Parliamentary
Budget Office

Policy costing

Reforming dividend imputation	
Party:	Australian Labor Party
Summary of proposal: The proposal would change the tax treatment of franking credits attached to distributions (otherwise known as imputation credits) from a refundable tax offset to a non-refundable tax offset. Under the proposal, franking credits would be able to reduce an individual's personal income tax liability (including Medicare levy liability) to zero. The proposal would apply to individuals and superannuation funds, except for recipients of Australian Government pensions and allowances with individual shareholdings, and self-managed superannuation funds with at least one member who was an Australian Government pension or allowance recipient before 28 March 2018. The proposal would have effect from 1 July 2019.	

Costing overview

Policy background

Dividend imputation applies to some Australian-source dividend income, reducing the amount of income tax paid by Australian resident shareholders.

Under the dividend imputation system, Australian resident companies that distribute dividends from after-tax profits have the option of passing on franking credits (also known as imputation credits) to their shareholders, attached to the dividends they receive. This provides shareholders with a credit for the tax that a company has paid on its profits.

Shareholders include an amount equal to the franking credit attached to their dividend in their assessable income for tax purposes. Australian residents and complying superannuation funds are entitled to claim a tax offset equal to the amount of franking credits included in their income.

This franking credit can be used to reduce a taxpayer's tax liability from all forms of income, although non-refundable offsets do not reduce a taxpayer's Medicare levy liability. Currently, any excess franking credits are refunded to the taxpayer by the Australian Taxation Office (ATO).

Under the proposal, franking credits would become non-refundable for individuals who do not receive an Australian Government pension or allowance, and for superannuation funds, except for self-managed superannuation funds with at least one member who was a recipient of an Australian Government pension or allowance recipient before 28 March 2018. Under the proposal, franking credits would be able to reduce an individual's personal income tax liability, including Medicare levy liability, to zero.

Financial impact

The proposal would be expected to increase the fiscal and underlying cash balances by $14,297 million over the 2019-20 Budget forward estimates period. This impact reflects an increase in revenue of $14,300 million, partially offset by an increase in departmental expenses of $3 million over this period.

The proposal would be expected to have an ongoing impact that extends beyond the 2019-20 Budget forward estimates period. The detailed financial implications of the proposal over the period to 2029-30 are included at Attachment A.

Table 1: Financial implications ($m)[(a)(b)]

	2019-20	2020–21	2021–22	2022–23	**Total to 2022–23**
Fiscal balance	-103	4,400	4,800	5,100	**14,297**
Underlying cash balance	-103	4,400	4,800	5,100	**14,297**

(a) A positive number represents an increase in the relevant budget balance; a negative number represents a decrease.

(b) Figures may not sum to totals due to rounding.

Uncertainties in the costing

The costing is subject to uncertainties surrounding income and population growth rates, changes in the number of individuals and superannuation funds with excess franking credits, changes to dividend payout ratios, relative returns between asset classes, preferences of self-managed superannuation fund account holders, volatility in the earnings of companies that pay franked distributions, and behavioural responses to superannuation measures that generally applied from 1 July 2017. At this point, data that reflect the superannuation changes applying from 1 July 2017 are not yet available. There are also significant uncertainties around the behavioural responses of affected individuals, superannuation funds and companies to the proposal.[1]

The costing incorporates the effect of all existing government policies. These include the planned reductions in personal income tax and company tax (including the 2019-20 Budget measure *Lower taxes for hard working Australians: Building on the Personal Income Tax Plan* and the 2018-19 Mid-Year Economic and Fiscal Outlook (MYEFO) measures *Company Tax – not proceeding with tax reductions for large companies* and *Small Business Package – lower taxes for small and medium businesses*), changes to age pension asset test thresholds, and the transfer balance cap of $1.6 million for pension phase superannuation accounts.

Key assumptions

The Parliamentary Budget Office (PBO) has made the following assumptions in costing this proposal.

Behavioural responses

- Individuals and superannuation funds that are affected will respond to the proposal in order to reduce its impact.

[1] There are inherent uncertainties in all policy costings, regardless of who produces them. For a more detailed discussion of the nature and sources of these uncertainties, see PBO information paper no. 01/2017, *Factors influencing the reliability of policy proposal costings.*

  - For individuals, potential behavioural responses could include shifting from shares to alternative investment arrangements (including to investments within superannuation), and couples shifting the ownership of shares from the lower income earner to the higher income earner such that the higher income earner can use the franking credits as a non-refundable tax offset.
  - For superannuation funds, potential behavioural responses could include rolling assets from a fund with negative net tax to a fund with positive net tax (including from a self-managed superannuation fund to an APRA-regulated fund), changing funds' asset portfolio allocations, or changing the membership structure of the fund, in order to maximise the utilisation of franking credits.
  - In the absence of a behavioural response from individuals and superannuation funds, the expected revenue gain from the proposal would be around 18 per cent ($10.7 billion) higher over the period to 2029-30.
- Some companies would bring forward the payment of dividends that would have been paid in the 2019-20 financial year to the 2018-19 financial year to limit the impact of the proposal on their shareholders.
  - This behavioural response leads to a relatively small reduction in revenue in both 2019-20 and 2020-21.
  - In addition to this one-off behavioural response, companies may also respond to the proposal by changing the amount of dividends distributed (and profits withheld) or by entering into more aggressive tax planning and paying more unfranked dividends due to the decrease in the value of franking credits for some shareholders.
    - This behavioural response has not been separately incorporated into this costing as the size and direction of the revenue impact is highly uncertain.

