Let's be frank about franking credits

Briefing on Labor's proposal to remove refundability of **franking credits for investors and super funds that** don't pay tax

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About ACOSS

The Australian Council of Social Service (ACOSS) is a national advocate for action to reduce poverty and inequality and the peak body for the community services sector in Australia. Our vision is for a fair, inclusive and sustainable Australia where all individuals and communities can participate in and benefit from social and economic life.

Summary

The Labor Party proposes, if elected, to remove refunds of 'franking credits' currently paid by the Australian Taxation Office (ATO) to company shareholders (individual investors and super funds) that do not pay income tax. Recipients of income support payments (for example pensions) would be exempted from the policy. The policy is estimated to raise $5.3 billion a year.

ACOSS supports this policy, though we argue it would simpler to remove refunds of franking credits above a fixed annual threshold rather than exempting all income support recipients. As well as restricting franking credit refunds to people who don't pay tax, the next government should plug the gaps in the taxation of retirement incomes so that retired people who can afford to pay tax do so.[1]

Many claims and counter claims have been made about the effects of this policy. The purpose of this briefing is to inform ACOSS members and the public of our assessment of its likely impacts.

Our main conclusions are that:

1. The next government will face a challenge to properly fund decent, affordable health, aged care and disability services for an ageing population.

   The Parliamentary Budget Office estimates that the cost of these services will increase by $21 billion a year by 2028, even without any improvements in services or reductions in out-of-pocket costs.[2] The Aged Care Royal Commission and other inquiries are exposing the chronic under-resourcing of these essential services.

2. Given these pressures on essential services, the present tax arrangements for retired people – which effectively exempt five out of six people over 64 years from paying income tax – are not sustainable.[3]

   This applies especially to the exemption from income tax of superannuation fund earnings (such as interest, dividends and capital gains) for retired fund members who are being paid a superannuation pension. As the population ages, this will open up a gaping hole in the public revenue base.

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[1] The detail of ACOSS' position is outlined in our submission to the House of Representatives Standing Committee on Economics and is available here.
[2] Parliamentary Budget Office (2017), *2017-18 Budget: medium-term projections.*
[3] Daley, Coates & Young (2016), *Age of Entitlement: Age-based tax breaks.* Grattan Institute. Available: https://grattan.edu.au/wp-content/uploads/2016/11/879-Age-of-entitlement.pdf

3. Franking credits are in effect a refund of the income tax paid by companies to their shareholders who receive dividend payments. They are intended to avoid 'double taxation' of company income.

   In 2000, the then government extended franking credits to individuals and super funds that don't pay income tax – so they effectively receive a *cash payment* instead of a *rebate of tax paid* from the ATO.

4. Refunding franking credits to people who don't pay income tax is not *wrong in principle* (the company they invest in has already paid tax on its income), but it is *unaffordable*. These refunds cost the budget $6 billion a year, according to Labor.

5. The policy affects people with low *taxable* incomes *and* substantial shareholdings. Most people falling into both categories are retirees, since superannuation is generally tax-free after retirement. Their *actual* incomes are generally much higher than their taxable income (which is often zero) suggests.

   The Parliamentary Budget Office (PBO) estimates that 60% of the savings from Labor's policy would come from Self-Managed Super Funds or SMSFs, mainly from the top 10 per cent of funds with balances of $2.4 million or more. The rest comes mainly from retired people owning shares directly (86% of which are held by the wealthiest 20% of retired people).

   People on public pensions (generally, older couples with income below $80,000 and assets apart from their home of less than $850,000) are exempted from the policy.

   On the other hand, SMSFs with over $1.6 million in assets are no longer exempt from income tax. They pay at least some tax against which franking credits can be offset, reducing the impact of Labor's policy on those funds by around 10% over the next decade, according to the PBO.[4]

6. By definition, those with large annual franking credits have large shareholdings. As a rule of thumb, an individual or SMSF losing $10,000 a year in refunded imputation credits under the policy would hold around $500,000 in shares (50 times the value of foregone franking credits).

7. Charities and deductable gift recipients would not be directly affected, as those investing in shares would continue to receive franking credits despite not paying tax on their income.

8. We conclude that the policy is a fair way to raise public revenue for essential services such as health and aged care, as those affected can afford to pay. It is much fairer than increasing user charges for those services or cutting services. Retired people are worst affected by under-funding of future health and aged care services.

