The Alliance for a Fairer Retirement System

2 November 2018

Committee Secretary
Standing Committee on Economics
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Canberra ACT 2600

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Dear Committee members

Inquiry into the Implications of Removing Refundable Franking Credits

The Alliance for a Fairer Retirement System was formed to advocate for the principles of adequacy, sustainability, certainty and fairness in retirement policy. It exists to represent millions of senior Australians, shareholders, self-funded retirees planning a sustainable retirement and, as such, is keen to explore options to fix problems with the existing superannuation taxation, Age Pension means testing and broader retirement income systems.

Organisations included in the Alliance are the Australian Shareholders' Association; Australian Listed Investment Companies Association; National Seniors Australia; SMSF Association; Self-managed Independent Superannuation Funds Association; Stockbrokers & Financial Advisers Association; Association of Independent Retirees; Australian Investors Association; Association of Financial Advisers; WA Self Funded Retirees Inc; and Gold Coast Retirees Inc. In representing their constituents, the Alliance represents 745,000 paid members Australians in aggregate, representing the interests of those who will be affected by the proposed policy who number in the millions.

The formation of the Alliance was in response to Labor's proposal to disallow refunds of excess franking credits for a range of retirees and shareholders. An important objective for government is to encourage older Australians to save for retirement and to support the majority of retirees (58%) who take pride in being either fully or partly self-funded in retirement. This majority includes many self-funded retirees and 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.

The ALP's stated policy to remove cash refunds for those who have excess unused franking credits will impact directly on many retirees on modest incomes and is a disincentive to saving for retirement. It infringes on the principles held by the Alliance for a Fairer Retirement System of adequacy, sustainability, certainty and fairness. As such, the Alliance welcomes the Inquiry into the Implications of Removing Refundable Franking Credits (the Inquiry) and the opportunity to set out our views on the proposal to remove refundable franking credits.

Adequacy

Adequacy measures the degree to which the retirement system enables people to achieve a sufficient standard of living in retirement relative either to the standard they enjoyed while working, or as compared to

an objective budget standard for retirees. No single retirement income target will be appropriate for all groups. Denying the tax rebate on franking credits will have an immediate impact on many retirees and substantially reduce retirement incomes, threatening income adequacy.

Example 1:
An SMSF in pension mode with no age pension and $1m of savings invested in Australian shares will see a 30% drop in income.

- Current system — dividends $42,000 + franking credit cash refund $18,000 = total cash income $60,000
- Proposed policy without franking credit cash refund — total cash income $42,000

Example 2:
A retiree couple with no age pension, $800,000 in shares and $75,000 on deposit in the bank.

- Investment income $36,000 plus franking credit cash refund $15,400 = total cash income $51,400
- Without franking credit cash refund — total cash income for the couple is $36,000

Sustainability

Sustainability requires that government expenditure on the retirement income system through the age pension and superannuation tax concessions must be affordable over the long term. Changes to retirement income policy must contribute to fiscal sustainability by incentivising self-sufficiency. For many retirees, the potential loss of income under the ALP policy is a direct incentive to sell down assets and seek income support through the age pension. This is especially true in example 2 above, given that the full age pension for a couple with a house and assessable assets of less than $387,500 $35,916. Upsizing to a more expensive home, for example, could ensure they receive a very similar income and preserve their assets. Placing a disincentive on saving for retirement is not good policy and threatens the sustainability of the system.

Certainty

Older Australians require certainty to plan for retirement with confidence and should have sufficient time to alter their arrangements in response to proposed policy changes. The ALP's intention to legislate for the removal of cash refunds on franking credits, if and when they gain office, leaves little opportunity for those in retirement to alter their savings plan. Such short-term thinking completely contravenes the need for policy certainty in retirement planning and creates undue anxiety.

