Submission to the Standing Committee on Economics inquiry into the implications of removing refundable franking credits.

Alternatives – by Lorraine, December 2018

I have previously sent in two submissions to the inquiry.

My first submission (222) covered some general considerations of the proposed policy and why it should not be supported.

My second submission pointed out that the franking credits arise only because of the nature of the capital raised (debt or equity) and the structure of the business enterprise (company or trust). It appears that some people do not fully understand how the current system works and I have attempted to clarify this.

For my third submission I want to cover the final term of reference of the inquiry, the reliability of providing a sustainable revenue base over the long term.

I want to look at what the real problem is with the superannuation system and how it could easily be improved to provide some extra revenue in a fair and equitable way.

I also want to suggest a simple change to the current system that would reduce the payment of cash refunds of franking credits and which no investor could object to. This is by outlawing share buybacks with a franked dividend component. These are totally unnecessary and only really of benefit to zero rate taxpayers.

The real problem with retirement incomes

The real problem with tax on retirement incomes is not the refund of unused franking credit, it is the fact that any retiree over the age of 60 can organise their financial affairs so they pay little or no tax almost regardless of how much income they have. The cap on pension mode super benefits has mitigated this a little, but the tax rate on the excess is still low.

With an increasing proportion of retirees to taxpayers this tax free way of life may not be sustainable in the long term. On the one hand we definitely want to encourage people to save for retirement and tax incentives are an important part of this. On the other hand we do not want a system where retirees can use superannuation as a tax shelter for very high incomes.

Any attempt to increase the tax paid by this group should concentrate on the actual problem, the tax free status of pension mode super, rather than tinkering at the margins with a complex franking refund policy that will not solve the problem and will leave vulnerable low and middle income retirees worse off.

I have included in Chart 1 below a graph of income and assets for Australian retirees splitting the income into various components. This is for a couple who have 20% of their assets in a bank account, earning 2% interest, and 80% of their assets in shares paying a 4% fully franked dividend. These couples have all their assets held in a SMSF. I have covered combined asset amounts for the couple from zero to $4m. A larger format version of this chart is included on page 9.

This would be a typical and valid strategy for many retirees, with enough cash available to pay their super pension amount when needed and their shares held in various conservative listed investment companies such as ARG and WHF as well as PMC which invest globally.