[4] PBO (2018), *Policy Costing: Dividend imputation credit refunds, further information.*

The tax treatment of retired people: an example

In the Sydney Morning Herald 'Money' section on 17/4/19, a retired couple sought tax advice:
- They had $1.5 million in their self-managed super fund (SMSF), investing in shares earning 5.9% per year, providing an estimated annual income of $88,000.
- The fund received an estimated $37,000 a year in franking credits, lifting their annual income to $125,000.
- Tax on this $125,000 was estimated to be $13,000 (an overall tax rate of about 10%), which was more than offset by the franking credits.
- So, instead of paying tax, they received a net $24,000 ($37,000-$13,000) from the ATO.
- If the SMSF sold the shares, they would not have to pay Capital Gains Tax on any profits.

They would have paid tax on their super contributions and fund earnings before retiring, but those are normally taxed at a flat rate of 15% - a saving of more than 30 cents in the dollar for a person on the top marginal tax rate.

The tax treatment of super (usually 15% as funds accumulate and 0% as they are drawn down) is extraordinarily generous for people with high incomes. Large refunds of franking credits mainly go to people who don't receive Age Pensions, but have already benefited from superannuation and other tax breaks which are often more generous than the pension.

Labor's proposed reform of refundable franking credits for investors and super funds

If elected, the Labor Party proposes to end refunds of 'unused' or 'excess' franking credits to investors and super funds who don't pay income tax. Recipients of pensions and other government benefits would be exempted, and would continue to receive the refunds. Superannuation funds with members who receive government benefits as at March 2018 would also be exempted.

The policy is estimated to raise $5.3 billion in its first full year of operation, in 2020-21.

Dividend imputation: how it works

Under the dividend imputation system, Australian resident companies that distribute dividends from after-tax profits have the option of passing on 'franking credits' (also known as 'imputation credits') to their Australian shareholders, attached to the dividends they receive. This provides shareholders with a credit for the tax that the company has paid (generally around 25%) on its profits.

Shareholders include an amount equal to the franking credit attached to their dividend in their assessable income for tax purposes. Australian residents and complying superannuation funds are entitled to claim a tax offset equal to the amount of franking credits received.

Broadly speaking, the idea behind this is to prevent company income from being taxed twice (once in the hands of the company and then in the hands of the shareholders), so that the tax treatment of a company shareholder is equivalent to that of an individual who runs their own business directly.

The franking credit tax offset can be used to reduce a taxpayer's income tax liability.

Since 2001, if they don't pay enough income tax to fully benefit from this offset, any 'excess' franking credits have been refunded to taxpayers by the Australian Taxation Office (ATO). This change was introduced as part of the then Coalition government's GST tax package.

The cost of these refunds escalated after 2007, when the same government exempted superannuation benefits (pensions and lump sums) from income tax. Fund earnings (e.g. interest and dividends) were already tax-free once the fund started paying a superannuation pension. This meant that many retired people no longer had income tax liabilities against which to offset their franking credits, so they became entitled to the refunds instead. Given the implications for public revenue and equity, both the refunds of franking credits and tax-free status of super fund earnings should have been reviewed at that time.

In addition, rapid growth of self-managed super funds (SMSFs) meant that more funds lacked income tax liabilities against which to offset their franking credits (super funds are also entitled to franking credit refunds).

Is the policy justified?

Yes: the main argument for the policy is that future governments cannot afford to guarantee decent health and aged care services for all while five in six people over 64 years pay no income tax, and despite this many receive franking credit refunds from the ATO.

In theory, Australia can afford to guarantee decent health and aged care services for all who need them. According to Credit Suisse, Australian households are now on some measures the wealthiest in the world. In practice, under current tax settings, future Australian governments will not have the revenue they need to provide this.[5]

The Parliamentary Budget Office (PBO) estimates that the cost of these services will increase by $21 billion a year by 2028, even without any improvements in services or reductions in out-of-pocket costs.[6] The Aged Care Royal Commission and other inquiries are exposing the chronic under-resourcing of these essential services. For example, there is a waiting list of over 100,000 for home care services. Our older people deserve better.

One way to pay for increased health and aged care costs is to charge more user fees. However, Australia already has among the highest user charges for health services in the OECD.[7] One of the biggest worries for retired people is their ability to pay for health and aged care – including medical specialists, home care services, and nursing home deposits.

A better way is to pay for these services by taxing the general population, on the basis of their ability to pay. This is a form of collective insurance. Everyone, including younger workers, will benefit at some stage of their lives if we have good quality, affordable health and aged care services.

However, our income tax system has a major weakness. Due to the over-generous tax treatment of superannuation, and other special tax breaks for older people (see box below), only 16% of people over 64 years pays income tax, despite the fact that this cohort is now the wealthiest among all age groups (with average net wealth of $1.3 million of which half is from their home).[8]

In addition to not paying income tax, many retired people and super funds that don't pay income tax receive refunds of excess franking credits, at an annual cost to the budget of $6 billion.[9]

Removing the refunds, and taxing super fund earnings after retirement at the same 15% rate that applies before retirement, are fair ways to help fund essential health and aged care services.

