INSTITUTE OF PUBLIC ACCOUNTANTS®

Implications of removing refundable franking credits

October 2018

Introduction

The Institute of Public Accountants (IPA) welcomes the opportunity to offer our **‘Implications of removing refundable franking credits’** submission and looks forward to working with the Economics Committee inquiry into the implications of removing refundable franking credits.

The IPA is one of the three professional accounting bodies in Australia, representing over 36,000 accountants, business advisers, academics and students throughout Australia and internationally. The IPA prides itself in not only representing the interests of accountants but also small business and their advisors.

We look forward to discussing further in more detail the IPA’s recommendations. Please address any further enquires to Tony Greco, General Manager Technical Policy via tony.greco@publicaccountants.org.au

02 November 2018

House of Representatives Standing Committee on Economics
Parliament of Australia

By email: economics.reps@aph.gov.au

Dear Sir/Madam

Inquiry into the implications of removing refundable franking credits

We welcome the opportunity to provide this submission in response to the inquiry titled "Implications of removing refundable franking credits".

The IPA is supportive of the inquiry to heighten community understanding of an established feature of our tax system. The Australian Labor Party is proposing to change the rules to remove the ability for individuals and superannuation funds to claim their full entitlement to franking credits. The inquiry will serve to highlight the significant implications, of any change in Government policy on refunding imputation credits. If we were designing a new tax system today, you would most likely not have full imputation where the taxation is assessed in the hands of the recipient and any excess franking credits are refunded. In today's economic circumstances it would be difficult to justify from a fiscal sustainability perspective. However the refunding of imputation credit policy has been in operation for close to two decades and removing it in a piecemeal way without dealing with the consequences is fraught with danger.

The case for removing dividend imputation is not strong and any tinkering needs to be assessed against some alternative benchmark tax system such as removing dividend imputation entirely and replacing it with a discounted tax rate. More importantly we need to be looking at how we tax all forms of savings more consistently. A more holistic approach to taxing personal savings across all asset classes as recommended by the Henry Review would be more beneficial than changing one aspect in isolation. We do not support any changes in the removal of refundable franking credits unless it is associated with more holistic tax changes to the treatment of savings more broadly.

There are two schools of thought on the principal purpose behind our company imputation system. Most agree that its aim is to avoid double taxation. The alternative argument which is more contentious is that its principal purpose is to apply a level of tax that reflects the recipient's tax position. No different from the tax withheld by an employer under our PAYG system. If the latter position is supported, then the refunding of excess imputation credits is justifiable as it reflects the overall tax position of the taxpayer receiving the dividend.

The current policy is that pre-tax company profits distributed to shareholders should be taxed overall at the rate applicable to the shareholder who ultimately receives the dividend. The same process applies for dividends received via a trust as imputation entitlements can flow indirectly.

Any change in the policy in refunding excess imputation credits will have differing impacts depending on the recipient overall tax situation. And here lies the challenge to policy makers in that impacts of any changes to refunding of imputation credits will vary quite substantially depending on individual circumstances. High income earners and large superannuation funds will not be impacted creating unfair outcomes from any policy changes to the refunding of imputation credits. These inconsistent outcomes can create bad policy outcomes if changes are made in isolation. Those on more modest incomes will be mostly impacted.

The entitlement to a refund is dependent on the taxpayer's taxable income and their marginal tax rate. Ignoring the Medicare levy and low income tax offset, if a taxpayer's taxable income is below our tax free threshold then the taxpayer will claw back tax paid by the company on dividends received. Pensioners or low income taxpayers in this category will therefore, miss out on refunds as well. Between $18,200 and $37,000 the marginal tax rate is 19 per cent which is less than the company tax rate so these taxpayers will also benefit from receiving fully franked dividends as they will have a partial entitlement to a refund. Once a taxpayer's taxable income exceeds $37,000, then the imputation credits are offset against the tax they need to pay on the dividend to avoid double taxation. Taxable incomes exceeding $37,000 incur a marginal tax rate of 32.5% so, in effect, taxpayers will need to pay further top up tax with no refund entitlement. As you move up our progressive income tax scale more top up tax applies but shareholders receive a imputation credit for the tax paid on their behalf by the company which is handed down to taxpayers.

Just to complicate matters further, we have a two rate company tax system so some dividends will only have imputation credits calculated using a 27.5% tax rate so this will create less refunds or more top up tax.