Fairness

Fairness requires that the retirement system treats people in the same circumstances equally. The move to refund franking credits to all shareholders was undertaken with the intention that shareholders should be taxed at their marginal rate. Failure to refund credits to those who pay no tax or have excess unused franking credits means that their investment income would be taxed at up to the corporate rate of 30%. Further, exempting those receiving social security benefits means that retirees on the same income will be taxed at very different rates.

Example 3:
A couple on the full age pension and with $300,000 invested in Australian equities in an APRA regulated pension fund.

- Age pension income of $35,573 + $18,000 in dividends and franking credit benefits = total income of $53,573 – no change under the new policy

Compare Example 3 with Example 1. The couple who worked hard to save for retirement, and who have no age pension, but $1m in their SMSF are worse off than those who have only saved $300,000. This is clearly not fair. It is also a clear disincentive to save for retirement and will threaten the sustainability of the retirement system.

Importantly, the proposed policy treats Australians in the same financial situation and with very similar investment portfolios differently, which runs counter to the principle of fairness. Australians will be treated differently depending on whether they save through an industry or retail superannuation fund, a self-managed superannuation fund or save outside superannuation. Those who save through an industry or retail superannuation fund will generally still be able to utilise franking credit refunds, as they will be able to use credits to offset their tax liability subject to the majority of members being in the accumulation phase. However, those saving in self-managed superannuation funds — generally in the pension phase — and those saving outside superannuation (many older Australians for whom superannuation was never an option) are not be able to utilise the franking credits as a tax offset, but will no longer have access to them in the form of a cash rebate.

An important policy principle is that all pensioners in the same category will be treated equally. However, the proposed policy changes this long-held principle. Australians who were registered as government pensioners on 28 March 2018, irrespective of where they held their savings, are exempt from the proposed policy and thus continue to receive their franking credit cash refund. Those who register for the age pension on 29 March 2018 or any date thereafter are no longer able to receive their franking credit refund unless they hold their savings in an industry or retail fund with the majority of members in the accumulation phase.

Facts on the impact of the proposal to remove refundable franking credits

According to the explanation provided by the Government in 1999, the law to enable cash refunds for excess franking credits was changed to ensure eligible taxpayers were taxed at their appropriate marginal rates of tax on assessment. The emphasis was on ensuring that self-funded retirees and other low-income resident individuals would no longer face an effective rate of tax on their investments in entities greater than their marginal rate.[1] Reference to a speech by the then Prime Minister John Howard upon the introduction of refundable franking credits makes it clear that it was Australians on modest incomes who were being targeted by the introduction of refundable franking credits.[2] The ALP supported this, noting that the introduction of refundable franking credits was aimed at people on small incomes, both retirees on fixed incomes from returns on investments and those on pensions with a very small return from investments.[3]

The Alliance has compiled a fact sheet setting out the impact and implications of the proposal to remove refundable franking credits. The fact sheet is attached.

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[1] New Business Tax System (Miscellaneous) Bill 1999

[2] Transcript of the Prime Minister the Hon John Howard MP, Press Conference, Parliament House, 13 August 1998, “I am delighted to be able to announce that as part of the plan provisional tax will be abolished. And that will be of enormous encouragement to many people in business, many self-employed people, and it will be a very great advantage to many self-funded and retired people. Very importantly for that group also we are introducing a system — hereby we are going to fully refund imputation credits. And that is very, very important to people on modest incomes who hold shares who will get dividends franked to the tune of 36 cents, which is the company rate, and they might be on 20 and they can't get the other 16. Well under this system they'll get the other 16 as a refund on the franked increment from the Taxation Office.”

[3] Michael Hatton MP, Labor, Blaxland, Hansard, 17 February 2000, page 13,750

Salient matters set out in the fact sheet include the fact that an analysis of ATO data and the Treasury[4] reveals that it is those on modest incomes who will be most affected by the proposed policy, despite the ALP being on record that the proposal is targeted at "the wealthiest 10% of SMSFs.[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 2014-15 more than half of the 1.16 million individuals initially impacted had taxable incomes below the $18,201 tax-free threshold of the time, 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[6], many of whom have little, if any, superannuation.

