Finally, the third example illustrates a situation where dividend imputation credits are granted to Australian shareholders in New Zealand parent companies which have subsidiaries in Australia, as per the recommendations of this paper. In this case, the shareholder receives $805 in post–tax dividends, equal to example two, having paid $45 to the Australian Government in income tax. The disincentive effect is thereby removed, as are distortions to the investment decision.

It is noted that the examples refer to an Australian individual investor, however the comparison is equally valid for Australian institutional investors.

3.2 The Review of Business Taxation

The Review of Business Taxation (The 'Ralph' Review) addressed the issue of franking credits being made available to Australian residents investing in non–resident entities — such as Lion Nathan. Box 3.1 presents the Ralph Review's discussion of the issue.

Box 3.1

The Ralph Review — Should franking credits be available to residents investing in Australia via non–resident entities — the 'triangular case'?

Current Arrangements

31.35 The so–called 'triangular case' arises when a non–resident company derives income in Australia through a resident company and there are Australian shareholders in the non–resident company. When income is derived in Australia through a resident company, company tax is paid and dividends are paid to the non–resident parent. Franked dividends are not subject to DWT — the company tax that has been paid represents the total amount of Australian tax. Therefore, if the non–resident parent pays a dividend to its Australian shareholders the dividend will not carry an Australian franking credit and the dividend will be fully taxable to the Australian shareholders. Consequently, Australian investors in companies that are deriving Australian source income do not receive credit for Australian tax paid on that income.

Option: Allow franking credit to 'flow' through non–resident companies

31.36 There are conceptual grounds for addressing this issue, but the (relatively minor) efficiency and equity benefits have to be balanced against the cost of any changes in terms of increased complexity. The case for providing relief would be strengthened if full franking is adopted.

31.37 A possible solution in relation to resident companies is to allow those companies paying dividends to non–resident parents to issue dividend franking certificates to Australian residents that are shareholders in the parent. The franked amount notified to an Australian shareholder in the non–resident parent could be calculated as the product of the following two amounts:

- that part of the parent's dividend payments in the income year that can be attributed to the receipt of dividends from the Australian company; and
- the market value of the Australian shareholder's shareholding in the non–resident parent as a proportion of the market value of the non–resident parent's shares on issue.

31.38 In order to carry out the calculations necessary to provide relief, the Australian company would have to be supplied with the relevant dividend and shareholding information from its parent and would be held accountable if there was any evidence of fraudulent abuse of the system. By restricting relief to cases where the parent was a listed company resident in a broad-exemption listed country there would be a better chance of arranging any auditing on a cooperative basis with the taxation authorities of those countries. There would also be much less scope for manipulation of share valuations or shifting of headquarters overseas to avoid Australian taxation measures such as controlled foreign corporation measures.

31.39 Consideration would need to be given to the extension of relief to entities other than companies.

31.40 While reform could be implemented unilaterally, there would be advantages in negotiating a reciprocal arrangement or other comparable benefit with other countries.

Source: Review of Business Taxation, *A Platform for Consultation*, *Discussion Paper 2*, 1999, Pp 660–661.

While paragraph 31.36 states that the *relatively minor* efficiency and equity benefits have to be balanced against any increased complexities such a change would impose, it can be argued that these relatively minor gains are only applicable when considering it in a broad, economy–wide context. In the case of an individual firm, such as Lion Nathan, the effect on its ability to raise capital on the Australian share market of *not* changing the current system, instead has significant negative consequences.

With regard to the final paragraph, 31.40, while a reciprocal arrangement would be desirable, Australia should not wait to make these changes — or else risk missing out on the positive investment and competition implications that are likely to follow.

3.3 Arguments for Change

There are a number of arguments that can be made for removing this anomaly from the tax system. This section will consider each in turn.

Capital Markets

The ability to access capital as cheaply and as easily as possible is an important determinant in a company's ability to invest in added plant and equipment. The share market is one key avenue through which a company can do this. However, as discussed thus far, as tax laws currently stand, foreign companies with Australian subsidiaries are less attractive to investors, and hence are disadvantaged compared with their Australian–based competitors. In order to prove attractive, these companies must provide higher pre–tax dividends, thereby reducing the amount available for investment.

