



An Unnecessary Giveaway? Refunds of Franking Credits

ISA Submission to the House of Representatives
Economics Committee

About Industry Super Australia

Industry Super Australia is a research and advocacy body for Industry SuperFunds. ISA manages collective projects on behalf of a number of industry super funds with the objective of maximising the retirement savings of over five million industry super members. Please direct questions and comments to:

Phil Gallagher PSM
Retirement Policy Adviser

pgallagher@industriysuper.com

Matt Linden
Deputy Chief Executive

mlinden@industriysuper.com

Dr Stephen Anthony
Chief Economist

santhony@industriysuper.com

ISA Pty Ltd ABN 72 158 563 270 Corporate Authorised Representative No. 426006 of Industry Fund Services Ltd
ABN 54 007 016 195 AFSL 232514

Contents

Key Points	3
Introduction	4
Taxation Principles	5
Incidence and the economic circumstances of non-pension recipients of refunds of franking credits	8
Impact on funds	9
Behavioural change	10
Impact on markets	10
Revenue sustainability	11

Figures

Figure 1: Personal Tax Paid by Non-Senior - Different portfolios and contrast of Dividend offset versus refundable credit	6
Figure 2: Disposable Income of Non-Senior - Different portfolios and contrast of Dividend offset versus refundable credit	6
Figure 3: Personal Tax Paid by Senior - Different portfolios and contrast of Dividend offset versus refundable credit	7
Figure 4: Disposable Income of Senior - Different portfolios and contrast of Dividend offset versus refundable credit	7

Key Points

Taxation Principles:

- Australia's imputation system is an important feature of our taxation regime. It prevents Australian taxpayers, whether individuals or entities including superannuation funds, from paying double taxation. An offset for franked dividends is completely sufficient to prevent double taxation.
- Virtually all rebates in the personal taxation system are offsets, not credits. The notion that rebates should be taxed at the person's marginal tax rate is a made-up principle which in this case appears to have been advanced to justify costly cash transfers to very wealthy cohorts who do not pay tax.
- The dividend imputation credit is not neutral and would appear to distort personal tax neutrality.
- The dividend imputation credit gives lower income retirees a major incentive to invest in a risky rather than balanced fashion. In addition to market risk, there is also significant sovereign risk for (so-called) blue chip investments because of the market behaviour of many large companies.

Incidence and the economic circumstances of non-pension recipients of refunds of franking credits:

Original analysis of ABS and ATO unit record data by the Treasury's former Manager of Retirement and Income Modelling shows that the non-pensioner recipients of refunds of franking credits constitute just 4 percent of the adult population. Credit recipients hold significant wealth and that the loss of the refund will have little impact on their spending capacity.

- For example, For retired non-pensioners aged 65 and over with no tax liability -
 - 85% are in the top wealth quintile of households;
 - The total group had an average non-home wealth of \$1.60 million;
 - If we include the value of the family home less any loans, their total wealth was \$2.49 million.
- In 2015-16 the average SMSF member benefit payment was \$127,252 and the average member balance for beneficiaries aged 65 to 69 was \$1,012,869. In addition, SMSF payment recipients are highly likely to have other investment income.

For those non-pensioner retirees 65 and over receiving refunds from the personal tax system the median refund in 2015-16 was \$586 (50% receive less), the mean \$1,878 and the 90th percentile was \$5,228. A 7% drawdown on the average non-home household assets of this group (\$1.6 million) would give \$112,000. Added to the mean taxable income of this group of \$16,206 the average spending potential of a retiree household receiving refunds would exceed \$130,000. Accordingly the impacts of converting franking credits from credits to offsets would not appear to spell financial disaster for a group with such considerable means.

Behavioural change:

Those receiving credits in the personal tax system would have little reason to change behaviour, although some may choose to make their investment mix less risky.

Impact on Markets

We anticipate the proposed policy will have minimal or no impact on a diversified share portfolio with a long-term investment horizon. Also, the short term effects of the policy will, more than likely, be subsumed by normal market volatility and fundamental global economic and valuation issues.

Impact on Funds:

The impact of restricting imputation to offset tax liabilities will have little impact on the circumstances of members in funds which pay tax irrespective of sector. This includes members in the tax free retirement phase when the fund they are a member of pays net tax on account of contributions and investment earnings of accumulation phase members.