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.[7]

The fact sheet sets out that the following will be affected by the denial of cash franking credit refunds:

- **Australian shareholders who have franking credits that exceed their tax liability:** Shares have been a preferred saving vehicle for many Australians under the dividend imputation system. Retail investors make up 92% to 99% of shareholders on the register of companies such as Telstra, AMP, IAG, BHP and the major banks. They own 53% of Commonwealth Bank shares and 34% of BHP Billiton shares companies.[8] Retail shareholders who have franking credits that exceed their tax liability will be adversely affected, including 18-65-year-olds running their own business, single parents, and non-working spouses, that is, those on lower incomes who don't have sufficient non-dividend income to maximise utilisation of the franking credits.

  An example is set out below:[9]

[4] Treasury paper (FOI_2292_-documents_final_redacted.pdf) March 2018, p.3
[5] 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).
[6] ABS December 2017, 6238.0 - Retirement and Retirement Intentions
[7] Treasury paper (FOI_2292_-documents_final_redacted.pdf) March 2018
[8] Australian Shareholders' Association submission to Standing Committee on Economics Inquiry into the implications of removing refundable franking credits, 9 October 2018, p. 3
[9] Michael Croker, Tax Australia Leader, Chartered Accountants Australia and New Zealand, 19 March 2018, 'Labor's moment of frankness: a Tax Time 2018 client conversation starter', "On refundable franking credits for example, comparisons like that in Example 1 will occur:"
Notes:
1 Assumes a consistent dividend amount franked to the same extent by reference to the 30% company tax rate, received by a taxpayer on the same personal tax scale paying a 2% Medicare levy.
2. Deemed amount included in assessable income.
3. 2017-18 resident individual rates.
4. Entitlement ($21,429) limited to amount which reduces Karen's tax to nil ($16,190).

Example 1[1]: Karen's only income is from a parcel of shares in ASX listed companies. Her tax calculation under current law and Labor's model is as follows:

	Current law		Proposed law	
	$		$	
Assessable income				
Fully franked dividend	50,000		50,000	
Gross-up for company tax paid[2]	21,429		21,429	
Deductions	0		0	
Taxable income	71,429		71,429	
Income tax[3]	14,761		14,761	
Medicare levy	1,429		1,429	
Franking tax offset	-21,429		-16,190[4]	
Tax refund	-5,239		0	
Unused franking tax offset	0		5,239	
Karen's cash in hand	**55,239**		**50,000**	

- **Self-funded retirees:** 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.[10] The majority of these older retirees have little if any superannuation savings.[11] 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.[12]
- **Self-Managed Super Funds:** 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 pensioner exemption will apply to age pensioners in SMSFs as of the 28 March 2018, but not subsequently. 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.[13]
- **Small APRA-regulated funds**: While the ALP claims that only 10 per cent of APRA-regulated funds would be affected by the changes, ATO data reveals that 2013 of the 2,603 APRA-regulated funds received franking credit refunds in 2015-16.[14] 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.

[10] ABS December 2017, 6238.0 - Retirement and Retirement Intentions
[11] 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.
[12] Treasury documents obtained under FOI March 2018.
[13] Example 2: a retiree couple with no age pension, $800,000 in shares and $75,000 on deposit in bank. - Investment income $36,000 plus franking credit $15,400 = total income $51,400 - Without franking credits total income for the couple is $36,000 under new policy
- Example 3: A Couple on the full age pension and with $300,000 in APRA regulated superannuation - Age pension income of around $35,573 + $18,000 in dividends and franking credits = total income of $53,573 – no change under the new policy
[14] Simon Benson, *The Australian*, 'Labor's $3.75bn retiree savings grab revealed', 18 April, 2018

- **Large retail APRA-regulated funds**: While the Opposition Leader has argued that the large retail funds would not be affected, 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.
- **Retired small business owners who invested equity in their companies**: 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.