This is a major issue for companies whose Australian operations make up a large proportion of earnings. In Lion Nathan’s case, the company, while headquartered in New Zealand, earns over 80 per cent of its earnings in Australia, has Australian shareholders, employs over 1,200 staff, contributes over $900 million per annum into Australian Government revenue, and is for all intents and purposes an Australian company. However, it is currently disadvantaged relative to its competitors due to the nature of the tax laws with regard to dividend imputation.

The implications of this for companies such as Lion Nathan are clear. Obtaining capital is more expensive than for its competitors, and in the longer term, the company will be less likely to invest in plant and equipment in Australia — having negative implications for growth in employment, tax revenue and competition.

Competition

As emphasised throughout this paper, maintaining competition in industries such as the beer industry is very important, given that two players so heavily dominate the industry. As such, it should be the goal of Government to remove any impediments to competition in such an industry. As it currently stands, Lion Nathan remains at a competitive disadvantage with Fosters due to its higher cost of capital. Removing the dividend imputation anomaly should be favoured on the grounds of creating competitive neutrality in the beer industry. It should *not* be the case that one company is at a competitive disadvantage brought about by an anomaly in the tax law, especially in a two–company industry, where competition is important[1].

Closer Economic Relations[2]

The Australia New Zealand Closer Economic Relations Trade Agreement (known as ANZCERTA or the CER Agreement) is the main instrument governing economic relations between the two countries. It came into force in 1983 and was by design intended to be an outward–looking trade agreement. The objectives of the agreement are:

- to strengthen the broader relationship between Australia and New Zealand;

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[1] Competition in the beer industry has typically taken two forms — both price and brand appeal. Brand competition is the most prevalent, but price discounting is used tactically to meet specific objectives in selected markets or market segments.

[2] Much of this section is drawn from: Department of Foreign Affairs and Trade, *Closer Economic Relations — Background Guide to the Australia New Zealand Economic Relationship*, February 1997.

- to develop closer economic relations between Australia and New Zealand through a mutually beneficial expansion of free trade between the two countries;
- to eliminate barriers to trade between Australia and New Zealand in a gradual and progressive manner under an agreed timetable and with a minimum of disruption; and
- to develop trade between New Zealand and Australia under conditions of fair competition.

While the CER Agreement contains no specific provisions on investment, in the spirit of CER, Australia and New Zealand have agreed to avoid to the fullest possible extent the imposition of new restrictions on investors and have confirmed that trans–Tasman investment should be subject to minimum constraint. Additionally, the Agreement does not, with the exception of Article 7 relating to revenue duties, cover taxation with specific provisions.

In many ways, the CER Agreement implicitly supports the argument that the current dividend imputation laws as they relate to non–resident entities, are an anomaly and should be removed. The overriding aim of the CER Agreement is to facilitate greater trade and investment between the two countries, under conditions of fair competition. In this context, the impact of the current anomaly on companies such as Lion Nathan appears to contravene the spirit of this Agreement. While taxation of this nature is not explicitly covered under the CER Agreement, the impact on competition and investment decisions *is* of concern to the Agreement. Therefore, reform of the cause of these impacts, the dividend imputation anomaly, should be considered.

In short, Australian Government policy is to have a uniform market for goods and services between Australia and New Zealand, as well as a uniform labour market given the free migration that exists between the two countries. Removal of this tax anomaly would move Australia and New Zealand closer to a uniform capital market as well.

The Broader Context

While this paper has focused on the implications of the non–granting of franking credits for Australian investors in NZ companies such as Lion Nathan, the issue can of course be broadened to Australian shareholders in any foreign–based company. If however, following the lead of the CER Agreement between Australia and New Zealand, it was limited to New Zealand firms only, other firms such as Fletcher Challenge, Ceramco, Brierley Investments and Nuplex Industries would also benefit.

