Australian Shareholders' Association

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Committee Secretary
Standing Committee on Economics
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Dear Committee members

INQUIRY INTO THE IMPLICATIONS OF REMOVING REFUNDABLE FRANKING CREDITS

The Australian Shareholders' Association (ASA) represents its members to promote and safeguard their interests in the Australian equity capital markets. The ASA is an independent not-for-profit organisation funded by and operating in the interests of its members, primarily individual and retail investors and self-managed superannuation fund (SMSF) trustees. ASA also represents those investors and shareholders who are not members, but follow the ASA through various means, as our relevance extends to the broader investor community.

ASA members, many of whom have entered the share market as a means of providing for their retirement, are deeply concerned by the Australian Labor Party's (ALP's) proposal to limit the cash refund for franking credits. It is not seen to be fair policy, given that individuals with the same backgrounds and histories will experience widely divergent outcomes. We therefore welcome the Inquiry into the Implications of Removing Refundable Franking Credits (the Inquiry).

Having a self-funded retirement income requires long-term planning and stability. Many ASA members have structured their investments and drawn a self-funded pension taking into account that since 2000 they will receive a cash refund for all franking credits. While the ALP intends to exempt part and full pensioners (Age Pension) from its proposed changes, this does not take account of other Australians who have diligently saved for and depend on their self-funded retirement income (self-funded pension).

The proposed changes will penalise investors who prefer high dividend-paying Australian shares where the 30% corporate tax has been paid already to the Australian Taxation Office (ATO). It penalises retirees who have saved for their retirement and invested in Australian companies.

Our objection to the proposal to disallow refunds of excess franking credits for a range of retirees and shareholders arises from the financial and psychological impact on investors currently receiving or structuring their investments in the expectation of receiving these refunds at some time in the future.

Our more detailed comments in response to the Terms of Reference follow.

1 Analysis of who receives refundable franking credits, the opportunities it provides to offer alternative savings and investment vehicles to low and middle income earners, and the impact it has on lowering tax bills

Who receives refundable franking credits and opportunities it provides to offer alternative savings

Australia's 6 million retail shareholders favour companies that pay fully franked dividends (that is, the companies pay the full tax rate of 30%), in preference to low dividend and low tax-paying companies. This preference has been lifted by the ability to receive a refund of any excess above taxable income, as well as the reduction of interest rates received for alternative investments such as term deposits since the global financial crisis.

The preference is the result of the introduction of the dividend imputation system, introduced by the Labor Government in 1987, whose policy purpose was to encourage Australians to invest in equities, so that the benefits of corporate prosperity could be spread, and to support the use of our savings to finance equity in Australian companies.

Public policy encouraging demutualisations and privatisations in turn also encouraged ordinary Australians to become shareholders. In 2018, Australia has the strongest culture in the world for individual direct share market investment by ordinary citizens. This is the result of decades of public policy driving Australians in that direction, as noted in the *Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Vol 1, p 76, September 2018):

> The 1990s brought even more of the Australian public into the market for financial products and services …. A series of privatisations (such as CBA, Telstra and Qantas) and demutualisations (such as AMP and NRMA Insurance) increased middle class share ownership.

Australians therefore are now comfortable owning shares as a means of generating income. It is not reflective of absolute wealth or a desire to extract the maximum gain from the government.

Moreover, research shows that the term 'control' resonates with Australians strongly when it comes to their finances.[1] This has seen an increase in SMSFs. Nearly 600,000 SMSFs (596,516) run by more than 1.1 million members control more than $697 billion in total assets, as at 30 June 2017.[2] Of this, 30% is held in ASX-listed securities, which in turn constitutes 13% of the total combined market cap of all ASX-listed securities.

The current situation therefore is that almost ***one-third*** of the adult population owns shares, with the majority investing in companies that pay fully-franked dividends. When shareholders receive these franking credits, they can be used to offset other income tax liabilities. In 2000, the Coalition

[1] *ASX Investor Study 2017*
[2] Data from the Australian Prudential Regulation Authority (APRA) and the Australian Taxation Office (ATO) January 2018

government moved to ensure that lower income individuals received the same benefit of investing in Australian companies as higher income earners, by receiving the franking tax credit in the form of a cash rebate and thereby effectively being taxed on dividends at their marginal tax rate. In 2006, the Coalition government made earnings on superannuation for those over 60 tax-free. This gave rise to primarily retired Australians having a nil marginal tax rate.

