Media Release (UNDER EMBARGO UNTIL MIDNIGHT SUNDAY 6 MAY 2018)

New Alliance wants fairer retirement outcomes for all Australians

7 May 2018: Several associations have formed the "Alliance for a Fairer Retirement System" to explore options to fix problems with the existing superannuation taxation, Age Pension means testing and broader retirement income systems. The formation of the Alliance is in response to Labor's proposal to disallow refunds of excess franking credits for a range of retirees and shareholders.

The Australian Shareholders' Association, Australian Listed Investment Companies Association, National Seniors Australia, SMSF Association, Self-managed Independent Superannuation Funds Association and Stockbrokers & Financial Advisers Association have formed the Alliance to work together on this important issue. We expect more groups to join the Alliance shortly.

These associations represent millions of senior Australians, shareholders, self-funded retirees and those planning a sustainable retirement, including over one million members of self-managed super funds.

The spokesperson for the Alliance, Professor Deborah Ralston, said: "I am very pleased that the Alliance has been formed as it will contribute substantially to the debate on improving retirement outcomes for millions of Australians.

"We need more evidence-based research and policy development and increased bipartisan support to complete the development of Australia's retirement income system. Once that development has been completed, there needs to be a period of ongoing stability for the system so that Australians can plan for their retirement with confidence."

"Providing for retirement requires trust that the system won't change," said Judith Fox, the CEO of the Australian Shareholders' Association. "Having a self-funded retirement income requires long-term planning and stability. Ad hoc policy changes erode trust and don't meet the need for a sustainable retirement savings plan. We need policy that looks at the superannuation and tax systems comprehensively rather than cherry picking elements to raise revenue."

"National Seniors' charter is to improve the lives of all older Australians," said Ian Henschke, National Seniors Australia Chief Advocate. "Let's hope this issue triggers a broader debate on systemic tax reform to fund sustainable, fair, private and public pensions. We'll be working hard for that outcome."

The CEO of the SMSF Association, John Maroney, welcomed the creation of the Alliance and stressed the need for clear communication on key issues. "Let's talk about 'company paid tax credits' rather than 'franking credits' because that's what the issue is. Companies have already paid tax on behalf of their shareholders; hence it is appropriate for those tax credits to be available for all shareholders."

Michael Lorimer, Managing Director, Self-Managed Independent Superannuation Funds Association (SISFA), added "The consequences of this proposed policy will hurt real people who are not wealthy. Just because you have a SMSF or small APRA fund does not mean you are "wealthy". Labor's proposed policy will change investment behaviour which may drive more people onto reliance on the Age Pension. The announced carve-outs are arbitrary and mean there may be more complexity and unfair consequences will ensue."

The Alliance is considering a report prepared by Michael Rice, CEO of Rice Warner, on the implications of Labor's proposed policy on franking credits. That report clearly exposes many of the poor design features of the policy and the unlikelihood that the projected revenues will eventuate if the policy was implemented. The Alliance will commission and encourage further research and policy discussion on these topics and intends to convene a summit later this year on retirement system design.

"Labor's proposal will cause a distortion of the market and give an unfair advantage to large taxpaying superannuation funds at the expense of everyday Australians who have worked hard, paid their taxes and carefully saved for their retirement through their SMSF or small APRA fund," said Andrew Green, CEO of the Stockbrokers & Financial Advisers Association.

The Alliance calls on all political parties to carefully consider issues related to superannuation taxation and retirement design and to ensure that policy development is undertaken on a holistic basis and not via ad hoc steps in response to short-term revenue objectives or political objectives that could undermine confidence in the retirement system. Other associations who share these concerns are invited to join the Alliance.

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2 May 2018

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Dear Andrew and John

Removing the refundability of franking credits

I refer to our discussions around Labor's proposed changes to the refundability of franking credits. You have asked Rice Warner to analyse the likely impact of these changes should the proposal be implemented. In particular, you want us to assess the potential impact of this new tax on the Australian equity market.

