

28 June, 2018



Dear Sir,

I understand that the AER has recently published a Discussion Paper on Gamma, as well as:

1. A note that summarises discussions between the AER and the ATO regarding the ATO tax data and specifically some of the matters raised in my December 2017 report to you.
2. A report from Dr Lally on the AER's views on gearing and gamma, dated May 2018.

In addition, the ATO have published a note, issued on 9th May 2018, about the subject of: Franking account balance – tax of time series data from Taxation Statistics. I have also been provided with a copy of an email from Esmond Smith, Director Rate of Return, Network Regulation, Australian Energy Regulator to you dated Friday 1st June 2018 referring to the use of ATO statistics. In addition, on 21 June 2018 I participated in a telephone conference with representatives of the AER and the ATO to discuss the ATO statistics.

I have been asked three questions about these items.

1. Whether any of the matters raised in the AER's note summarising its discussions with the ATO or the Lally May 2018 report attached change any of the opinions you expressed in your December 2018 report for Energy Networks Australia.
2. Whether the comments of the ATO recorded in Attachment 1 shed any light on the inability you have referred to in your December 2017 report to reconcile the franking account balance (FAB) data and the dividend data reported to the ATO?
3. It is said in point 4 in Attachment 1 and section 3.3 of the Lally 2018 report that a limitation on your previous analysis is that it does not account for non-resident companies paying company tax in Australia which do not generate franking credits. It is stated in the ATO notes that this proportion may appear to be small at first glance, but it "adds to the report's inability to reconcile the imputation system using aggregate data." What is your response to this said limitation and if it exists, in your opinion would it have a material impact on your analysis?

This is my response to the three questions you have put to me.

This is my response to the first question: **Whether any of the matters raised in the AER's note summarising its discussions with the ATO or the Lally May 2018 report attached change any of the opinions expressed in my 2017 Report.**

I preface my remarks by the comment that I am delighted to at last see a response by the ATO to my analysis of ATO statistics, notwithstanding that it is a second hand account of the ATO comments as reported by some staff of the AER. It is this one-person removed account of the ATO's comments which I think has a bearing on my responses to the AER's reported comments of the ATO.

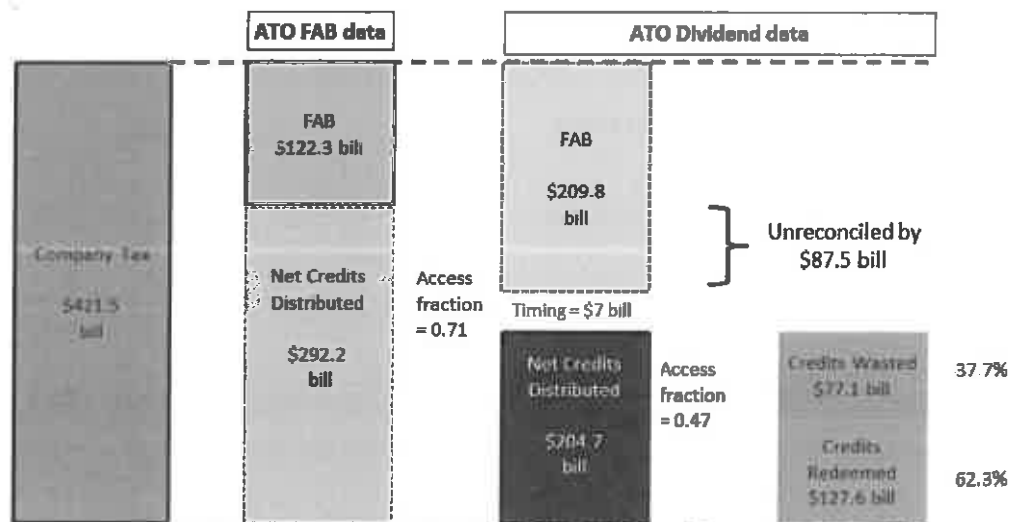
The AER note has six substantive comments within it:

1. "Net Tax" does not equate to Tax Payable
2. There are items within Labels C and Z of the company tax return that are not germane to franking credits.
3. The dynamic nature of changes over time within companies pose particular problems, especially with respect to the FAB and demergers.
4. Non-resident companies paying tax within Australia do not give rise to franking credits.
5. Within mergers and acquisitions, companies may not be able to utilise the combined FAB.
6. The FAB is poorly reported over time.

The effect of these points strengthens my view that the FAB data is the data item that is the overall weakest one among the ATO statistics relevant to franking credit research and gamma.