ASA has compiled the numbers of retail shareholders on the registers of some of Australia's largest listed companies — see Figure 1. Up to 90% of these retail shareholders hold 5,000 shares or less. These are not wealthy holdings. Many retail shareholders do not have extensive investment portfolios, but are retirees living off their dividends and franking credits.

Figure 1: Retail Shareholdings of ASX larger companies

Company Name	Retail Shareholding % register by value	Retail Shareholding % register by number	No. of Retail Shareholders up to 10,000 shares	As at date
Commonwealth Bank	53%	99%	797,272	31/03/2018
ANZ Bank	42%	97%	505,781	31/03/2018
National Australia Bank	47%	97%	552,245	31/03/2018
Westpac	46%	96%	591,161	31/03/2018
Telstra	20%	92%	1,284,818	2016
Insurance Australia Group	34%	99%	690,297	2017
BHP Billiton	22%	97%	540,248	2017
AMP	27%	99%	740,887	2018

Incomes of those utilising the system of refundable franking credits

According to the ALP, the policy to remove cash refunds on franking credits is targeted at "the wealthiest 10% of SMSFs"[3]. As analysis of ATO data and the Treasury reveals, however, that it is those on modest incomes who will be most affected.[4] The data presented below has been compiled by the Alliance for a Fairer Retirement System, of which ASA is a member.[5]

> Of the $5.9 billion in franking credit cash refunds disbursed in 2014-15, $2.3 billion went to individuals, $2.6 billion went to SMSFs, $0.3 billion to other super funds and $0.7 billion to tax-exempt entities. In the weeks following the ALP's announcement, exemptions were extended to 230,000 individuals and 20,000 SMSFs receiving age pension benefits, and 4,600 tax-exempt entities. The latter included the Future Fund, which received the majority of franking credit cash refunds going to tax-exempt entities.
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> In 2014-15 more than half of the 1.16 million individuals initially affected had taxable incomes below the $18,201 tax-free threshold, and 96% had taxable incomes of less than $87,000. The most severely affected in this group, however, will be the 34% of older Australian retirees who take great pride in being self-funded in retirement, many of whom have little, if any, superannuation.
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> As at December 2017, just over one-third of Australia's 3.6 million retirees were self-funding, and one half of these were over 70. The majority of these older retirees have little if any superannuation savings. Indeed, in the *2015 Household Income and Wealth Survey*, 45% of women over 65 reported having no super, and the median super balance for retirees over 70 was nil. Individuals over the age of 65 years receive around half ($1.1bn) of franking credit cash refunds going to individuals, with an average value of around $5,000.

This provides considerable evidence that Australians on low and modest incomes who seek to remain off the Age Pension will be those most significantly affected by the proposed policy, while those on higher incomes will be able to restructure their affairs so that the policy will have little impact on them.

The ALP's figures support this, acknowledging that 75% of the benefit goes to 10% of the recipients. ASA is concerned with the remaining 90% of recipients, as this cohort will be the most disadvantaged. It will affect people on incomes of less than $65,000 who rely on this additional source of income. It would be preferable to introduce a policy designed to close off the benefit to the 10% without affecting the 90%, as these are not wealthy individuals. ASA suggests there are other ways of raising taxes on wealthier Australians, if that is the aim of the policy.

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[3] The top 10% of SMSFs received $1.366 bn or 23% of franking credit cash refunds in 2014-15, with an average of around $40,000 per fund, or $20,000 per based on 2014-15 tax returns. Less than 5 (maybe only 1) claimed $2.5m, but this was prior to the $1.6m cap on tax-free pension accounts (PBO May 2018).