The dividend imputation system

Dividend Imputation was introduced in Australia in 1987 to avoid the double taxation of company dividends. It was extended to superannuation funds a year later. Australian companies provide a franking credit for each dividend payment based on the company taxes paid. The credit, which is fully franked if the company has paid sufficient tax, is attached to the dividend. If insufficient taxes have been paid, the dividend will be partly franked, and a lower credit will apply. In cases where companies have losses carried forward or where most of income is generated abroad, the dividend might be unfranked with no credit attached.

When a taxpayer completes their own tax return, they receive a credit for the company tax paid. As an example, if a company pays a fully franked dividend of $70, this will include an imputation credit of $30 based on the current tax rate for large companies of 30%. For their own tax return, the taxpayer will record taxable income of $100 from the dividend together with a credit of $30 tax already paid. The credit applies similarly to PAYG tax instalments and is deducted from any tax due in the taxpayer's own return.

The system was made more generous from July 2000 when the franking credits became refundable if they exceeded the owner's tax obligation. This meant that superannuation funds investing mainly in Australian shares effectively use the franking credits to generate a refund from the ATO following lodgement of their tax return.

Superannuation funds are taxed as an entity with taxable income being concessional contributions and investment earnings. Capital gains (if the share has been held for at least 12 months) are taxed at two-thirds

the tax rate (that is 10%). The fund's costs including insurance premiums are allowable deductions from taxable income.

The tax in a superannuation fund is allocated to all members based on their own situation – are they in accumulation or pension phase, have they paid concessional contributions and what investment strategy are they in? Although the assets are pooled, they are notionally separated for tax purposes.

A gross return (net of investment fees) is allocated to those in the pension phase and a return net of tax (and investment fees) is allocated to accumulation members. Effectively, all members pay the tax attributable to them, and, if they are in pension phase (retirees), they will be allocated the full franking credit on the equities within their investment strategy.

It should be noted that there is no difference in taxation between APRA-regulated funds and SMSFs. There are structural differences, including the pooling of investments into various strategies in APRA funds. Some APRA-regulated funds allow members to hold direct investments, particularly of listed shares, so, for some members, they replicate the investment structures used by many SMSFs.

This system has encouraged investment in Australian shares both directly and via pooled vehicles such as LICs and ETFs. It has also led to Australian companies paying higher dividends than those in other regimes. For example, in the USA, where there is double taxation of corporate dividends, it is more common for a company to pay smaller dividends (if any) and to use retained earnings to invest in growth of the business. This tends to increase the capital value of the company, which is desirable when tax on capital gains is lower than the tax on dividends.

Proposed changes by the Federal Opposition

In March, the Federal Opposition, via a speech from the Opposition Leader, Bill Shorten, announced that, if elected, it will remove the refundability of franking credits. It initially claimed that this policy would save about $59 billion over a decade, including around $11.4 billion over the final two years of current forward estimates and would primarily affect around 200,000 SMSF funds with higher balances.

The rationale for the tax increase was that the concession had grown from $550 million to $5.6 billion in 15 years and had become unaffordable. While this is a large amount when viewed in isolation, it reflects the sensible strategy of investors and superannuation funds, particularly retirees, investing in the growth of the Australian economy. Labor was quick to blame the Howard government for the cost, but it had six years of government, in which it ran a major review of tax (Henry) and of superannuation (Cooper) where these apparent failings were not raised.

It appears that the change was not thought through and the day after the Opposition leader's speech, Labor released a statement that the Future Fund, which receives nearly $1 billion a year in tax refunds would be exempt. After a few weeks, there was concern about the impact on several hundred thousand Age Pensioners, and it was decided to exempt anyone receiving welfare payments from the new tax. It also exempted any SMSF with a member receiving the Age Pension on the day of the announcement (28 March). However, all SMSFs with future retirees receiving even a small part-pension will not qualify for the exemption.