We have previously stated that in Lion Nathan’s situation even though the company is headquartered from New Zealand, over 80 per cent of its earnings are sourced from Australia. Much of these earnings are then returned to Australian shareholders in the form of dividends. In this case, the location of the company's ownership should not be relevant — the company employs Australian workers, pays a large amount of taxes to the Australian Government, and forms the second largest player in an important industry — yet the company is currently being hampered by an anomaly in the tax law.

Cost to Government

Under current circumstances, this anomaly appears to be tax revenue positive to the Australian Government, as it allows it to engage in double taxation — it taxes the company income earned by Lion Nathan in Australia, as well as the non–franked dividend income earned by Australian shareholders in Lion Nathan. We say “appears to be” for the reasons set out below.

In the short term, Government taxation revenues will be negatively affected by extending franking credits to Australian shareholders in non–resident companies. But this was the case when the dividend imputation system for Australian companies was first introduced — removing the double taxation of dividends was a specific aim of government policy — and the rationale used then to argue for its introduction is just as relevant today. However, in the longer term, it can be argued that such a move would have positive effects on tax revenue. This will occur in two ways.

Firstly, the increased attractiveness of shares in companies like Lion Nathan with franked dividends is likely to significantly increase the number of Australian shareholders in such companies. This in turn will cause an increase in the flow of dividends to Australian shareholders, and thereby lead to a number of important benefits for Australia:

- The increased flow of dividends to Australian shareholders will provide the Government with the opportunity to obtain higher tax revenue on the difference between the shareholders’ marginal tax rates and the franking credits.
- The extra cash held by Australian shareholders will be invested by them (at least to a significant extent) in Australian securities and properties, which will cause additional transactions in such assets and thereby lead to additional tax revenue.

Secondly, a reduction in the cost of capital for foreign companies like Lion Nathan is likely to enable them to expand their investment in Australia, thereby increasing investment and employment, and providing the Government with increased indirect, excise and income taxes. Moreover the cost of capital benefits will provide a positive incentive for such foreign companies to direct their foreign investment to Australia rather than other countries.

3.4 Process

The process by which franking credits would flow through non-resident companies to Australian shareholders, is briefly considered in the Ralph Review report. The report proposes a complicated system involving the issue of “dividend franking certificates” by the Australian subsidiary to Australian resident shareholders in the non-resident company (see para 31.38 of the report, which is re-produced in box 3.1 above).

The most efficient solution would be to simply allow non-resident companies to maintain Australian franking accounts if they wish. If such a simple change were made, the franking credits would then be able to be passed through the non-resident parent company to the Australian shareholders. The non-resident parent would be required to file annual franking account reconciliations with the ATO and could issue Australian shareholder dividend statements to meet the Australian requirements if they decide to pass the Australian franking credits onto their Australian shareholders in this manner.

4 Recommendations & Conclusion

In order to rectify the anomaly identified in this report, it is recommended that the Government remove the anomaly that currently makes it impossible for Australian shareholders in non–resident entities such as Lion Nathan to claim franking credits on their shares in companies. This should be done in the name of competitive neutrality and encouraging more competition within industries, as well as maintaining the spirit of the Closer Economic Relations Agreement with New Zealand.

In conclusion, the Government should accept that although this proposal may affect short–term revenue flows, in the longer term, it should lead to more Australians investing in non–resident entities with operations in Australia, thereby increasing the flow of dividends to Australia and raising Government income. Additionally, the increased ability of foreign companies to raise capital at lower cost, will lead to greater incentive to invest and employ larger numbers of Australians, resulting in increased Government revenue through income, and other taxes.

We agree with the Ralph proposals that there would be advantages in negotiating reciprocal arrangements with other countries. This would benefit Australian listed companies who have operations in those other countries in the same way that foreign companies will benefit. That is, it will allow competitive neutrality in the foreign jurisdiction and thereby lower the cost of capital and will eliminate double taxation making the Australian company shares a more attractive investment.