[4] Treasury paper (FOI_2292_-documents_final_redacted.pdf) March 2018, p.3

[5] The Alliance for a Fairer Retirement System, Alliance Fact Sheet, 25 September 2018, < http://www.fairerretirement.com.au/news/2018/9/25/updated-fact-sheet-who-will-be-affected-by-the-denial-of-cash-franking-credit-refunds>

For a subset of older people on genuinely modest and low incomes, abolishing refundable credits will leave them substantially worse off. If the franking credit constitutes about 30% of the dividend paid, one might expect that a self-funded retiree totally reliant on returns from a share portfolio might lose as much as one-third of their income. See our case studies of ASA members below.

Case studies of a sample of ASA members who will be affected by this change

a) A couple aged 78 and 75 have a Commonwealth Heath Seniors Card (CHSC). They hold their investments outside super, being $700,000. They also have a $450,000 holiday house. Taxable income is $54,000, refund of franking credits $14,000 representing 26% of income
b) A retired mother supporting her disabled son. Assessable income is $28,974, which includes $4,000 refund of franking credits representing 14% of income. She will restructure her finances to access a pension as she feels she can't survive on $4,000 less income.
c) A 77-year old with a CSHC, owns home, has non-super investments of $839,268. Taxable income is $44,011, franking credit refund is $5,336 or 12% of income.
d) 52-year old single, retired due to poor health. Superannuation of $120,000 preserved, other investments of $300,000. Taxable income $53,670, refund of franking credits is $15,580 or 29% of income.

From an analysis of a policy costings from the Parliamentary Budget Office requested by Senator David Leyonhjelm and completed 4 May 2018, it appears the bulk of the assumed savings will come from denying refund of franking credits to individuals and SMSFs. Unsurprisingly, the size of the refund increases with the level of taxable income and fund balance. *With respect to individuals, 58% of the savings arise from denying refunds to those individuals with a taxable income of less than $35,000.*

Impact on lowering tax bills

In March 2018, the Federal Opposition initially claimed that its proposed 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. The suggestion was made that the savings would be predominantly recovered from those receiving high nominal refunds. University and charitable funds would be excluded from the changes.

In the following days and weeks, the ALP released statements that the Future Fund, which receives nearly $1 billion a year in tax refunds would be exempt, as would anyone receiving welfare payments from the new tax. Also exempted were any SMSF with a member receiving the Age Pension on the day of the announcement. The ALP claimed that the policy would have little to no impact on APRA-regulated funds (both industry and retail), given that the majority of the imputation credits would be exhausted because of the tax liabilities of most funds. However:[6]

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[6] The Alliance for a Fairer Retirement System, Alliance Fact Sheet, 25 September 2018, <
http://www.fairerretirement.com.au/news/2018/9/25/updated-fact-sheet-who-will-be-affected-by-the-denial-of-cash-franking-credit-refunds>

- ATO data reveals that 2,013 of the 2,603 APRA-regulated funds received franking credit refunds in 2015-16 — 1,963 of these were small APRA-regulated funds with fewer than five people, and with franking credits worth $74m. These funds are in a very similar position to SMSFs when in pension mode.
- Treasury analysis reveals that 50 out of 240 of the large APRA regulated funds — comprising hundreds of thousands of members — received refundable franking credits worth $235m. The degree to which a fund has reduced returns will depend on the proportion of members in pension mode, and the proportion of the funds committed to Australian shares.

For some retirees, a decrease in franking income will result in an increase in their self-funded pension payments, which will diminish the capital available to support their self-funded retirement, and more self-funded retirees would therefore start to rely on a part Age Pension sooner. This defeats the purpose of the policy which is to decrease government expenditure.

2 Consideration of how refundable franking credits support tax principles, particularly implications for tax neutrality, removal of double taxation and fairness

Franking credit cash refunds have been claimed by the ALP as a loophole. However, they are an equalisation, between those who pay 30% tax or more and those who happen to pay less, mainly because they earn less.