Revenue Sustainability:

The Parliamentary Budget Office (PBO) forecasts of revenue from making franking credits into offsets demonstrate that the change will add significantly to the sustainability of the revenue base affording greater flexibility to meet the fiscal demands of an aging population including remedying savings disincentives from the age pension asset test.

Introduction

Dividend imputation was introduced by the Hawke-Keating Government as a way of preventing the double taxation of dividends as part of the profits of companies and as personal income for the investor. In this system, the franked amount was added to taxable income and a **tax offset** of the same size prevented taxation of the amount and lowered taxation of the dividend.

The tax offset was fully sufficient to prevent double taxation of the dividend.

In his second reading speech for the Bill on 2 April 1987, Paul Keating made it crystal clear that the purpose of the Bill was to remove double taxation. He began:

This Bill will give effect to the most significant business taxation reform in this country in the post-war years-the elimination of the double taxation of company dividends.

Keating made no mention of a principle that people should pay tax at their marginal tax rate on dividends.

He made non-refundability clear:

For resident individual shareholders on lower rates, imputation credits attached to franked dividends will exceed the tax payable on the franked amount of the dividends. The excess rebate will be available to offset tax on other income, including unfranked dividends and capital gains, but will not be refundable where it exceeds such tax, and will not be offset against the Medicare levy. Imputation credits attached to franked dividends will not form part of separate net income for dependent rebate purposes, but will be included in the Medicare levy tax base.

Nevertheless, in 2000 the Howard-Costello Government converted the offset to a **credit**, which meant that retirees with lower taxable income could get cash payments from the Government. In 2007 Treasurer Costello made funded superannuation payments tax free for people 60 and over who had ceased an employment arrangement. This led to a huge surge in the creation of SMSFs, particularly by people who could utilise the business real property exemptions, limited recourse borrowing arrangements, capital gains tax exemptions or franking credit refunds available through an SMSF in the retirement phase.

In March 2018 the Australian Labor Party announced a policy of converting franking credits to franking offsets which exhaust when there is no tax liability. Costings from the Parliamentary Budget Office (PBO) showed that the policy would address a significant and growing revenue loss.

This submission will complement the PBO analysis by demonstrating that the vast majority of retirees will be unaffected by the proposal and the wealthy are the beneficiaries of most of the refunds of franking credit for non-pensioners. It will also show that the refunds do not result in tax neutrality for individuals and could inappropriately incentivise lower income retirees to adopt risky portfolios overweight in dividend paying stocks.

The proposal for a return to a franked dividend offset is sufficient to prevent double taxation for tax paying entities (such as most APRA regulated superannuation funds) and it is unlikely to lead to hardship, or behaviour change by individuals or companies.

Taxation Principles

An offset for franked dividend is completely sufficient to prevent double taxation. A non-taxable person does not pay tax again on the same dividend.

Virtually all rebates in the personal taxation system are offsets, not credits. Examples include the Seniors and Pensioners Tax Offset, the Low Income Tax Offset, the new Low and Middle Income Tax Offset and the Beneficiary Tax Offset. In addition to non-refundability, most offsets have a maximum cap and are income tested.

There are some payments which are incorrectly called offsets, and which are treated in budget accounting as expenses. The Low Income Superannuation Tax Offset continues to be administered as an expense using taxation information for administration. It is income tested and capped in order to deliver targeted redress for those who otherwise would have a negative superannuation tax concession or a very small concession.

The notion that rebates should be taxed at the person's marginal tax rate is a made-up principle which, in the case of franking credits, is being used to justify costly cash transfers to objectively wealthy cohorts who do not pay tax.

The dividend imputation credit is not neutral. It distorts personal tax neutrality. Charts 1 to 4 compare the net tax paid in five scenarios -

- A taxpayer who has 100% of their income from net rent (or other taxed sources not attracting rebates such as wages or interest);
- A tax lodger who has 100% of their income from dividends which have a franking offset;
- A tax lodger who has 100% of their income from dividends which have a franking credit;
- A tax lodger who has 40% of their income from dividends which have a franking offset and the remainder from net rent; and
- A tax lodger who has 40% of their income from dividends which have a franking credit and the remainder from net rent.