In our opinion, the new tax is flawed and will not deliver the revenue expected by Labor:

- It is product-specific, attacking all SMSFs but few other types of superannuation funds.
- It is easily avoided by a change in asset-allocation, by bringing accumulation members into the fund or by partial or full transfer into an APRA fund, so it will not deliver all the tax claimed.
- It signals that retirees should shift away from Australian shares to less appropriate assets, weakening our domestic capital market (SMSFs hold more than 12% of listed Australian shares).

- It will lead to some SMSF retirees earning less and moving to a part Age Pension earlier.
- It further weakens confidence in the stability of Government policy towards superannuation – even those not directly affected may experience reduced confidence that saving extra for retirement will be rewarded.

Alternate tax strategies

In the first instance, we question whether this new tax is needed. Labor has already foreshadowed many changes to our tax system which will raise significant amounts from wealthier Australians. These changes include:

- Supporting the Coalition's 2016 changes to superannuation taxes and the 2017 changes to means-testing of the Age Pension.
- The threshold for taxing superannuation contributions at 30% (Division 293) is to be cut from $250,000 to $200,000 (note the Coalition has already reduced this from $300,000).
- The threshold for non-concessional contributions is to be reduced from $100,000 to $75,000.
- Reduction of negative gearing for individuals investing in property.
- Elimination of negative gearing within an SMSF.
- Halving the concessional capital gains tax rate from 50% to 25% for individuals.
- Potentially reintroducing the Budget repair levy (bringing the marginal tax rate for individuals to 50% including Medicare at the relatively low threshold of $180,000).
- Taxing distributions family trusts at 30% on all distributed income.

Should Labor need this additional revenue (for reasons yet to be disclosed), there are better ways of collecting it.

Rice Warner has suggested two simpler mechanisms for collecting tax from those with large imputation credit rebates. The simplest one is to have a rebate threshold which would exclude most people with low credits and cap those with large ones. The amount could be set at $3,000 to $5,000 per taxpayer.

The second option would be to force members to transfer excessive amounts out of superannuation when they reach a certain age (say, 65). We suggested a threshold of (say) $3.2 million for all accumulation and pension accounts combined (in other words, double the Pension Transfer Balance. Amounts above this would be transferred tax-free out of the low-tax superannuation environment.

Financial impact of change

Those with higher superannuation balances in the pension phase will likely lose their refundable franking credits under the opposition's proposed policy. If they are no longer able to receive refundable franking credits, they may change their allocation away from Australia Equities, and to higher yielding investments such as overseas listed shares.

Examples included in table 1 below highlights the impact of the proposed policy retiree with $1 million invested in Australian equities in an SMSF in the pension phase. This scenario is compared to the outcomes for a person with $1 million in an SMSF in the accumulation phase. Scenarios included in Table 1 and Table 2 assume a dividend yield of 4.2% for Australian shares and a company tax rate of 30%.

Table 1. Impact of proposed policy on individual amount of franking credit received

Scenario	Assets	Dividend	Franking credit	Tax (before franking credits)	Franking credits foregone
	($)				
$1 million in Australian shares in pension phase SMSF	1,000,000	42,000	18,000	-	18,000
$1 million in Australia shares in accumulation phase in SMSF	1,000,000	42,000	18,000	9,000	9,000

Table 2 compares the outcome for a couple with $1 million invested in Australian shares in the pension phase within an SMSF to a couple with $300,000 invested in Australian shares in their own names whilst also receiving the Age Pension.

Table 2. Comparison of outcomes for people with different levels of assets

Scenario	Assets	Dividend	Franking credit	Franking credits foregone	Age pension income	Total income
	($)					
$1 million in Australian shares in pension phase SMSF	1,000,000	42,000	18,000	18,000	0	42,000
$300,000 in Australian shares in the pension phase	300,000	12,600	5,400	0	35,573	53,573

Under the policy proposed by the Federal Opposition, a couple with $300,000 in assets would receive more in total income that year than the couple with $1 million in assets in their SMSF. This scenario assumes that the couple with $1 million does not adjust their drawdown behaviour in response to the proposed policy.