The fundamental principle behind dividend imputation is to ensure that income is taxed once by those who are obliged to pay it. The purpose of dividend imputation, introduced by the Labor Government in 1987, was to remove the double taxation of dividends. Previously a dividend would be subject to a corporate tax of about 30%, in addition to marginal tax applied in the hands of the shareholder. Under dividend imputation, the Australian taxpayer receives a tax credit equivalent to the company tax already paid on their dividend, which can be used to offset other tax liabilities.

If people who have a zero tax obligation do not receive franking credit refunds, then they have paid tax on income when they should not have. This results in them paying more tax than someone who earns the same gross income.

If too much PAYG is deducted from wages it is refunded. This proposal instead states that if income derives from Australian shares, the refund will not be given. The ALP proposal treats the two classes of income very differently. All people who have a zero tax rate should be treated the same and people who have a zero tax obligation should not be forced to pay tax. This is a matter of not discriminating against those who happen to earn their income through shareholdings.

The following data is the result of research by the Alliance for a Fairer Retirement System:[7]

[7] The Alliance for a Fairer Retirement System, Alliance Fact Sheet, 25 September 2018, < http://www.fairerretirement.com.au/news/2018/9/25/updated-fact-sheet-who-will-be-affected-by-the-denial-of-cash-franking-credit-refunds>

> Of the $5.9 billion in franking credit cash refunds disbursed in 2014-15, $2.3 billion went to individuals, $2.6 billion went to SMSFS, $0.3 billion to other super funds and $0.7 billion to tax-exempt entities. In the weeks following the ALP's announcement exemptions were extended to 230,000 individuals and 20,000 SMSFs receiving age pension benefits, and 4,600 tax-exempt entities. The latter included the Future Fund, which received the majority of franking credit cash refunds going to tax-exempt entities.
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> In 2014-15 more than half of the 1.16 million individuals initially impacted had taxable incomes below the $18,201 tax-free threshold, and 96% had taxable incomes of less than $87,000. The most severely affected in this group, however, will be the 34% of older Australian retirees who take great pride in being self-funded in retirement , many of whom have little, if any, superannuation.
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> Also severely affected will be SMSFs where almost half of all trustees are over 60 years, and 70% have taxable incomes of less than $100,000. Around 370,000 SMSF member accounts will be impacted, with a median franking credit refund of $5,100. It is also estimated that 40-50 large and 1,963 small APRA-regulated superannuation funds will be affected, with between 2.6 to 3.5 million member accounts .

If the view is that some taxpayers shouldn't be in the zero tax bracket, with SMSFs in pension phase a particular target, the policy response should be to propose a change to their tax rate, being explicit about who is being taxed and why.

Finally, we note that the policy is a departure from the principle that people pay tax at their marginal income tax rate. If Australians are in the lower tax brackets they will pay at the corporate rate because, in effect, the ALP proposal would apply a 30% tax to one class of pension income, that is income from fully-franked shares, while leaving all other pension income untaxed. This is clearly inequitable.

3 If refundable franking credits are removed; who it would impact and how and the implications from expected behavioural change by investors, including for

- **increased dependence on the pension**
- **stress and complexity it will cause for Australians, including older Australians to adjust their investments**
- **if there are carve outs applied, what this might mean for additional complexity, uncertainty and fairness**
- **reduced incentives to save and distortions to which asset classes are invested in and funds are used, and**
- **the reliability of providing a sustainable revenue base over the longer term**

If the proposal is enacted, individuals with the same backgrounds and histories will experience widely divergent outcomes, either due to:

- receiving an Age Pension on the day of or the day after the announcement, or

- receiving an Age Pension or not, or
- having an SMSF pension compared to an industry or retail fund pension
- having never benefited from inclusion in the superannuation system.