Figure 1 shows that the refund of tax for the non-senior 100% dividend case continues up to a dividend amount of \$98,000 before a single dollar of personal tax is paid. In the 40% dividend case, it continues up to \$40,000. This refund gives a large incentive to move from returns without credits to franked dividends. This additional refund may distort portfolios towards riskier equity investments. Many of the large finance, telecommunications and electricity generation companies offering fully franked dividends have been subject to scrutiny by Royal Commissions, reviews or threatened price capping. The response to the behaviour of these companies has had a predictable impact on share price.

Figure 1: Personal Tax Paid by Non-Senior - Different portfolios and contrast of Dividend offset versus refundable credit

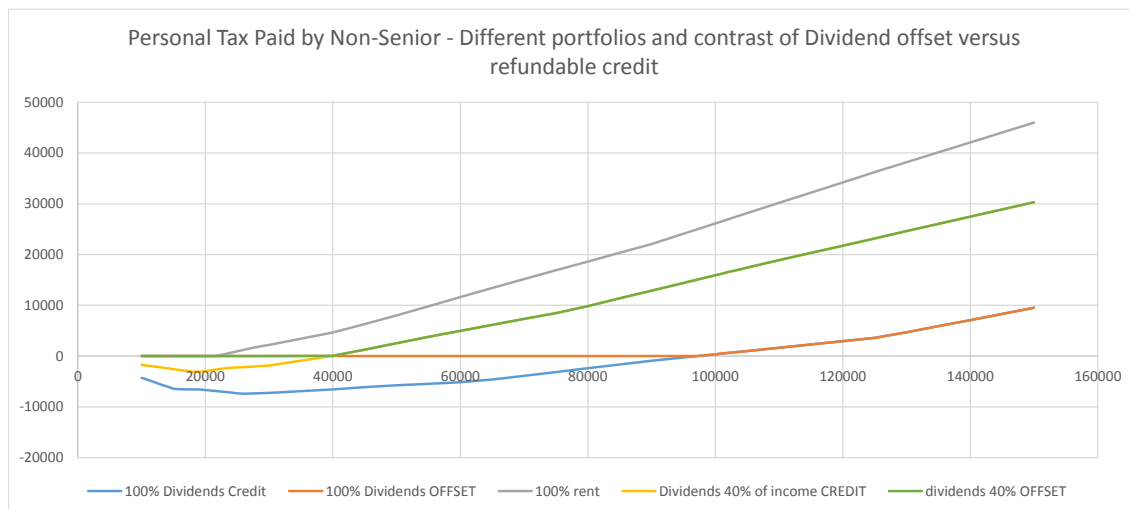
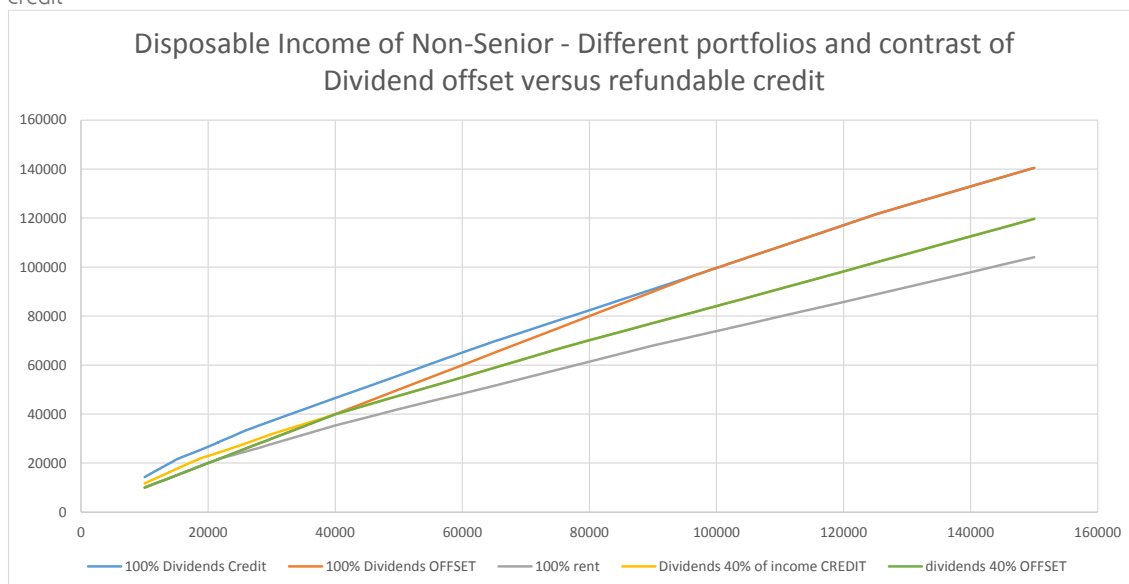


Figure 2 shows how the advantage of credits flows through to the disposable income of non-seniors.