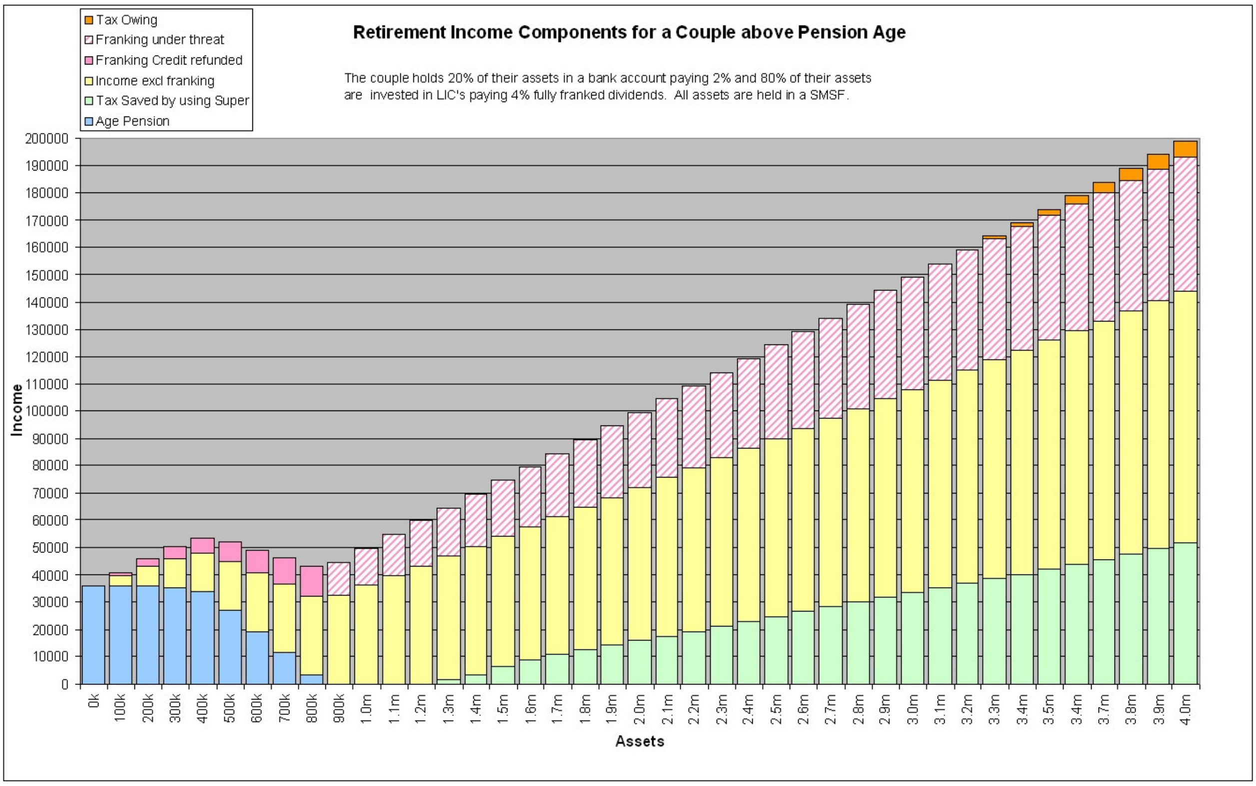


Chart 1 – Components of Retirement Income

The blue area of the graph is the age pension, the green area the tax benefit gained by having the income inside super and the yellow area is the remainder of the income. The franking credit is shown in pink with the franking credit that would be confiscated shown striped, and the tax owing on the excess above the cap is in orange. The tax benefit is the tax that would be payable if all of the income was outside of super and includes the Medicare levy, the low income offset, the new low and middle income offset and the seniors offset.

This is not a well thought out system and the proposed changes will make it worse
This is not the picture of a well thought out retirement income system. The benefits (age pension and tax benefits) favour only the retirees with the lowest and highest assets. Those in the middle get no benefit at all and these are the people whom the Federal Opposition wants to hit with a further loss of income.

All retirees above the age pension asset limit would lose up to 30% of their income
All retiree couples on our chart with assets from $848k upwards would lose the total pink striped section of their income if franking credits were no longer refunded.

Losing the refund of franking credits would further reduce incentives to save
There is already a deep income sump for retirees with savings from $500k to $1.2m caused by the very steep taper rate for the age pension. There is little incentive for anyone to save amounts over $500k unless they are able to save $1.2m or above. If the franking refunds are no longer paid out then this amount increases to $1.5m.

As well as this there would be a sudden drop of over $12k in income for the couples on the chart who are even $1 over the asset test limit for the age pension as they immediately go from having franking credits refunded to losing them. This aspect of the proposed changes is so poorly thought out it is nothing short of appalling.

Couples with assets above the pension limit but below $1.2m are hardest hit
Those couples with assets between the pension cutoff limit of $848k and $1.2m already have less income than they would have if their assets were only $400k. If they lose their franking credit refund they would have less income than if they had a full pension and no assets at all. They fall into an income sump. These are the people hardest hit by the proposed policy.

The franking credit lost is higher than the tax the couple would normally owe
If franking credit cash refunds are confiscated as planned, then all of the retirees on the chart except age pensioners and the two couples with over $3.9m in assets would lose more in franking credit than they would pay in tax if their investments were outside of super.

Couples with assets below $1.1m obtain no benefit from super
Those couples with assets below $1.1m obtain no benefit at all from having their funds in super at these investment returns. If the income was outside of super they would still pay no tax. They could save the cost of running a super fund and invest in their own name.