However, I reinforce my previous comments that in order to estimate an overall system-wide gamma, we do not need any of these interim calculations. All we need is the amount of company tax paid that gives rise to franking credits. In order to address this I reproduce the following diagram from my 2013 Report.

Figure 1: Summary of ATO tax flow data: 2004-2011



The Company Tax total payment of \$421.5 billion and the Credits Redeemed of \$127.6 billion are both data generated from the ATO processing taxation filings. There is no other source than the ATO who essentially create these data. If it were readily available, I would have to modify this statement by allowing for any non-resident company tax payment that does not give rise to franking credits. I return to this below. The Company Tax item is the total company tax collected by the ATO during the relevant period and the Credits Redeemed item is the total amount of credits redeemed via the filing of personal and other tax returns. These two data items are 100% reliable as they are figures that relate directly to ATO tax collections. There is no reason to question the ATO's records of the amount of corporate and personal tax it has collected.

These two data items immediately produce a national average gamma of 0.3 calculated as gamma equals credits redeemed divided by company tax (or credits created), namely gamma = \$127.6 billion/\$421.5 billion = 0.30.

The other two data items are created by companies reporting their data to the ATO. They report their dividends paid, their franking credits distributed and the Franking Account Balance (FAB). These are the two data items that do not reconcile with one another. In the past, I have had trouble deciding which one of these two items is the cause of this lack of reconciliation. In the light of the comments above attributed to the ATO, I now heavily lean towards the FAB data as being the unreliable one. Substantial under reporting of the FAB would be a strong driver of the apparently unreconciled data.

Turning to the six points individually, for point 1 I have always recognised this issue. Indeed, the definition of “Net Tax” has changed over the years. I do not use it directly but work through the issues that these changes pose. For example, in the Notes of the Tax Statistics 2014-15, there is an explicit comment that

5. Net tax has a new definition. The new definition no longer deducts refundable credits, i.e. new Net tax = gross tax less non-refundable tax offsets.

However, in the latest statistics (Tax Statistics 2015-16) this has changed to:

- 5 Net tax has a new definition where new Net tax = Tax payable + Refundable tax offsets.

Point 2. In relation to the data at Labels C and Z of the Calculation Statement, I have always looked behind these headline labels and considered the components where reported by the ATO. For example, with the 2012 data we could identify the following components within label CS.C.

Instructions 2012 for CS:C		
• Entrepreneurs tax offset (11F)	11F: Entrepreneurs' tax offset	\$2,381,357
• Allowable franking tax offsets for the income year. The amount claimed here should include the share of franking credits included in gross distributions from partnerships and gross distributions from trusts, the amount recorded at J Franking credits item 7 and the amount recorded at C Australian franking credits from a New Zealand company item 7	Share of franking credits	
	7J: FC income	\$10,752,751,724
	7C:NZ cpy credits	\$5,768,682
• Tax offsets for bonuses and certain other amounts received under short-term life insurance policies taken out after 27 August 1982.		
• Tax offsets for interest on certain government and semi-government securities.		
• Tax offsets to approved resident lenders for infrastructure borrowings.		
• Foreign income tax offset (the amount at item 21 label J).	21J: Foreign income tax offset	\$456,588,208
CS:C		\$14,966,325,692

I have analysed the data by extracting the relevant items where they are identified by the ATO. I also commented that there was missing items and these could modify our conclusions.

Points 3, 5 and 6 all relate to the FAB data and reinforce the view that the FAB is the weakest data upon which to rely. I take note of those comments and they direct me towards relying much more on the dividends paid data than the FAB data for any interim factor calculations alluded to above. This also answers the second question put to me: **Whether the comments of the ATO recorded in Attachment 1 shed any light on the inability you have referred to in your December 2017 report to reconcile the franking account balance (FAB) data and the dividend data reported to the ATO?** The reported comments by the ATO direct me to putting much less credence on the FAB data and direct me to relying much more on the dividend data. Under reporting of the FAB data would be a large element in explaining my inability to reconcile the two sets of data.

I would not suggest that companies misreport their FAB data and so make it unreliable data. Instead of a problem of commission of reporting false data, I would tend to believe it is more a problem of omission of data. The end result is the same though – the FAB data would be unreliable for the purpose of my analysis. Indeed,

the unreliability of the FAB data, as pointed out by the ATO, would lead me to generally counsel anyone against relying on any analysis based on FAB data.

