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

An investor's perspective – by Lorraine, October 2018

My submission deals with some aspects of the proposed removal of the cash refund of unused franking credits from the perspective of an investor. I will cover some of the changes that I believe investors will make to their finances if this proposal becomes law and what effect this may have on the economy and the sharemarket.

Please note that I am not a financial planner, an accountant or a tax agent, but I do have a good understanding of the likely effects of this policy and how it will affect self-funded retirees and low income Australians.

I have been investing in Australian shares since 1994, I have had two books published on personal finance, I was a tax help volunteer for ten years and I am an active member of the Australian Shareholders' Association. I run a discussion group for the ASA and there has been a lot of discussion among members on this proposal.

Summary of Topics Covered

1. Low income earners are unfairly targeted. At the personal income tax level this policy will only affect those with less than $37,000 in other income apart from their franked dividends. Those with more than this will not be affected.
2. There has been very little information on how this will work in practice – will the franking credit still cover the Medicare Levy and will unused credit be subtracted from adjusted taxable income?
3. Anyone close to the assets test limit for the age pension will reduce their assets to qualify for a part pension and retain their franking credit refund.
4. The proposed changes will be a disincentive for Australians to save enough for an independent retirement.
5. Investors will change the way they invest to favour trust and interest income over franked dividends. Investment structures will also change.
6. The proposed timing does not give investors and finance industry participants sufficient time to adjust. A change as sweeping as this needs at least a year's notice from when it becomes law to when it is implemented.
7. SMSF's will be the hardest hit and retirees will change their superannuation arrangements. This will have flow on effects.
8. In the longer term there will be less money in the economy, probably from around Christmas 2020.
9. Self-funded retirees have already been hit with two major changes in the last two years. Retirees can only plan according to the rules current at the time of their retirement. They deserve those rules to remain stable.
10. If this policy was applied to employment income there would be an uproar.
11. Conclusions – this policy is poorly thought out and poorly targeted. It mainly affects independent low income retirees who are no longer in the workforce and have no way of replacing the lost income. No fair-minded Australian who fully understood the impact of this policy would support it.

1. Low income earners are unfairly targeted.

There would be no change at all to the personal income tax owing or net income for taxpayers with more than $37,000 in salary, wage, business, interest and unfranked dividend income (although their SMSF income may be affected). This policy will only affect taxpayers who have less than $37,000 in income apart from their franked dividends. It will have no effect on high income earners.

To illustrate this, for a taxpayer with $37,000 or more in other income, adding a $7,000 dividend with franking of $3,000 increases their taxable income by $10,000 and their tax owing by $3,450 (including Medicare Levy). The $3,000 franking offset reduces the extra tax they owe to $450. The franking credit is used up. There is no cash refund to lose.

The highest possible personal income on which a cash refund of franking credit is possible is around $138,000 (including franking) where all of this income is comprised of franked dividends, and at this level the refund would be very small.

The highest possible cash refund is around $7,400, paid to those with a taxable income of $37,000 (including the value of their franking credit) where their income is totally franked dividends. These people pay some income tax and currently take home around $33,300. This would reduce to only $25,900 if their unused franking credit was not refunded. These are the people who will be the most disadvantaged by this policy.

Here is a table of income and refunds where all of the taxpayer's income is in franked dividends. This is to illustrate the maximum likely franking refund. There would be very few taxpayers with only franked dividend income so most refunds would be well below this maximum level. I have allowed here for the low income offset, the new low and middle income tax offset and Medicare Levy, but not the senior's tax offset.

Taxable Income	Cash Dividend	Franking Credit	Tax Owing	Current refund	Current after tax	New after tax
140,000	98,000	42,000	42,097	0	98,000	98,000
138,000	96,600	41,400	41,317	83	96,683	96,600
130,000	91,000	39,000	38,197	803	91,803	91,000
120,000	84,000	36,000	34,217	1,783	85,783	84,000
100,000	70,000	30,000	26,117	3,883	73,883	70,000
80,000	56,000	24,000	18,617	5,383	61,383	56,000
70,000	49,000	21,000	15,167	5,833	54,833	49,000
60,000	42,000	18,000	11,617	6,383	48,383	42,000
50,000	35,000	15,000	8,017	6,983	41,983	35,000
40,000	28,000	12,000	4,657	7,343	35,343	28,000
37,000	25,900	11,100	3,667	7,433	33,333	25,900
35,000	24,500	10,500	3,247	7,253	31,753	24,500
30,000	21,000	9,000	2,197	6,803	27,803	21,000
25,000	17,500	7,500	1,147	6,353	23,853	17,500
22,000	15,400	6,600	517	6,083	21,483	15,400
20,000	14,000	6,000	0	6,000	20,000	14,000

It would be theoretically possible for a taxpayer with a high amount of deductions to exceed this maximum refund, but this would rarely be by any significant amount.