The cap on pension mode super does not raise a lot of tax from these retirees
The cap on the amount allowed to be held in pension mode super results in only a very small amount of tax owing for these couples, at least for the investment strategy and the asset range up to $4m that we are considering here. If our couples with assets above the cap moved the excess into their own personal names, the tax owing would reduce to zero.

For some retirees the tax benefit is more than they would receive as a pension
For some retirees, the tax benefit of holding their assets in super exceeds the amount they would receive if they qualified for an age pension. This defies logic. We give retirees a tax benefit higher than the age pension to avoid paying them an age pension.

This is the situation for those couples with a joint income above $153k. In my chart this is those retiree couples with joint assets above about $3.2m. These retirees save more in tax than they would receive if they qualified for a pension. They could easily afford to pay some tax on their income.

The tax on super above the $1.6m cap has not fixed this. Our couple with $4m save nearly $46k in tax by having their assets in super, well above the couple pension amount of $36k.

For higher incomes the saving is even higher. For example a single retiree with $3.2m in super with their funds in corporate bonds earning 6.25% would earn $200k for the year. The tax on this would be $15k (15% on the earnings for the half of their funds over the $1.6m cap). If this $200k income was outside of super the tax would be over $67k. They receive a tax benefit of $52k, which is far more than a single pension of around $23k.

So how can we fix this?

Although I appreciate that this is outside of the terms of reference for this committee I am offering a few suggestions on how we should deal with this problem in a fair and equitable way, rather than punishing savers by taxing them at rates in excess of the tax they would normally owe on their income.

Outlaw off-market buybacks with a franked dividend component
Some off-market buybacks are structured so they are paid out as a small capital component and a large franked dividend. These buybacks mainly benefit zero rate taxpayers and can result in large amounts of franking credit refunds. I have included more detail and an example on page 7.

If the law was changed to outlaw this type of off market buyback, then there would be a considerable reduction in the amount of franking credit paid out as cash refunds. As these buybacks are really only a windfall for the zero tax rate investors, I would not anticipate too much opposition to banning them.

Reduce the cap on pension mode super
We could reduce the cap on pension mode super further, to say 1.2m, and in return offer a one off opportunity for couples to split their combined super equally between them. This would raise some extra revenue from the couples on the chart with $2.4m or more in total, but would not address the income sump.

Return to the previous assets test taper rates
We could return to the previous assets test taper so retiree couples in the $848k to $1.2m asset brackets were not reduced to an income lower than they would have if they had saved less than half of this amount. This would eliminate the dip in the graph where retirees who have saved $1m have less income than if they had saved only $400k. We could pay for this by introducing a small tax on pension mode super.

Reducing the taper rate is the ONLY way this income sump can be eliminated. Retirees would need an investment return of 7.8% to overcome the current loss of age pension income and this rate of return is difficult to achieve safely.

Tax pension mode super
We could tax pension mode super at a rate of 5%, rising to 10% after a year or two and eventually to 15%. This would affect all super funds equally.

A 15% tax rate on all super fund earnings may result in some pension mode super being converted back to accumulation mode so there was no minimum withdrawal required. However this could be fixed quite easily by legislating that everyone over age 70 was required to take out a minimum of 5% per year of their total balance.

If the tax on super resulted in retirees paying tax when they would not owe tax if the money was held outside of super, then they could simply close down their super fund and invest their money in their own names.

I have included as Chart 2 below how this and the above change to the age pension taper rate would change the graph to look much more reasonable. A larger format version of this chart is on page 10.

Although still not ideal, this is more what a well planned retirement income system should look like and the changes are not major. Most self-funded retirees would prefer a tax on earnings to a total loss of franking credit.