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[5] Credit Suisse (2018), *Global Wealth Report 2018.*
[6] Parliamentary Budget Office (2017), *2017-18 Budget: medium-term projections.*
[7] Australian Institute for Health and Welfare (2016), *Australia's Health*.
[8] ACOSS-UNSW (2018) *Inequality in Australia*.
[9] Some people of working age also receive refunded franking credits, but this is much less common since people of working age with low taxable incomes are unlikely to have substantial direct shareholdings.

Current tax breaks for older people

1. Superannuation fund earnings and benefits after retirement are tax free:

Once a super fund pays a pension to a retired member, the investment income of the fund (e.g. interest and dividends and capital gains) is tax free. This extraordinarily generous tax treatment is not available for many other investments outside owner-occupied housing. In contrast, super fund earnings are taxed at (a still low) 15% in the 'accumulation phase' before the fund pays a pension.

Consistent with the tax treatment of savings in bank accounts, superannuation benefit payments (including pensions and lump sums) are also generally tax free.

2. People over 64 years have a higher tax free threshold:

The *non-superannuation* income of older people is taxed above a much higher tax free threshold than for people under 65 years, due to the Seniors and Pensioners Tax Offset (SAPTO). For example, a retired couple can earn up to $56,000 tax free *in addition to superannuation*, without paying income tax. This compares with a combined tax free threshold of $41,000 for a younger couple.[10]

Since most retired people have low *taxable* income, and the better-off among them have substantial shareholdings (directly or through their self-managed super fund), they are the main beneficiaries of refundable franking credits.

In addition to not paying income tax, many retired people receive between $500 and $10,000 in franking credit refunds annually from the ATO.[11]

Who is affected?

Those affected by removal of franking credit refunds are unlikely to be at risk of poverty, for two reasons:

- First, people receiving full or part pensions and other income support payments (e.g. Newstart Allowance) are exempted from Labor's policy. Generally, older couples with income below $80,000 and assets apart from their home of less than $850,000 are entitled to at least a part-pension.

  SMSFs with pensioner or other income support recipients among their members are also exempt, provided the fund had such a member as at March 2018 when the policy was announced. This limitation is presumably intended to prevent SMSFs with wealthy members from adding an income support recipient to their membership to get around the policy.[12]

[10] Including the Low Income Tax Offset (LITO).
[11] House of Representatives Economics Committee (2019), Implications of removing refundable imputation credits.
[12] The Government estimates that each year after March 2018, 2,000 to 3,000 pensioners will join SMSFs. If those funds did not have a member on a pension prior to March 2018, they would be affected by the policy.

Nevertheless, it is clear that people receiving pensions who don't use an SMSF are exempted from the policy and would continue to receive franking credit refunds.

- Second, people or super funds with substantial refunds of franking credits must have substantial shareholdings. As a rule of thumb, a shareholder with $10,000 in imputation refunds would be likely to hold approximately $500,000 in shares (50 times the value of the refund).[13]

  Since superannuation is for retirement rather than passing on assets to their heirs after death, it is reasonable to expect people to draw down their super after they retire, including by selling assets such as shares.

The PBO estimates that in 2019-20, Labor's policy would affect: [14]

- 840,000 individuals;
- 210,000 SMSFs; and
- 2,300 industry and retail super funds.

Those most affected by the removal of refundable imputation credits are relatively wealthy people with substantial income from self-managed superannuation funds, who pay little or no income tax due to a combination of the generous tax treatment of superannuation post-retirement and the SAPTO. It would be misleading to describe this group as 'low income-earners', as their taxable incomes are a poor measure of their ability to pay.

The Grattan Institute estimates that among the wealthiest 10% of people aged 65 and over (whose average wealth is nearly $2 million, excluding the principal residence), almost half report annual incomes of less than $18,200.[15]

The PBO estimates that 60% of the savings from Labor's policy would come from SMSFs, of which half would come from the top 10 per cent of funds with balances of $2.4 million or more.[16] The impact of the policy on SMSFs with large shareholdings is reduced by the government's recent decision to extend income tax to super fund accounts holding assets above $1.6 million. This means the fund must pay at least some income tax against which franking credits can be offset. However, the $1.6 million ceiling on tax free assets is estimated by the PBO to reduce the impact of Labor's policy on these funds by just 10% over the next decade.[17]

The other 40% of budget savings from Labor's policy would come mainly from retired people owning shares directly (86% of which are held by the richest 20% of retired people). The vast majority (92%) of individual taxpayers do not claim excess franking credits.[18]

The exemption from Labor's policy for social security recipients is estimated to extend to 320,000 pension and allowance recipients, and 20,000 SMSFs with a member receiving a pension or allowance as at March 2018.