As clarified in research undertaken by the Alliance for a Fairer Retirement System, the pensioner exemption will apply to age pensioners in SMSFs as of the 28 March 2018, but not subsequently.[8]

> Almost half of the current 1.1 million SMSF trustees who are either in the pension phase, or who will move into that phase shortly, will be adversely affected. The inequitable impact of this policy will result in the anomalous situation where a retiree on a full Age Pension with $300,000 in retirement savings in an APRA-regulated fund will receive a significantly greater income than a SMSF retiree who has invested $1m in Australian equities to fund their retirement.
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> While the pensioner guarantee provides a carve-out for those receiving Age Pension benefits and allowances, imputation credit refunds will be denied for pensioners who own units in a unit trust. A pensioner who owns BHP shares directly will get a refund, but not a pensioner who owns units in a unit trust.
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> The policy will also impact on small business owners who derive their retirement income from dividends and franking credits on the equity they invested in their unlisted companies. There are around 500,000 incorporated SMEs, although it is difficult to estimate how many will be affected.

Consequences of proposed changes

The median superannuation balance for Australians over 65 years is modest in the extreme, and for those over the age of 70 the median balance in 2014-15 was zero. For this cohort, share ownership has been a critical part of retirement planning over past decades. It is this older generation who will feel the most impact, and who in many cases will need to seek income support from the Age Pension.[9]

ASA members are concerned as to how they will manage a significant drop in income, at a stage of life when they are unable to seek employment to make up the financial shortfall. Modelling by ANU economists confirms that imputation credits are potentially the equivalent of a 5%-6% increase in spending during retirement.[10]

> We find that imputation delivers a value equivalent to an average 5%-6% increase in spending over the course of retirement, an 8%-9% larger superannuation fund balance at the point of retirement, or a 0.6%-0.8% per annum increase in returns on the portfolio

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[8] The Alliance for a Fairer Retirement System, Alliance Fact Sheet, 25 September 2018, <http://www.fairerretirement.com.au/news/2018/9/25/updated-fact-sheet-who-will-be-affected-by-the-denial-of-cash-franking-credit-refunds>

[9] ASFA, Superannuation Balances by Age and Gender, October 2017

[10] Adam Butta, Gaurav Khemkab and Geoffrey J. Warren, ANU, 'What Dividend Imputation Means for Retirement Savers', 26 August 2018

during retirement. Such not-insignificant numbers underwrite the consternation among those in or nearing retirement about a potential change in policy.

ASA members advise that they will:

- reverse their determination to be a self-funded retiree and avoid access to the Age Pension – this will increase the funding cost
- restructure their investments to reverse the preference for fully franked dividends
- restructure their superannuation to join funds which pay sufficient tax to utilise the franking credits — a proportion of any shares sold will go to taxpayers who are able to access the franking credit refund, increasing the utilisation of franking credits
- no longer be able to use the refund to pay for their private Health Fund premium and so will be unable to afford private health cover in the future – increasing the funding of healthcare, either by direct increase in demand at public hospitals or longer-term impact of inadequate healthcare.

In summary, older Australians are likely to undertake the following:

- Those close to asset limits will spend capital to qualify for a pension.
- Investors will move to LIT's, REIT's and ETF's.
- Some retirees will close their SMSFs.
- Some retirees will move to retail or industry super funds.
- Some retirees will move their superannuation back to accumulation phase in order to have taxable income.

Other outcomes are that:

- earning small amounts of other income will be effectively tax free
- capital gains will be postponed to next year to use some of the lost credit
- tax deductions will cease to be useful
- in the longer term, retirees will spend less.

ASA members who were experiencing poor health also advise that they are less able to face restructuring their finances to adapt to the rule changes. The level of distress among our members is significant — a high proportion of our members are 70 and over, and the level of distress at having to restructure their finances increases with age.

The ALP is on the record as noting that its policy will see more Australians invest in markets other than the Australian market. While ASA supports diversification and encourages our members to invest in international equities as well as in Australian equities, we do not support public policy making investment in Australian equities comparatively less attractive. Public policy should continue to encourage rather than discourage investment in Australian companies given those companies employ people in Australia, buy Australian goods and services to run their businesses and build Australian infrastructure and pay tax in Australia.

A recent Citigroup report explores further the consequence of the ALP policy for Australian equities, anticipating reduced local investor demand for high-dividend shares and potentially cutting the share price of the big banks by 5 to 10%.[11]

There is also likely to be increased relative demand for shares in companies that don't pay high dividends or high levels of tax.