If you do include the seniors' tax offset then the refund may be as high as $9,000, for those earning around $30,000, but many of these taxpayers would qualify for a government age pension so would receive their cash refund anyway.

This policy is not a tax on the rich; it is a tax on low income earners whose main income is from investments. It will affect not only retirees but any low income earners who have some of their money invested in shares.

Is the Federal Opposition really so desperate for revenue that they would deny a legitimate $6,000 tax refund to someone earning only $20,000 a year from their investments who may be unable to work due to old age, frailty, sickness or family responsibilities, leaving them with only $14,000 a year to live on? No fair-minded Australian would support this.

2. How will this work in practice?

There are many aspects of this proposed loss of franking credit refunds that have not yet been properly thought out. It will add a lot of complexity to the tax system for very little additional revenue.

There has to date been insufficient information released on how this change will be implemented. Will the franking credit cover the Medicare levy? Non-refundable tax offsets normally don't. Will unused credit be considered part of a person's taxable income? What about their adjusted taxable income? Will unused credit be carried forward?

If the franking credit simply becomes a normal non-refundable tax offset, then it would not cover the Medicare Levy owing and taxpayers could face a double whammy of losing their franking cash refund and owing Medicare Levy on income they never received.

Can we then assume that this will be a special new type of non-refundable offset that will cover the Medicare component and that only the actual cash refund will be forfeited? Nothing has yet been said regarding this issue, but hopefully this would be the case and I have assumed this in all calculations.

Will the unused franking credit still count as part of a taxpayer's taxable income? We hope it would at least be subtracted from their adjusted taxable income for calculating private health insurance rebates and eligibility for the Seniors' Health Care Card.

A premise of our tax system is that you pay tax on income you receive, not on income you don't and never can receive. Will this be thrown out of the window to accommodate this change?

If you do take the unused franking credit away from the taxable income then the taxable income becomes lower and therefore the tax owing is less so more of the franking credit is excess so we take this off as well and we end up with a system where only the mathematical elite will be able to calculate their taxable income.

To illustrate this here is an example. A taxpayer has $50,000 in income all of which is franked dividends. They receive $35,000 cash and $15,000 franking credit. Their taxable income is $50,000 and the tax owing is around $8,000 including $1,000 of Medicare Levy.

They are unable to use $7,000 of their franking credit, so let's take this away from their taxable income. Their taxable income has now reduced to $43,000 and the tax owing is now approximately $5,650.

So now there is another $2,350 of unusable franking credit that we can subtract from their taxable income which becomes $40,650. The tax owing on this reduces to $4,870 so another $780 is subtracted. This continues on and eventually does reach a solution but I think by now we have all seen the point.

Yes, okay the bottom line is that they receive only their $35,000 cash regardless of their theoretical taxable income. But their taxable income is used in calculations for some tax offsets and health care card eligibility. It does need to be calculated fairly.

3. Retirees close to the assets test limit will reduce their assets

One very obvious effect of the proposed changes is that retirees who are above age pension age and who have assets slightly above the assets test limit for a government age pension will reduce their assets as they will then qualify for a small part pension as well as a full cash refund of their unused franking credits.

Consider a retired couple with $900,000 in assets who receive $55,000 income between them of which $5,000 is bank interest and $50,000 is franked dividends ($35k cash and $15k franking credit). Their assets are all outside of super. They pay no tax as they are below the threshold for seniors.

Under the proposed rules they would lose the benefit of any franking and their total income would reduce from $55,000 to $40,000.

If this couple spent $60,000 of their capital on overseas holidays or house renovations, they would then qualify for a small amount of government age pension. Once they become age pensioners they are entitled to have their franking credit refunded and they gain back most of their $15,000. Some shares were sold to pay for the holiday so their dividend income is slightly lower but they gain some age pension income to compensate for this.

For a short time the economy will benefit from retirees in this position spending up big time on holidays and house renovations. As a rough estimate this could be 100,000 self-funded retirees becoming age pensioners and spending a total of around $8bn in the process. Sadly much of this may be spent overseas.

4. The proposed changes will be a disincentive to save

We already have a lot of disincentive to save built into our retirement system. The proposed changes to franking credit refunds will make this far worse.