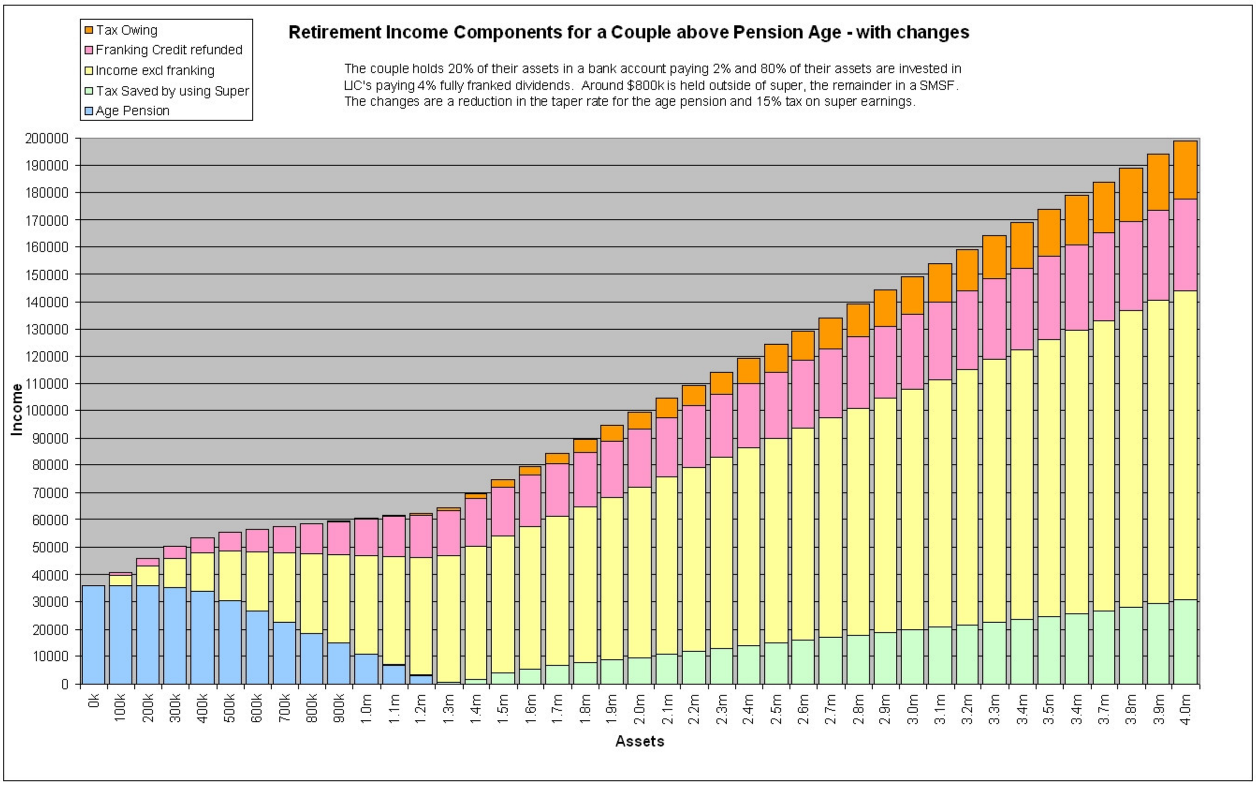


Chart 2 – Components of Retirement Income if pension taper was lower and super was taxed at 15%

The income sump has been flattened by the change to the asset taper, and every retiree gets some benefit from saving more.

No retiree in the range considered has a tax benefit higher than the age pension.

The highest marginal tax rate that any retiree pays is 15%. I have assumed all couples split their assets between super and non-super to take advantage of the $58k tax free area for personal tax and have the remainder of their income in super so they pay the minimum total tax.

The government gets some new tax revenue from higher income earners with little effect on those couples earning less than $80k.

Pay all retirees a pension and tax all income
A longer term solution would be to pay everyone over 67 a non-means-tested age pension equivalent to the couple rate and make all other income taxable. Single pensioners could apply for a means tested supplement to bring their amount up to the current single age pension rate. This would need to be carefully planned so no current pensioners or low income retirees were worse off, and phased in so all new retirees were put onto the new system but existing retirees had up to five years to change over to it. It would also need to be very carefully costed.