Figure 2: Disposable Income of Non-Senior - Different portfolios and contrast of Dividend offset versus refundable credit



Figures 3 and 4 shows the impact on non-pensioners of age pension age eligible for Senior Australians & Pensioners Tax Offset (SAPTO). The disposable income chart shows that a dividend recipient with an offset achieves the same level of disposable income as one with a credit when the one with the credit begins paying tax.

Figure 3: Personal Tax Paid by Senior - Different portfolios and contrast of Dividend offset versus refundable credit

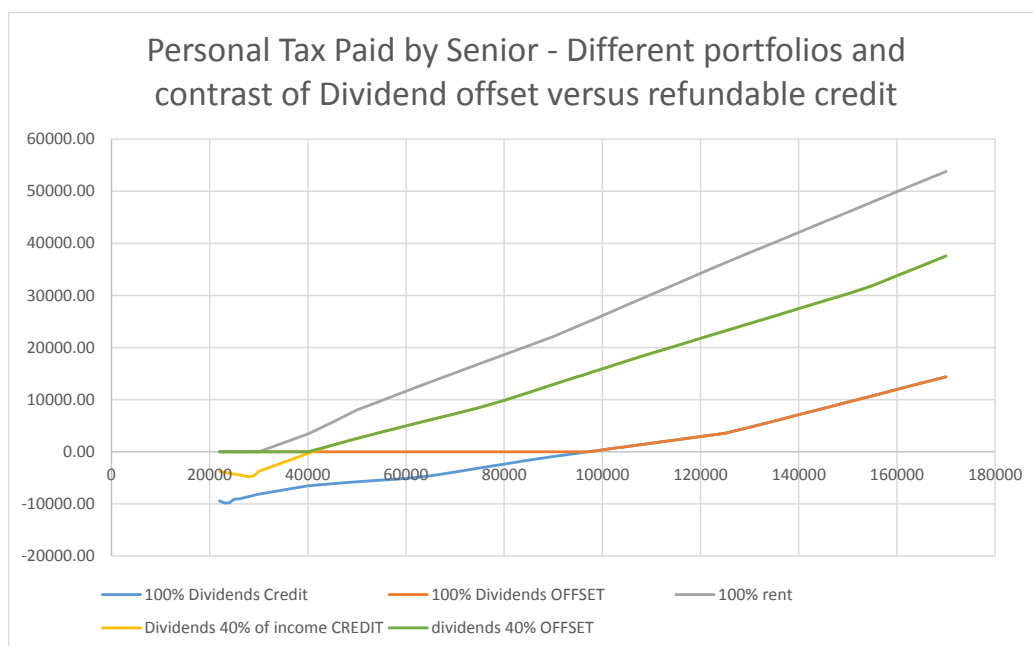
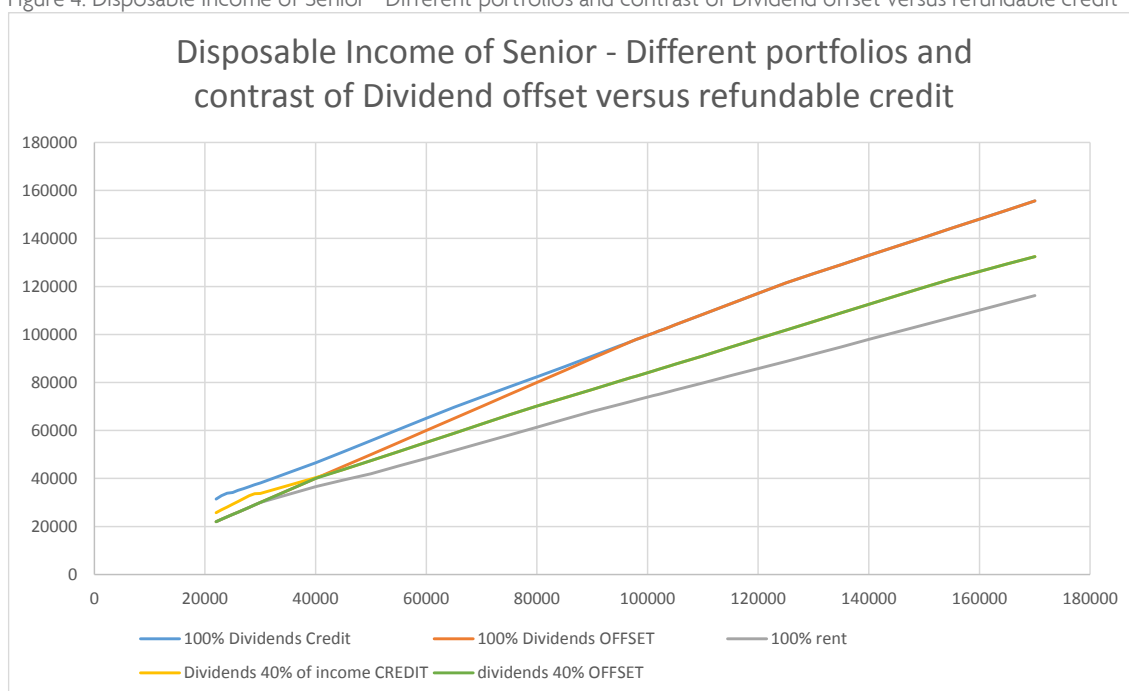