Age pension eligibility and payments

- The exemption applying to pensioners would increase the incentives for individuals to draw down on their assets in order to qualify for the age pension. The impact of this would be expected to be small and has been rounded to zero.
  - There are already strong incentives for individuals to reduce their assets in order to qualify for the age pension, particularly for those with assets just above the threshold for the age pension asset test. For most individuals affected, the proposal would have little impact on these incentives.
  - While some individuals may choose to reduce their assets and qualify for the age pension as a result of the proposal, this would be unlikely to materially affect the costing.
- The impact on payments to Australian Government pension and other income support recipients due to changing the tax treatment of franking credits would not be significant over the period to 2029-30.
  - Over the longer term, the proposal may lead to changes in assets held directly by (or through the superannuation accounts of) individuals, which may subsequently result in a change in means-tested payments. The PBO does not expect this impact to be significant over the time period examined.

Methodology

- The costing was based on a 16 per cent sample of de-identified personal income tax and superannuation returns (including self-managed superannuation funds) for the 2016-17 financial year.
- The data were used to estimate the total excess franking credits issued to individuals and superannuation funds that would be denied under the proposal, incorporating the pensioner exemptions and allowing franking credits to offset the Medicare levy liability. Adjustments to the base data were made to account for the transfer balance cap applying to superannuation accounts with balances exceeding $1.6 million and other relevant policies not in place in 2016-17.
- The adjusted data were projected over the period to 2029-30, taking into account the scheduled changes to personal income tax and company tax, and the assumed behavioural responses outlined above.
- The modelling has taken into account the timing of tax collections.
- Departmental expenses were estimated based on amounts allocated to the ATO for measures with similar administrative complexity.
- Revenue estimates have been rounded to the nearest $100 million. Departmental expense estimates have been rounded to the nearest $1 million.

Data sources

The ATO provided a 16 per cent sample of de-identified personal income tax returns for the 2016-17 financial year and the complete file of tax returns for superannuation funds (including self-managed superannuation funds) for the 2016-17 financial year.

The Treasury provided economic forecasts for personal and superannuation tax as at the 2019 Pre-election Economic and Fiscal Outlook.

RiceWarner, 2018. *Superannuation Market Projections*, Sydney: Ricewarner.

Attachment A – Reforming dividend imputation – financial implications

Table A1: Reforming dividend imputation – Fiscal and underlying cash balances ($m)(a)(b)

	2019–20	2020–21	2021–22	2022–23	2023–24	2024–25	2025–26	2026–27	2027–28	2028–29	2029–30	Total to 2022–23	Total to 2029–30
Revenue													
Superannuation funds	*-100*	*2,500*	*2,800*	*3,000*	*3,200*	*3,400*	*3,700*	*3,900*	*4,100*	*4,400*	*4,600*	***8,300***	***35,600***
Individuals	*..*	*1,900*	*2,000*	*2,100*	*2,200*	*2,200*	*2,400*	*2,400*	*2,400*	*2,500*	*2,500*	***6,000***	***22,600***
Total – revenue	**-100**	**4,400**	**4,800**	**5,100**	**5,400**	**5,600**	**6,100**	**6,300**	**6,500**	**6,900**	**7,100**	**14,300**	**58,200**
Expenses													
Departmental													
Australian Taxation Office	*-3*	-	-	-	-	-	-	-	-	-	-	***-3***	***-3***
Total – expenses	**-3**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-3**	**-3**
Total	**-103**	**4,400**	**4,800**	**5,100**	**5,400**	**5,600**	**6,100**	**6,300**	**6,500**	**6,900**	**7,100**	**14,297**	**58,197**

(a) A positive number for the fiscal balance indicates an increase in revenue or a decrease in expenses or net capital investment in accrual terms.
A negative number for the fiscal balance indicates a decrease in revenue or an increase in expenses or net capital investment in accrual terms.
A positive number for the underlying cash balance indicates an increase in receipts or a decrease in payments or net capital investment in cash terms.
A negative number for the underlying cash balance indicates a decrease in receipts or an increase in payments or net capital investment in cash terms.

(b) Figures may not sum to totals due to rounding.

.. Not zero but rounded to zero.

\- Indicates nil.