While this may have an effect on the financial planning industry as convoluted planning to maximise age pension income and minimise tax would no longer be needed, at least the accountants involved could get on with doing something more productive with their time. And no-one could argue that this system was not fair and equitable.

Review all aspects of retirement incomes
We need a total review of all aspects of retirement income to find a solution that raises some tax from better off retirees without adversely affecting those of more modest means. This review needs to have public input and a bipartisan approach. All flow on aspects of changes need to be thought about carefully. Any changes need to be phased in slowly, giving existing retirees two or three years to convert to any new system.

Conclusions

The current system of refundable franking credits should be left as it is.

Instead we should be looking at the real problem which is the very low tax rate applying to pension mode super.

There are some small ways we could improve this by outlawing off market buybacks with a franked dividend component and by restoring the previous age pension assets test taper rate as well as charging a small amount of tax on the earnings on pension mode super.

However what is really needed is a comprehensive review of the whole retirement income system.

If the committee would like to discuss any aspect of this submission, or if you would like further graphs showing different scenarios then please feel free to contact me.

Lorraine

December 2018

Off- Market Buybacks – example

Some of the off-market buybacks that have been undertaken in the last few years have the following structure. The shares are bought back at a discount to the prevailing share price, usually 10-15%, and include a small capital return and a substantial fully franked dividend, paid from retained profits.

It only works, of course, where the company has sufficient retained earnings and franking credit available for distribution.

The benefit to the company is that they buy back the shares for less than the current market price.

The benefit to the shareholder is that when the value of the franking credit is added to the proceeds of the sale, the total value is more than the current market price.

These buybacks are really only of use to investors with a zero tax rate, although super funds with a 15% tax rate usually also receive a small benefit.

All other investors would be better off selling their shares on market and would be unlikely to participate. Almost all of the franking credits paid out with these buybacks would result in cash refunds.

Take, for example the current buyback of BHP shares. The final price has not yet been determined, but we can work out a rough estimate of the refunded franking credit. These buybacks are almost always oversubscribed, so we can assume the maximum discount of 14%.

Here are the figures for each marginal tax rate including Medicare Levy. Please note this is for illustrative purposes only and the final buyback price may differ from this. All values are in AU dollars. The share price was as at 30 November 2018.

Share Price ($)	**30.70**
discounted price ($)	26.40
capital amount ($)	0.38
dividend amount ($)	26.02
franking credit ($)	11.15
value to zero tax investor ($)	**37.55**
Value to 15% tax investor ($)	31.98
value to 21% tax investor ($)	29.75
value to 34.5% tax investor ($)	24.73
value to 39% tax investor ($)	22.87
value to 47% tax investor ($)	20.08

When we look at the totals involved we see that if only zero tax rate investors sell into the buyback then the total value of cash refunds for the buyback is over $3 billion.

Total amount of buyback ($bn)	7.30
Amount of dividend ($bn)	7.19
Franking credit ($bn)	3.08

If instead of the off market buyback the same $7.3 billion was distributed as a special dividend, paid to all shareholders, this would amount to around $1.37 per share with $0.59 franking credit attached.