I found Point 4 quite interesting and sought to explore it further. The ATO data indicates that it is a minor distortion of the data. The latest data – see the following Table, indicates that such companies are a tiny proportion of all companies (0.34%) and pay a small 2.3% of Net Tax. This disparity here arises from non-resident companies being bigger on average than all Australian companies which have an abundance of small companies.

Residency Status: Tax Statistics 2016				
Number	Total	Non-Resident	% non-resident	
Taxable	393,048	1,601	0.41%	
Non-taxable	548,118	1,594	0.29%	
Total	941,166	3,195	0.34%	
Net Tax	\$66,662,876,031	\$1,539,689,000	2.31%	

Source: TaxStats2016Company03

My response is that whilst I would prefer the ATO to show both resident and non-resident data in their time series, it is a very small fraction of the total and does not materially change any of my conclusions

This also answers the third question put to me: **It is said in point 4 in Attachment 1 and section 3.3 of the Lally 2018 report that a limitation on your previous analysis is that it does not account for non-resident companies paying company tax in Australia which do not generate franking credits. It is stated in the ATO notes that this proportion may appear to be small at first glance, but it “adds to the report’s inability to reconcile the imputation system using aggregate data.” What is your response to this said limitation and if it exists, in your opinion would it have a material impact on your analysis?** Not only does the data for non-residents “appear to be small at first glance” but it is small and not material in the overall scheme of my analysis and conclusions. If the company tax collection within Figure 1 is reduced by 2.31% then the net resident company tax becomes \$411.7 billion, giving an overall national average gamma of 0.31. The effect of the non-resident data only changes the second decimal place of the gamma estimate. It is clearly not material in the overall scheme of gamma estimates.

My conclusion from reviewing the six points made by the ATO with respect to analysing their data is that whilst there may be some problems with analysing taxation, dividends and franking credits (primarily because they do not publish data in sufficient detail to allow for all the various nuances within the system), the major difficulty lies within the FAB data. Hence little credence should be placed on any research based on FAB data.

In reference to the ATO Note of 9 May 2018, I recognise the comments made by the ATO, namely

The ATO is of the view that the Taxation Statistics data should not be used for detailed time series analysis of the imputation system.

It would be difficult to use this data to reconstruct franking accounts due to the dynamic nature of the tax system as it impacts on business. Factors such as entries and exits, churn within consolidation groups, and other complexities such the rules relating to life insurance companies would affect any macro analysis.

Consequently, we would not recommend using Taxation Statistics data as the basis of a detailed macro analysis of Australia's imputation system.

My first reaction on reading this Note by the ATO was along the lines of - this is the case with nearly *all* finance and economics data. Data published by the ABS and RBA, for example, no doubt also have a host of real-world problems within their creation. That does not preclude any economist or financial analyst from analysing *any* official data. They consider the reliability of each piece of data that they are analysing. The advice from the ATO directly points to the weakness in the Franking Account Balance (FAB) data so caution should be applied when relying on any analysis based on that FAB data.

However, I would respond that the ATO are the *sole* source of the system-wide set of taxation data, including imputation tax statistics. The ATO is responsible for the Australian Taxation system and for publishing data about that system. Whilst there are obvious difficulties with the dynamic nature of the system, which is reflected in the ATO data, there is no other source of the data. The ATO effectively create these data. If I was instead to attempt to build a data set from individual company reports, I would still have the same problems. Notwithstanding the difficulties of using the ATO data, it is in effect the primary source of the imputation tax statistics.

In relation to the telephone conference on 21 June 2018 between the various parties, including representatives from the ATO, I was happy to hear the ATO staff confirm the conclusion that the FAB data were the most likely source of the conflicts within the ATO taxation statistics data. They suggested a few reasons for this, including that it was only informational data and had no bearing on corporate tax liabilities and so could be poorly reported.

There was one other issue raised by the ATO during that call that I found curious. They suggested that ATO tax statistics included tax liabilities as well as tax paid. Only tax paid gives rise to franking credits so this outstanding liability would reduce tax paid and hence the amount of credits created. By memory, they suggested about 2% of company tax was a liability not yet collected. What I found curious with that estimate is that the vast majority of company tax is already collected by PAYG instalments (typically about 85% of the total tax liability) so 2% of the total represents about 14% of the residual tax due. This struck me as a high proportion of tax outstanding. I will endeavour to explore this issue with further research over time.



None of these issues would cause me to change my overall conclusions presented above. They potentially represent small adjustments to the estimates but I consider them likely to only cause changes in the second decimal place of the estimates and so they are overall immaterial.

Yours sincerely



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