[13] Assuming a 4% dividend yield and that the companies in which they invest face an average tax rate of 25%.
[14] PBO (2018), *Policy Costing: Dividend imputation credit refunds*, PR18/00145.
[15] Coates B & Wood D (2018), *The real story of Labor's dividend imputation reforms*, in The Conversation, 20 March 2018. https://grattan.edu.au/news/the-real-story-of-labors-dividend-imputation-reforms/
[16] PBO (2018), op cit
[17] PBO (2018), *Policy Costing: Dividend imputation credit refunds*, *further information.*
[18] PBO (2018), op cit

Are charities affected?

Charities and organisations with gift deductable status are not directly affected, as they are specifically exempted.

This means that the franking credit refunds that charities receive from their investments will continue.

Some have argued that the policy would affect charities indirectly, via reduced donations from wealthy individuals. If the community sector was to take this into consideration, we would need to argue against any policy that reduces the after-tax incomes of wealthy people. At a time when public revenues are clearly inadequate to meet social needs, and inequality has been rising, this is not our view.

What impact would the policy have on the economy?

The policy is likely to change the profile of investments by people who would previously have received franking credit refunds, and company policies on dividend payments, but there is no evidence to suggest this would reduce overall investment or economic growth.

Since it only applies to investment in Australian companies paying dividends, dividend imputation biases investment towards those Australian companies that make relatively large or regular dividend payments (for example, the major banks).

Under Labor's policy, the imputation system would remain, but refunds of franking credits to those who don't pay income tax would be denied.

Investors (mainly individuals and SMSFs) are likely to adjust their portfolios in favour of overseas shares and other assets.[19] If they invest efficiently, and receive good financial returns from those investments, then all things equal this would boost economic growth in Australia, offsetting any impact from reduced investment in Australian firms. Further, since publicly-listed Australian companies also attract investment from overseas, their cost of capital is unlikely to be affected in the medium to long-run.[20]

Australian companies are likely to adjust their dividend policies as the value of 'excess' franking credits on their books grows. One possibility is that companies reinvest a greater share of profits and another is that they buy their own shares. To the extent that they reinvest, this is likely to boost economic growth, at least in the short term. Critics of dividend imputation argue that the system discourages reinvestment.[21] Supporters argue it reduces Australian companies' reliance on debt and encourages them to pay income tax.

[19] Butt A et al (2018), *Submission to House of Representatives Standing Committee on Economics: Inquiry into the Implications of Removing Refundable Franking Credits*, College of Business and Economics, Australian National University.
[20] This is ultimately determined by international costs (interest on debt and sharemarket values), not domestic ones.
[21] Koukoulas S (2018), *Submission to House of Representatives Standing Committee on Economics: Inquiry into the Implications of Removing Refundable Franking Credits.*

Any economic impact of the policy will be limited due to the fact that dividend imputation would still apply, as long as investors have income tax liabilities against which their franking credits can be offset.

It is noteworthy that the imputation system operated without refunds of excess franking credits from 1988 to 2001, without any demonstrated economic drawbacks.

ACOSS policy recommendations

In order to help finance necessary future expenditures on health, aged care and the NDIS, the public revenue base should be strengthened by:[22]

(1) Extending the 15% tax on superannuation fund earnings in the 'accumulation' phase to the 'pension' phase over a five-year period from July 2018 (a 3% increase each year), offset by a 15% rebate for taxpayers over the preservation age whose income (including Age Pension, earnings and investment income) falls below their tax free threshold;
(Revenue: $1.5 billion in 2019-20)

(2) Broadening the income definition for the Medicare Levy from 'taxable income' to 'Medicare Levy Surcharge income' to prevent people from avoiding the Levy through tax shelters such as private trusts, negative gearing or salary sacrifice arrangements;
(Revenue: $1.2 billion in 2019-20)

(3) Removing refundable franking credits above a low annual cap from individuals and investment vehicles with insufficient personal income tax liabilities to otherwise benefit from imputation.
(Revenue: $5.3 billion in a full year)

[22] More detailed proposals are outlined in our 2018 Budget Priorities Statement at https://www.acoss.org.au/wp-content/uploads/2018/02/ACOSS-Budget-Priorities-Statement-2018-19_FINAL.pdf