Figure 4: Disposable Income of Senior - Different portfolios and contrast of Dividend offset versus refundable credit



Incidence and the economic circumstances of non-pension recipients of refunds of franking credits

ISA has undertaken original analysis of two authoritative unit record files in order to examine the incidence and wealth and incomes of non-pensioner recipients of franking credit refunds¹. The 2015-16 ABS Survey of Income and Housing was analysed to estimate the household wealth of non-taxpayers with dividend income. The 2015-16 ATO 2% sample file of personal tax and superannuation records was analysed to obtain administrative based estimates of the income and superannuation assets of non-pensioner refund recipients.

The analysis of household wealth uses the 2015-16 ABS Survey of Income and Housing. It matches wealth of the household back to the person records. This brings all property into the analysis as well as financial assets. Liabilities are subtracted. The analysis matches the ABS net wealth measure for households and its estimate of shares owned by individuals.

Table 1 below shows the incidence of the receipt of franking credits of non-pensioner taxfilers as a proportion of the adult population:

Age Cohort	Non-recipients	Recipients
Under 65	98%	2%
65 and Over	89%	11%
All	96%	4%

Source: ISA analysis of the 2015-16 ATO 2% sample file and 2015-16 Survey of Income and Housing

There has been focus on the measure as a “retirement tax” (even though it is not a tax). It makes sense to discuss the results for people 65 and over first.

For retired non-pensioner/allowees 65+ with no tax liability (as imputed by ABS) who receive cash credits:

- 85% are in the top wealth quintile of households;
- Two thirds (66%) have non-home assets worth \$1 million or more;
- The total group had an average non-home wealth of \$1.60 million;
- If we include the value of the family home less any loans, their total wealth was \$2.49 million.

If the retirement restriction is removed to look at all 65+ non-pensioner/allowees with no tax liability and estimates of franking credits the means go up.

For those 65 and over potentially impacted by the conversion of a credit to an offset:

- 86% are in the top wealth quintile of households;
- The total group had an average non-home wealth of \$1.65 million;
- If we include the value of the family home less any loans, their total wealth was \$2.54 million.

The ATO sample file gives personal superannuation balance estimates which are consistent with the ABS household estimates. The average personal superannuation balance for people 65+ with refunds and super is \$558,000 (a balance which exceeds 96% of all individuals with superannuation and 86% of all individuals aged over 65 with superannuation). This is for one person, and many retiree households with super and dividend income will contain a couple. The ATO file does not provide estimates of the size of other financial assets or of investment and business property.

As you would expect, the wealth accumulations of those under 65 are comparatively lower but still impressive:

¹ The analysis was undertaken by Phil Gallagher PSM who managed retirement income modelling in Treasury from 1993 to 2013, as well as personal taxation and family payment costings and analysis from 2003 to 2007. He also led the demographic, economic and fiscal projections of the first three intergenerational reports.