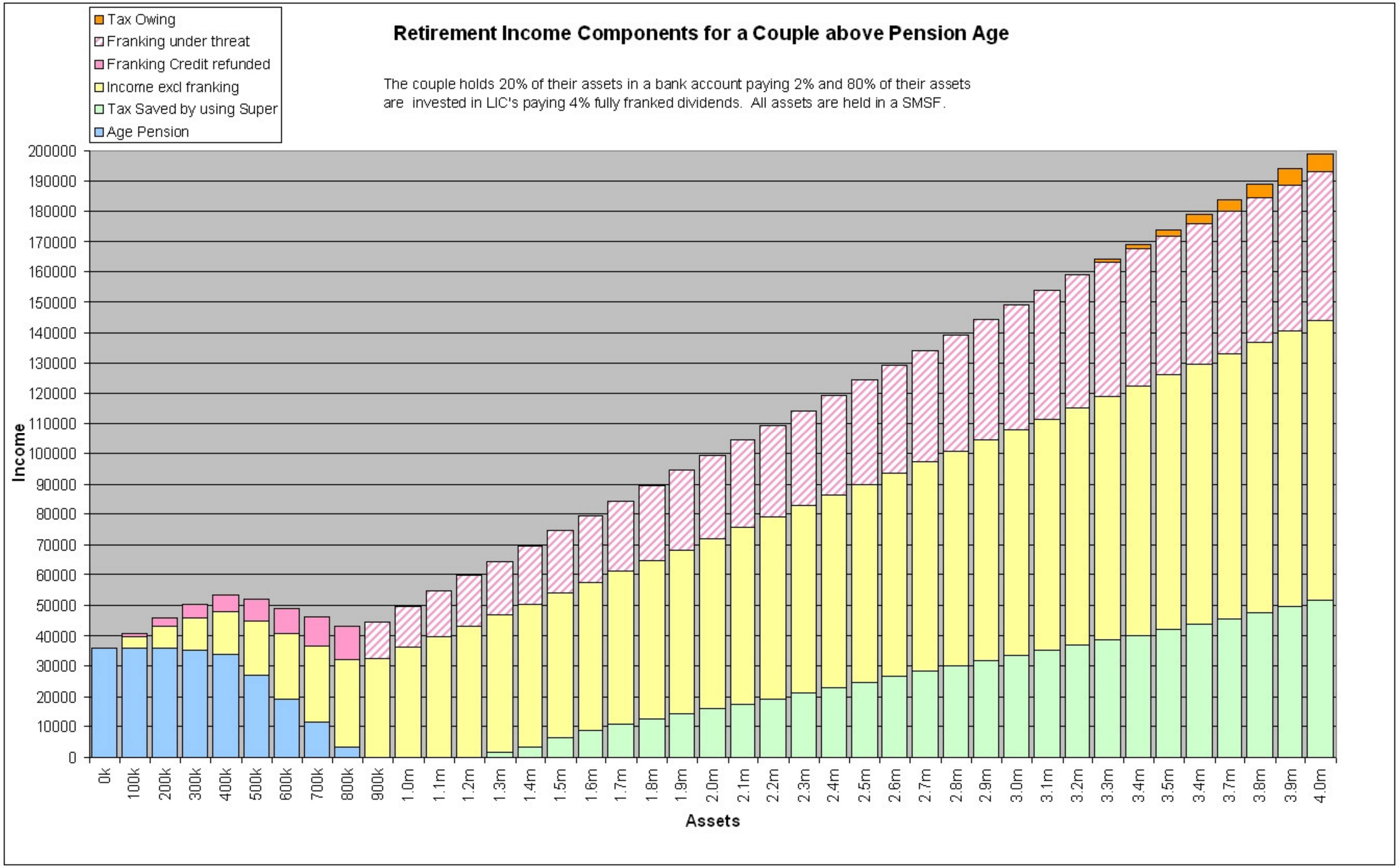
The same $3 billion of franking credit would be distributed with the dividend, but only a small portion of this would be refunded as cash. The overseas shareholders would receive no refund and all Australian shareholders with a marginal tax rate above 30% would owe more tax on their dividend than their franking credit would cover.

Depending on the proportion of investors owing extra tax to zero rate taxpayers, the net result may still be an overall cash refund but if so this would be far smaller than for the buyback.

If the company was keen to reduce the number of shares on issue to keep the share price and the earnings per share similar to before the special dividend, then this could be done quite simply by consolidating the shares on issue, for example for every 1000 old shares the company could issue 900 new shares.

If the law was changed to outlaw this type of off market buyback, then there would be a considerable reduction in the amount of franking credit paid by the ATO as cash refunds.

As these buybacks are really only a windfall for the zero tax rate investors, then I would not anticipate too much opposition to banning them.