Carve-outs and reduced incentive to save

A continuously changing retirement system will discourage long-term investment in superannuation, preferencing current expenditure (as opposed to saving for retirement) and alternative investments. Self-funded retirement needs to be adequate, sustainable, certain and equitable to encourage the behaviour of deferred gratification.

We are concerned that the policy will create two tiers of retirees, which will not easily be accommodated in future policy determinations, as well as requiring additional financial advice to navigate the dichotomy. Those on the Age Pension keep the benefit and those on a self-funded pension do not, which means in effect that if you save for retirement you will be penalised. Therefore, ASA is concerned about the inequity of the proposal – it affects different people on the same income differently and is not sustainable, as it will drive retirees to go onto the Age Pension.

Sustainable revenue base over the long term

The Coalition government has already limited the amount of tax-free income for retirees with the introduction of the $1.6 million cap on pension accounts as of July 1, 2017. Those reforms also changed the Age Pension asset test so that 91,000 part-pensioners became ineligible and another 235,000 had their part-pension reduced. As noted in research from the Alliance for a Fairer Retirement System:[12]

> These changes have already restricted tax-free income for retirees. Currently around 70%, or $1.8 billion of the $2.6 billion in SMSF refunds accrue to the top two deciles who hold balances in excess of $1.5 million. With superannuation tax-free incomes restricted to around $80,000, franking credit cash refunds will drop very significantly.

The interworking of the legislation introduced in the 2016 budget whereby those SMSFs with excess of $1.6M in pension have moved that excess back into accumulation and are paying tax means the wealthier SMSFs continue to benefit from the franking credits from Australian shares.

Inconsistent application of grandfathering arrangements

Any overarching evaluation of our tax system needs to ensure that self-funded retirement remains achievable and can be maintained. We note that the ALP has announced that it will allow grandfathering of existing arrangements in relation to its proposed change to negative gearing policy, yet it will not apply the same approach to many individuals' long-term planning when income

[11] John Kehoe, 'Labor election win to hurt high dividend stocks', *AFR,* 13 September 2018
[12] The Alliance for a Fairer Retirement System, Alliance Fact Sheet, 25 September 2018, <http://www.fairerretirement.com.au/news/2018/9/25/updated-fact-sheet-who-will-be-affected-by-the-denial-of-cash-franking-credit-refunds>

is generated from shares. The inconsistency of this approach from the ALP means that those who generate income from property will be treated favourably, while those who generate income from shares will not. This is clearly inequitable.

ASA recommendations

ASA members, many of whom have entered the share market as a means of providing for their retirement, are deeply concerned by the ALP's proposal to limit the cash refund for franking credits should it be elected. It is not seen to be fair policy for all the reasons set out above.

Having a self-funded retirement income requires long-term planning and stability. We have set out the psychological and financial implications of the proposed policy, noting how the impact will be most keenly felt by those on modest incomes. The proposal will penalise retirees who have saved diligently in order to be self-funding in retirement and not be a drain on the public purse. For this reason, ASA strongly recommends that the proposed ALP policy not progress as it is unfair and discriminatory.

Should the view be taken by either the government or the opposition that there are inequities in our retirement income system, then other policy options should be considered that are not unfair and discriminatory.

While ASA continues to oppose the proposed policy, should it progress, we are of the view that other options that could be canvassed that do not introduce the investment-distorting effects of the current ALP policy include:

- Limit the refund to a minimum amount for people on lower incomes, which would not come at a huge budgetary cost and could be phased out over time.
- Introduce grandfathering arrangements, so that those on modest incomes in retirement are not pushed onto the Age Pension.
- Tax superannuation earnings in pension phase at 15% (distributions from superannuation accounts would remain tax free).

Above all, Australians need a comprehensive exploration of options to fix problems with the existing superannuation taxation, Age Pension means testing and broader retirement income systems and a focus on a fair retirement system which provides adequate, sustainable, certain and fair outcomes for retirees and future retirees. We note that the proposed policy runs counter to all of those objectives.

We would be more than happy to meet with you to discuss these issues further.

Yours sincerely

Judith Fox

Chief Executive Officer