Let's consider three couples who had similar salaries and similar opportunities to save over their working life. The savings are held 20% in cash paying 2% interest and 80% in Listed Investment Company shares paying a 4% fully franked dividend. This is a typical return for conservative LIC's such as ARG, AFI, MLT and WHF.

Abe and Ada are spendthrifts, and all of their salary goes on dining out, holidays, designer fashion, lavish parties and a boat. They have a large riverside home and when they retire their super is used up paying out their remaining mortgage. They have no savings and their only asset is an old boat which is now worth very little. They qualify for a government age pension giving them an income of $36,000 a year.

Bob and Babs manage to save $500,000 and retire with a part pension of $27,000 as well as income from their investments of $18,000 plus franking credit of around $6,850. This gives them a total income of around $51,850.

Cecil and Celia are very frugal people and are good savers. They have managed to retire with $1m in savings. They don't qualify for an age pension and their income is $36,000 cash plus franking credit of $13,700 giving them a total of $49,700.

If the proposed changes are implemented, then there will be no change for Abe and Ada as they have no franking credit, there will be no change for Bob and Babs as they are pensioners and retain their franking refund, but poor Cecil and Celia will be reduced to an income of $36,000, the same as they would have if they had never saved anything at all and were on an age pension.

Yes, they do have $1m to spend as they please, but this is money that they could have spent on dining out and holidays and boats the same as Abe and Ada did. Their $1m did not fall from the sky.

Every single dollar that a person saves over their lifetime has an opportunity cost. If there is no obvious benefit from saving money for retirement above the pension assets test limit then there is no incentive to do so. Most people will choose to retire as part pensioners rather than self-funded retirees.

5. Investors will change the way they invest

Investors will favour trust and interest income over franked dividends. With a trust, the full income is passed on to the investor and they pay the tax on it.

As a reminder, if a company makes $100 in profit they pay $30 tax and pay their investors a dividend of $70 cash with a $30 franking credit attached. When a trust makes $100 profit they pay the $100 to their investors who pay tax on this at their marginal rate. Trusts may pass on some flow through franking credit from franked income that they receive, but in general a trust will pay the investor more in cash than a company is able to for the same profit.

The company structure has evolved to be the best way for business enterprises to be structured. Trusts generally hold income producing assets or investments in other entities and distribute rental or investment income.

Listed Investment Companies may change to a trust structure as this will benefit a large number of their shareholders with no disadvantage to the others, but normal companies obviously can't and won't do this.

Trusts, managed funds, ETF's, international companies paying unfranked dividends, and interest income will become more attractive to investors who do not qualify for a refund of unused franking credit. Australian companies paying franked dividends will become less attractive.

Hybrid securities with a franked distribution will be out of favour, as without the benefit of the franking credit the returns are usually very low. Hybrids paying interest rather than franked distributions will become more popular and some companies may choose this structure for capital raisings. There will be more ETF's offered and these may become the investment of choice for SMSF's.

These changes will not happen overnight as investors will need to consider the effects of capital gains tax, but they will happen.

6. There is insufficient time to adjust

If the proposed changes to franking refunds are implemented as planned, then there is very little time for investors, companies and the finance industry to adjust to the changes.

If the next election is held in May 2019 and the changes come into effect from July 2019 then there may be only a few weeks for changes to investment strategies and investment structures to be put in place, and for the software used by financial planners and SMSF's to be updated.

Some companies may wish to pay special dividends before the end of the 2018-2019 financial year and some LIC's will change to a trust structure. There may be less than six weeks for this to occur and even then the legislation is unlikely to be in place before the date the changes are due to start. By the time this becomes law the changes may in fact be retrospective.

A change as sweeping as this needs at least a year's notice from when it becomes law to when it is implemented.

7. SMSF's will be hardest hit

SMSF's in pension mode will be hardest hit by the proposed changes as they have no tax liability to offset and will lose all of the benefit of their franking credits. Retirees with SMSF's will change their superannuation arrangements, and this will have flow on effects.

Some SMSF's with all members in pension mode will roll their benefits over to an industry or retail fund, where their franking credits can be used to offset the tax liabilities of accumulation phase members, allowing the retirees to retain the benefit of them. This will help the retail and industry funds but will be disaster for the hundreds of small accounting and SMSF administration firms that currently assist with running and auditing these SMSF's.

Some SMSF's will bring in additional family members (they will by then be allowed up to six members) and set up a family fund with the franking of the retired members offsetting the contributions and earnings tax of the younger members. This may become the structure of choice and the financial planning industry will no doubt facilitate this process. But it will not suit all families.