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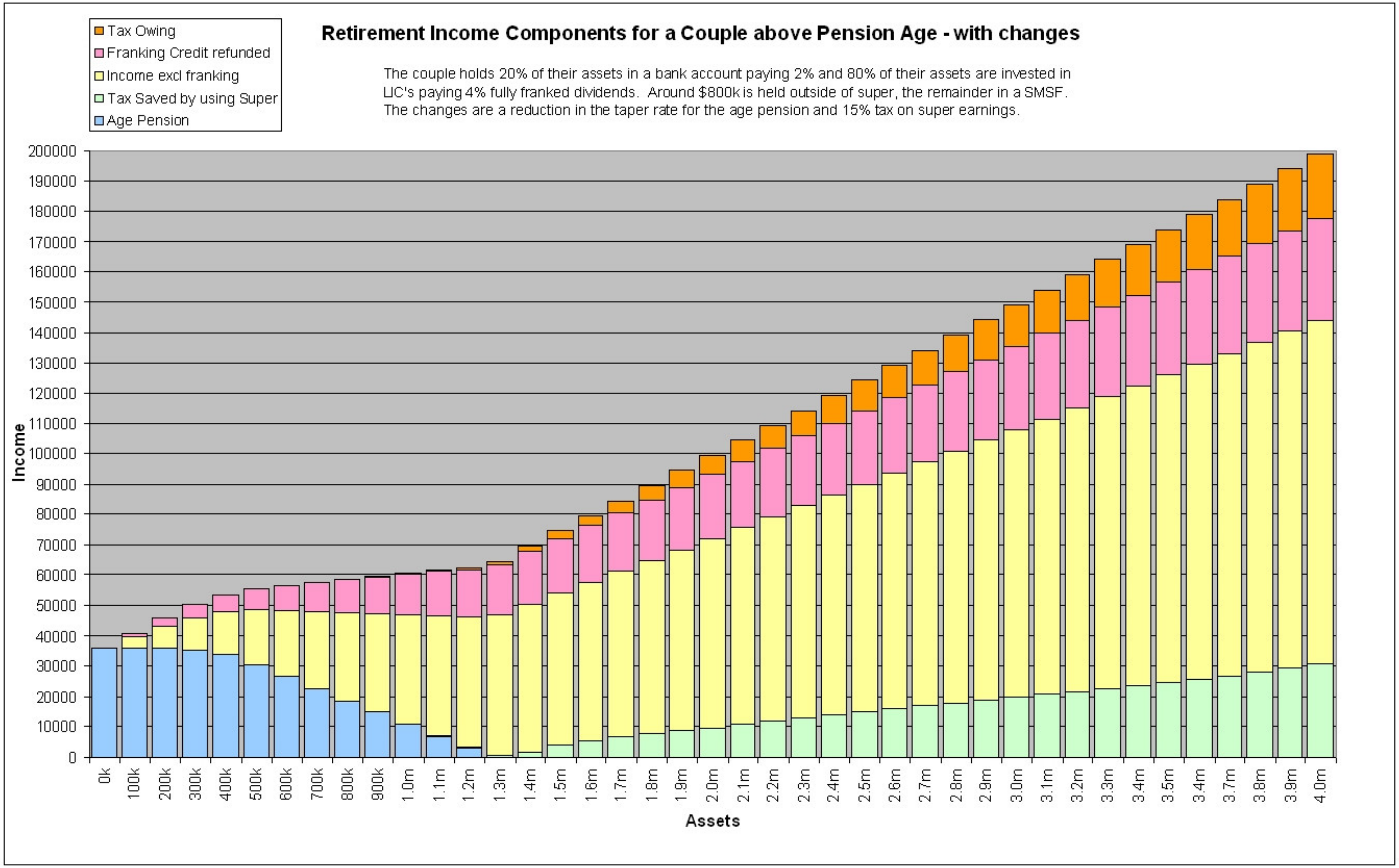

Chart 2 – Components of Retirement Income if pension taper was lower and super was taxed at 15%