The Parliamentary Budget Office estimated that over 1.2m Australian taxpayers would be impacted by the ALP policy in May 2018. These estimates grossly under-represent the number of Australians affected by the policy, as they do not reference the impact on those groups set out above.

To identify the full impact of the proposed policy the Parliamentary Budget Office may need to undertake a further review, especially to separate out the small and large APRA funds that are affected and provide more detail on assumed behavioural changes.

Is the ALP policy to abolish cash refunds on franking credits really necessary?

2001 saw the introduction of cash franking credits refunds for shareholders who had more franking credits than tax liabilities. The value of franking credits attached to dividends has increased from $31.1 billion in 2005-6 to $47.5 billion 2014-15.

Over the same period the value of cash refunds claimed by taxpayers has grown from $1.9 billion to $5.9 billion[15], driven by an increase in franked dividends paid, personal income tax deductions, and the 2007 Howard government superannuation policy change which made superannuation withdrawals tax free for retirees. Retirees with franking credits from Australian equities that exceed their tax liability can be said to have driven some of that growth.

From 2017-18 the introduction of the $1.6 million transfer balance cap and transition to retirement income changes will in many ways unwind the Howard 2006 super policy change, by restricting tax-free income for retirees. Currently around 70%, or $1.8 billion of the $2.6 billion in SMSF franking credit cash refunds accrue to the top 2 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.

These super policy changes plus the behavioural response to the ALP policy, wherein older investors substitute other forms of investment for Australian equities or move their superannuation into an APRA-regulated fund will have a substantial impact on the cash refunds claimed by SMSFs. As a consequence, the revenue anticipated by the ALP from this policy measure (which is calculated using 2014-15 data) is very unlikely to eventuate.

[15] Of the $5.9 billion, $2.6bn goes to SMSFs, $2.2 bn to individual tax-payers, $0.7 bn to tax exempt entities (the majority of which goes to the Future Fund) and $0.3 bn goes to super funds. (Treasury paper (FOI_2292_-documents_final_redacted.pdf) March 2018, p.5

Impact on behaviour

The change to income will result in behavioural changes whereby self-funded retirees and those on low incomes seek to make up the financial shortfall.

- Those self-funded retirees who have deferred gratification in order to save for their retirement in order not to be on the age pension and who find themselves close to asset limits are likely to spend capital to qualify for the age pension. There will therefore be a greater dependency on the age pension.
- Investors will change asset classes, moving away from dividend-paying Australian shares. Importantly, refundable franking credits do not 'disappear'. 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.
- Investors are likely to move into international equities.
- Investors are likely to move into riskier asset classes in a bid to retain the same after-tax income levels.
- Some retirees will close their SMSFs.
- Some retirees will move to retail or industry super funds, which means they lose the control of their investments, which was a key attraction to starting a SMSF in the first place.
- Many retirees will spend less, which will have flow-on effects in the economy, not only in terms of regular consumption items, but also in relation to industries such as tourism.
- Some retirees will no longer be able to afford private health care, which will increase demand at public hospitals and also is likely to have a longer-term impact of inadequate healthcare.
- At present, this is the first time that Australia has witnessed a cohort of self-funded retirees as a role model for saving for self-sufficiency in retirement. Removing refundable franking credits for a significant portion of this cohort sends a signal to younger Australians that saving for self-sufficiency in retirement is not a worthwhile objective, as a change in policy can significantly impact the adequacy of retirement savings. Younger Australians are therefore more likely to not seek to save for self-funding in retirement, which will in turn increase the burden on the age pension.