- 49% of the zero tax liability group who are not on income support are in the top wealth quintile of all households;
- The total group had an average non-home wealth of \$1.11 million ;
- If we include the value of the family home less any loans, their total wealth was \$1.76 million.

For comparison, if we remove the share, zero tax and income support filters, the corresponding statistics for all persons under 65 are:

- 22% of the persons are in the top wealth quintile of all households;
- The total group had an average non-home wealth of \$0.59 million ;
- If we include the value of the family home less any loans, their total wealth was \$0.95 million.

Basically the group under 65 with shares and no tax liability have twice the assets of the general population under 65. They are not poor people.

Taxable income is USELESS as a guide to the economic circumstances of retirees and people approaching retirement. Drawdowns from assets are basically not taxable income. Advocates who use taxable income to discuss the economic circumstances of people who are not wage earners paint a misleading picture.

The ABS survey is designed to capture assets in SMSFs, but they may be underreported.

In 2015-16 the average SMSF member benefit payment was \$127,252 and the average member balance for beneficiaries aged 65 to 69 was \$1,012,869. In addition, SMSF payment recipients are highly likely to have other investment income.

The ATO 2% sample file for 2015-16 is the basis of estimates on the likely size of refunded franking credits. For those non-pensioner retirees 65 and over receiving refunds from the personal tax system the median refund in 2015-16 was \$586 (50% receive less), the mean \$1,878 and the 90th percentile was \$5,228.

A 7% drawdown on the average non-home household assets of \$1.6 million would give \$112,000. The mean taxable income of the group was \$16,206. The average spending potential of a retiree household receiving refunds would exceed \$130,000.

For those non-pensioners under 65 and over receiving dividend imputation refunds from the personal tax system the median refund in 2015-16 was \$235 (50% receive less), the mean \$1,304 and the 90th percentile was \$3,645.

The impacts of converting franking rebates from credits to offsets would not spell financial disaster for a group with such significant means.

Impact on funds

Like other Australian taxpayers APRA regulated superannuation funds utilise dividend imputation to avoid double taxation of investment income derived from equity holdings in Australian companies that pay corporate tax and pay franked dividends.

Importantly superannuation funds pay tax at the fund level not individual member level. Large pooled funds typically incur substantial tax liabilities arising from contributions tax and investment earnings which results in imputation credits being fully utilised offsetting tax liabilities of the fund.

The tax benefit of these credits and earnings tax otherwise applicable to individual members usually flows through relevant investment crediting rates or unit pricing applied to individual member accounts. The objective of crediting rate and unit pricing mechanisms is to ensure members are treated equitably in a pooled investment environment.

These arrangements also apply to both pooled multi asset investment options (including the default) as well single asset class options with exposure to equities that pay franked dividends.

Accordingly the post-tax investment returns of members in funds which normally have tax liabilities – regardless of sector – are unlikely to be affected by proposals to restrict imputation so that credits are non-refundable. This treatment will also typically extend to SMSF's with assets in the accumulation phase.

Behavioural change

Those receiving credits in the personal tax system would have little reason to change behaviour, although some may choose to make their investment mix less risky.

It is also relevant to consider individuals who are impacted in superannuation funds that pay no tax and receive significant cash credits – especially SMSF's in the tax free retirement phase.

Some behavioural changes could be expected although it is likely to only be at the margins and not result in fund arbitrage as members seek out opportunities to minimise the impact.

We would not expect those who have gone to the trouble and expense of establishing an SMSF to wind it up in favour of an APRA regulated fund. For example high net worth individuals in SMSF's that have exceeded their balance cap will likely hold Australian shares in their taxable component using credits to reduce tax. We also do not expect many with SMSF's to cash out their benefits into non super investments as most pay personal tax despite the SAPTO.

For lower balance SMSF's they are unlikely to roll over into APRA regulated funds if they haven't already for a number of reasons including:

- Poor diversification and insufficient Australian shares to justify holding duplicated accounts;
- Transaction costs which might include CGT, brokerage and buy-sell and exit fees depending on the nature of the current Australian shares holding in the SMSF;
- The likelihood a lower balance SMSF may be exempt anyway due to the Pensioner guarantee;
- The use of other options such as encouraging a younger family member in the accumulation phase to join the fund.