Some SMSF's in pension mode will change back to being in accumulation mode. If the franking is sufficient to cover any tax owing and any excess is forfeited, then having super in accumulation mode has the advantage that the fund will have exactly the same net income but the retirees are no longer obliged to withdraw a minimum amount each year if they do not need to.

Some SMSF's will simply be closed. If there is no longer any tax benefit for holding assets in a SMSF, then it is pointless for retirees to pay the costs involved and spend their time on the extra paperwork needed. Closing their fund will also save death benefit tax for their heirs and will make things easier for the executor of their estate.

Here is an illustration of this. Assume a couple has $1.5m in pension mode super in a SMSF. Their fund earns $70,000 a year with $30,000 franking credit, giving them a total income of $100,000. They pay $4,000 a year in administration costs for their fund. Under the proposed rules they would lose the franking refund and have $70,000 total income less their $4,000 costs.

Now suppose they shut down their fund and invest their $1.5m in the same shares in joint names. Their personal income is $50,000 each ($35,000 cash dividend and $15,000 franking credit) and they each owe around $8,000 in tax. This is easily covered by the franking credit so their net joint income is still $70,000. But they have saved the $4,000 they pay for their fund administration.

This situation applies to couples with up to $275,000 in income between them if all of their income is from franked dividends. An individual taxpayer can earn a little over $138,000 before the tax owing reaches 30% of their income. These people may derive no benefit at all from retaining their SMSF.

However withdrawing super is a one way process. If the rules were changed again they would not be able to reverse this decision and put the money back into super.

8. In the longer term there will be less money in the economy

Initially the income of retirees will not be affected as in late 2019 they will receive the franking credit from the 2018-2019 financial year.

If the new system applies from 1 July 2019 as planned then in late 2020 there will be no refunds and the families of these retirees will have a pretty bleak Christmas, along with the families of retail business owners and the people the businesses can no longer employ.

If the retirees need to reduce their costs they will reduce discretionary retail spending and holidays and may no longer be able to afford private health insurance. All of this will flow through to the economy.

9. Self-funded retirees have already been hit with two major changes.

Self-funded retirees have already been hit with two major changes in the last two years, first to the age pension assets test and then to the amount they can hold in pension mode super. The loss of franking credit refunds would be yet another hit to the income and lifestyle of people who planned their retirement on the rules that were current when they retired.

Since retirees are no more capable of foreseeing future changes than anyone else, they plan their retirement according to the rules in place at the time they choose to leave the workforce. These people cannot decide to go back in time and work another two years before they retire.

These are not rich people, but low to middle income earners who worked for all of their lives, paid taxes, contributed to the fabric of our society and the success of our economy but are no longer able to work. The retirees affected are only those who are self-funded and currently costing the government nothing in age pension payments. There are probably around half a million of them.

These retirees deserve to be able to plan their financial affairs with certainty that the rules will remain stable. The proposed changes amount to throwing these honest, diligent, self-reliant and independent people to the wolves.

10. If this policy was applied to employment income there would be an uproar.

Consider if this policy was applied to employment income and bank interest.

All employers would be obliged to remit 30% of every employee's income to the ATO, and banks would similarly withhold 30% of all bank interest.

At the end of the year, taxpayers would put in their tax returns as normal and any extra tax owing above the 30% would be due and payable. But there would be no refunds if the tax owing was less than the 30% tax already paid. If you had paid more tax than you owe this would just be hard luck.

If this was proposed there would be an uproar, but this is exactly what this policy is doing to the income that retirees receive from the companies they invest their savings in. Think about it.

11. Conclusions

The policy is poorly thought through and would result in another layer of complexity in our already highly complex tax system.

It is poorly targeted as it mainly affects low to middle income earners who have left the workforce and have no way to make up the income they are losing.

At the very least this policy should not apply to individual personal income tax as it increases complexity and disadvantages low income earners for very little additional revenue, while having no effect whatsoever on the net income of the rich. There is a natural cap on the cash refund of around $7,400 and few taxpayers would receive anything like this much. The taxpayers affected are only those who are not costing the government anything in social security payments.

For super funds the policy disadvantages retirees who choose a SMSF over a retail or industry fund to save costs and to have total control over their investments. If the aim of the policy is to extract more tax from this group (above the caps to pension mode super that have recently been legislated), then the problem needs to be addressed by changing the tax on super for everyone, not by targeting a particular group of retirees who have saved an amount above a certain asset limit and chosen a particular fund structure for their super.

Cash refunds of excess franking credits are not a tax rort used by rich retirees to game the system. The refunds are a legitimate return of tax withheld by companies on the dividend income of their shareholders in exactly the same way as employers withhold PAYE tax and employees receive a refund of excess tax paid.

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October 2018