Impact on capital market

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

By enabling capital formation in Australia, the current dividend imputation policy enhances investment in Australia, which in turn generates tax revenue (franking credits are not earnt on foreign income) and the prosperity gains are enjoyed by Australian shareholders. This will change as investors move away from investing in dividend-paying Australian companies. While the move into international equities is good for diversification in an investment portfolio, a recent Citigroup report suggests the policy if implemented will reduce local investor demand for high dividend-paying companies and may see a decline of 5-10% in the share price of the major banks.[16]

Dividend imputation also lowers the cost of equity relative to debt, which encourages Australian companies not to gear. As noted at a Summit on the issue held by the Alliance for a Fairer Retirement System in October 2018, "Australian companies have relatively low levels of gearing compared to other countries. … Leverage creates volatility and exacerbates the cyclicality of financial markets as it drives companies'

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[16] John Kehoe, *AFR*, 'Labor election win to hurt high dividend stocks', 13 September 2018

performance during bull markets and exaggerates companies' losses during financial downturns. Leverage was a key factor in the magnitude of the global financial crisis."[17] An adjustment to the dividend imputation system by removing refundable franking credits for a cohort of investors will therefore have a detrimental impact on the equity markets in Australia, given that refundable franking credits have played a role in ensuring that Australian investors continue to supply equity to Australian companies. With Australia having currently entered a technical correction, and concerns that the long bull market is coming to an end, adjusting the dividend imputation system at this point in time is likely to have significant consequences.

The proposed policy would potentially also affect those borrowing to invest in private and public companies. Significant funding is provided by self-managed superannuation funds and self-funded retirees to businesses, which would change if the proposed policy becomes law. That would ultimately damage the economy and employment.

Conclusion

The Alliance has sought factual data from recognised sources to ascertain the impact of the proposed policy on Australians seeking adequacy, fairness, certainty and sustainability in planning for and maintaining self-funded retirement. Members of the Alliance are deeply concerned not only by the negative economic impact that the proposed policy will have on more than one million Australians, but also by the psychological impact.

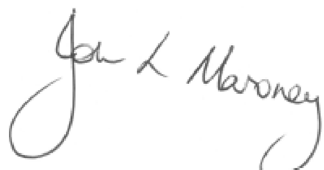
Australians who have deferred gratification in order to save for their retirement will be penalised should the proposal proceed. It has been a source of great pride among these Australians that they have been able to be self-sufficient in retirement and they are experiencing considerable distress at the thought that government policy could drive them onto welfare. The Alliance is very concerned that public policy should in any way drive people onto welfare, particularly when citizens have made every effort to save for retirement and be either fully or partly self-funded in retirement.

The Alliance is also concerned by a policy proposal that actively discourages Australians from investing in Australian businesses and which will have a significant impact on capital markets and capital management within Australian companies. The transfer balance cap rule change, introduced in 2017, has had a very big impact on high net worth retirees, because they no longer have 100% of their fund in pension phase. Before this was introduced, if a retiree had a $5 million pension fund, they were receiving a very large tax refund. However, the fact that now $3.4 million of that pension account has been returned to the 15% tax superannuation environment means that those with very large pension account balances have already seen a significant change to their tax refund.

As a result, the proposed policy will have a far bigger impact on self-managed super fund members who were always under that $1.6m cap. This reinforces that it is not the wealthy who will be affected by the proposed policy.

Members of the Alliance would be pleased to discuss the impact of the proposed policy with the Committee or answer any queries. The members of the Alliance and signatories to this submission appear on the following page.

[17] Speech by Geoff Wilson to Fairer Retirement Summit, Alliance for a Fairer Retirement System, 30 October 2018, Sydney



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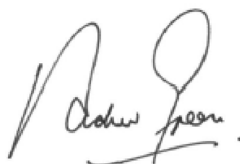

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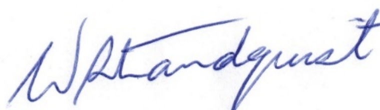

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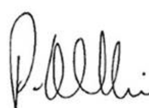

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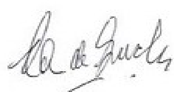

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