Asset allocation

One of the prime drivers of success of Australian superannuation has been the 5% real return (above inflation) provided for 25 years or more by many large MySuper products and their predecessors, Balanced Funds. The emphasis on growth assets has also led to significant investment in Australian shares, including by the SMSF sector.

Many SMSFs invest in Australian shares to obtain this equity risk premium and members have done very well from a combination of capital growth, dividends and franking credits. Many strategies have been built around living off the income (including franking credits) and preserving the capital until later in retirement. This strategy

has been far more effective than buying annuities or shifting into lower value lifecycle products. However, Labor's proposed new tax on SMSFs will require a shift in investment strategies.

The Opposition has proposed removing the refundability of these franking credits for those who are self-funding their retirement and do not receive any income support from the Government. Following the carve out for Age Pensioners, they have estimated this will return around $55.7 billion in revenue over the next 10 years.

However, as this policy will incentivise people to change their asset allocations, the change may not raise as much revenue as anticipated. As the change will likely see a shift away from Australian equities, there may also be unintended consequences for the Australian share market.

The proposed legislation is targeted at wealthy individuals holding direct share portfolios and members of SMSFs which hold high portions of listed Australian equities. We have considered whether these people, who have control over their investments and superannuation, will change their asset allocation in response to the lower returns they will receive from fully franked dividends.

Possible changes to behaviour

Investors with high taxable incomes benefit from a reduction in their tax bills and they will continue to do so after the changes. The main groups affected would be retirees on modest incomes holding equities directly, and many SMSFs which have assets predominantly in pension accounts. The latter group will have a relationship with an accountant and possibly a financial adviser. These intermediaries are likely to establish revised strategies for their clients.

We expect the policy will encourage people to change behaviour in order to preserve the value of their franking credits. We believe that people could do the following in response to this proposed policy change:

- Move their assets out of Australian equities and attain higher yields (including potential tax-free capital gains) in other assets such as overseas listed shares and infrastructure trusts.
- Move their assets into unfranked Australian equities where the price remains the same.
- Close their SMSF and move their assets to an APRA regulated fund where the franking credits will still have value (as they can still be offset against other taxable income within that fund).

These changes in behaviour may impact the relative value of these assets. In addition to these changes to asset allocations and investment decisions, the proposed policy may encourage self-funded retirees to increase their drawdowns from their superannuation (to preserve their current levels of income). This may result in those with moderate balances receiving the Age Pension earlier in their life, which would be an additional cost to Government.

Table 3 outlines the potential impact on the collection of franking credits from the various behavioural changes above.

Table 3. Behavioural outcomes

Member behaviour	Predicted Effect
Sell to APRA regulated funds	Revenue from proposed policy would be lower as franking credits would continue to be paid on those Australian Equity assets transferred into APRA regulated funds. These funds will have tax liabilities and will likely be able to claim the full franking credit.
Sell to foreign investors	Revenue from proposed policy would be unchanged as these investors are not entitled to a franking credit.
Transfer to member-direct option in APRA fund	Revenue from proposed policy would be lower as the APRA super fund will have a tax liability. The member/retiree is able to maintain their Australian equity exposure and still benefits from a full franking credit (at the expense of an annual administration fee of around $400 p.a.).
Add children to an SMSF	Some older members will introduce their children into the SMSF. Some of the wasted imputation credits will offset the taxes on the children's concessional contributions and their investment earnings.

In addition to the possible behavioural changes outlined above, this policy may result in a reduction in share buybacks or dividends by Australian companies. Typically, a proportion of the proceeds from a share buyback are deemed to be a return of capital, with the remainder a fully franked dividend. As these dividends will become less attractive under the proposed policy change, Australian companies may reduce share buybacks and instead reinvest in growing their business.