Impact on markets

We anticipate that ALPs policy will have **minimal or no** impact on a diversified share portfolio with a long-term investment horizon. Also, the short term effects of the policy will, more than likely, be subsumed by normal market volatility and fundamental global economic and valuation issues.

According to the equity returns model, the proposed saving directly affects the cash yield of a stock, reducing the after tax dividend income and so overall return for some investors. Presumably this results in an offsetting fall in share price. These could be described as the immediate impacts of the policy. However, it is likely the longer term impact of the policy are all positive.

The price market impacts of the proposed change are mainly limited to a collection of listed ASX companies that attracts investors seeking income rather than growth from their shareholdings i.e. yield investors. Typical shares would include Telstra, the big-four banks, supermarkets, big miners etc that pay dividends. The impact of the proposed policy on the prices of these shares and the overall market depends on:

- the holdings of these stocks by super funds in retirement phase and SMSF funds held in retirement balances.;
- the potential to restructure investment portfolios in advance of the proposed policy implementation on 1 July 2019 to take advantage of income streams incurring tax liabilities; and
- the extent to which the impacts of the policy fully or partially are already factored into the prices of certain shares.

In terms of the overall market impact, higher yielding dividend stocks which earn franking credit refunds form only part of the Australian equity market (around 37 per cent).

Indeed, only those taxpayers with low taxable income will be worse off under the proposed changes representing 11 per cent of those 65+, and 3.1 per cent of the ASX market.

As previously noted much of the potential behavioral tax effect of the proposed change has already been captured by the Government's \$1.6 million cap on retirement balances introduced in the 2017-18 Budget.

Any taxpayers that are still left worse off have options to mitigate the impact of the franking credit changes:

- High wealth individuals that hold around half of all assets invested in SMSFs which also hold around 30 per cent of their allocations in equities (historically the mainstay's demanders of dividend favorite shares) are certainly financially savvy enough to find ways to mitigate the financial impact of the proposed changes.
- Perhaps they may seek to sell some or all of their existing holdings or reallocate their portfolios using trusts, managed funds, exchange traded funds and international equities.
- These reallocations will tend to dampen any overall market impact on any particular listed share.
- More forward looking markets actors including larger institutions may have already priced in some or all of the impact of proposed changes discounted by probabilistic electoral calculus.

Presumably the 'immediate impact' of the changes depends to some degree on the influence of the marginal foreign investor (i.e. some retail investors might shift out of the banks etc. and move to other assets, while foreign investors might pick up the market slack).

In the final analysis, tax policy should never determine nor distort the savings-investment decision of investors towards certain companies and away from others without a sound policy rationale, for example, productivity enhancing investment. To the extent that the proposed policy will result in a shift in portfolios over time, it will see tilts towards growth or value businesses and away yield plays. These portfolio reallocations are both likely to benefit investors' portfolio balances and raise productivity and living standards across the Australian economy in the longer-term.

For example columnists (AFR, Greber 2015) have characterized tax policy in terms of the reluctance of Australian firms to undertake CAPEX via the re-investment of profits and the preference for the distribution as franked dividend as short-termism. As such many ASX listed companies had an overemphasis on delivering franked dividends.

Revenue sustainability

Annual cash imputation credits paid to non-pensioners with shareholdings are significant. In dollar terms they are broadly equivalent to total annual expenditure on Veterans Affairs income support and disability payments.² The PBO forecasts of revenue from converting franking credits into offsets demonstrate that the change will add significantly to the sustainability of the revenue base.

According to the ALP's revised policy (announced 27 March 2018) it will increase revenue by \$10.7 billion over the forward estimates and \$55.7 billion over the medium term. If realised this will provide the budget with significant additional fiscal flexibility to retire debt and respond to the challenges of an aging population particularly growing pressures on health and aged care. It would also provide some flexibility to improve the coherence of retirement income policy as circumstances allow including addressing savings disincentives caused by the age pension asset test which will increasingly act to undermine additional superannuation savings of middle income cohorts, and closing the gender super gap.

² In 2018-19 estimated expenditure on Veterans Income Support, Disability Support and Assistance to Defence Widows and dependents is \$5.1b (P 28 of 2018-19 Portfolio Budget Statement Department of Veterans Affairs -table 2.1.1)