In September 2017, Rio Tinto announced a $700 million buyback of Australian-listed shares. This type of buyback is attractive to superannuation funds as the buy-back consists of large amounts of fully franked dividends. However, they may not continue in future if investors view dividends as less valuable under this policy change.

We know that Rio Tinto and BHP have both built up large franking accounts and have the cash to be able to make special dividends. Further, the major banks are also generating cash from divesting or reviewing their interest in their wealth management, fund management and life insurance businesses. It is likely that they will also undertake buy-backs in the near future.

With fully franked dividends less attractive to some Australian investors, these companies may bring forward any buy-back into the 2019 FY. This would remove a significant number of future dividends from the targeted group, and would reduce the revenue expected.

Potential impact of behavioural change

Impact on Government revenue estimates

SMSF assets totalled approximately $635 billion in 2016 and hold around 12% of all listed Australian shares. ATO data suggests that around 69% of SMSF assets are held in the pension phase, with around 33% of these assets held in Australian listed equities.

As described above, if franking credits are no longer refundable for those not receiving any Government assistance, this may encourage some of these retirees to shift away from Australian listed shares to less appropriate assets, weakening our domestic capital market as well as weakening retirement outcomes. By making the conservative assumption that 25% of Australian Equity exposures will be divested, the possible impact on the governments revenue change can be estimated.

Using publicly available ATO data and assuming a dividend yield of 4%, we estimate total dividends received by SMSF pensioners in 2016 was an estimated $5.7 billion, providing franking credits of $2.5 billion.

Table 4 estimates the impact of various behavioural changes. These impacts are difficult to quantify but we have assumed 25% of the value of those shares held by SMSFs are sold. Table 4 assumes 10% of the value of shares are transferred to a member direct option in an APRA regulated fund, a further 10% are sold to APRA regulated funds and 5% are sold to foreign investors.

In addition to these franking credits forgone by SMSFs, Treasury analysis of ATO data reveals that around 2,000 APRA regulated funds received franking credit refunds worth around $300 million in 2015 to 2016. These funds, with around 2.6 million-member accounts, would forgo their franking credits under the proposed policy. Table 4 assumes 10% of the value of shares held by these APRA regulated funds are transferred to a member direct option in an APRA regulated fund that is not in a net refund position and a further 10% are sold to APRA regulated funds that are not in a net refund position.

Finally, there would be a significant loss from any buybacks to Australian investors made in the 2019FY.

Table 4. Effect of 25% shift away from Australian Equities in SMSFs on Opposition costings

Member behaviour	Predicted Annual loss under Opposition policy ($m)
10% sold to APRA regulated funds	245
5% sold to foreign investors	Nil
10% transferred to member direct option in APRA fund	245
Small APRA funds and private investors	60
Total predicted annual loss under Opposition Policy	**550**

This annual loss would be greater in future years if share buybacks are brought forward in FY2019. If $2 billion of share buybacks are brought forward in FY2019 (and therefore the franking credits on those shares are removed from the system) we estimate an additional $34 million in annual revenue could be lost (assuming a dividend yield of 4%).

Impact on the Australian share market

Reducing the income received from franking credits will encourage retirees to shift away from Australian shares. We expect that other forms of growth assets such as infrastructure trusts, REITS and syndicated property will become more popular and more overseas listed shares will be bought in place of Australian companies.

The impact on share prices from this shift away from Australian equity depends on the value of the franking credits to investors. Research on the value of franking credits suggests that their value is largely dependent on the relevant market power of international investors and their influence on domestic share prices[1].

[1] Dividend imputation and the Australian Financial System: What have been the consequences? Kevin Davis October 2015.

At one extreme, if the Australian share market is assumed to be fully integrated with international markets then the domestic price of equities is not affected by franking credits. Global markets will set domestic prices via international arbitrage. Alternatively, if international arbitrage is not possible, domestic equity prices will be relatively higher due to refundable franking credits received. Under this assumption, removal of refundability in credits would likely see a fall in the value of Australian shares and an increase in the cost of capital for Australian companies.

Yours sincerely

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