When it comes to SMSFs, the change to the rules will result in adverse outcomes for funds heavily invested in companies paying fully franked dividends. SMSFs in accumulation mode pay tax at 15% so a refund entitlement can result in the fund paying no tax and receiving a refund. For SMSFs in pension mode, no tax is payable and all the imputation credits are refunded back to the fund. The entitlement belongs to the fund and not its members, so it will depend on whether the fund has members in accumulation or pension phase or a combination of both, which can impact on how the proposed change plays out. Large superannuation funds will not be impacted as they will have a large enough pool of members in the accumulation phase to use up available franking credits so any change in policy will have anomalous impacts on the retirement sector.

Some of the anticipated impacts if imputation credits were not refunded are as follows:

- Change in investments mandates from individual and professional investors. The perceived savings from this measure may be overstated due to behavioral changes that affected taxpayers will make to minimise the negative impacts of the policy change. There are a number of strategies to mitigate some of the impacts by moving away from shares paying franked dividends into other asset classes. Refunding of imputation credits has been a cornerstone policy for many investors investment strategy for nearly two decades.

- Investors will be more attracted to riskier investments in search of ways to recoup loss of income due to loss of franking credits. Riskier investments could lead to higher incidence of capital losses which can have implications on individuals trying to self-fund their independent retirement.

- Any change in franking credit entitlement will encourage investors to move funds to other asset classes and away from listed and unlisted shares. Foreign shares, property and other asset classes become more attractive propositions so it will not be unexpected that there will be significant impacts on asset allocations. Listed entities could find themselves starved of capital as funds move elsewhere.

- Impact on SMSF retirees. First there was the pension deeming change, which was quickly followed by the introduction of the $1.6 million transfer balance cap, and now the possibility that the ability to claim back excess imputation credits may also be removed. Self-funded retirees can rightly claim that they are being punished for doing what was asked of them from respective governments; namely, to provide for their own retirement. It is difficult to plan when the goalposts keep moving with little ability to deal with the consequences when in retirement. The pension deeming change has already created dead spots in super (balances between $400,000 and $800,000) where a self-funded retiree pension offers an annual income only marginally better than the government pension, further discouraging efforts to be independent of government welfare. Retirement planning requires stability and this constant tinkering with the goalposts is creating a loss of confidence in the superannuation system especially for those who cannot re-enter the work place to make up for any loss in income to support their resulting from adverse changes.

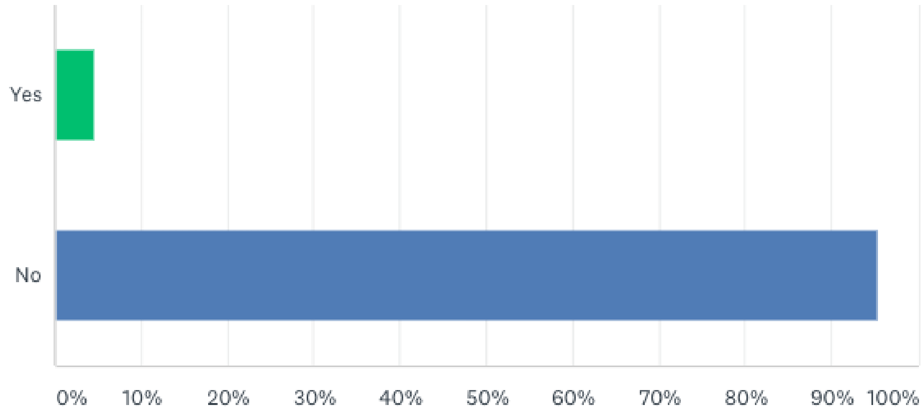
- Unfairly discriminates SMSFs and creates a distinction between SMSFs and large industry and retail funds, including the Future Fund. The policy change impacts SMSF differently to other segments and this creates an uneven playing field. Pooled funds will become a more attractive option for SMSF members as they will continue to make full use of all the credits they receive whereas SMSFs may not have enough tax liabilities to offset the full value of any imputation credits they receive. Hence the potential policy change is sector specific, which is grossly unfair, especially when the objective of the superannuation industry is universally to provide for retirement.

- Moving the goalposts plays havoc with retirement planning as many are now realising. Ad hoc changes undermines confidence in our superannuation system putting more pressure on our pension system. If confidence starts to sway, citizens start to question why they bother providing for their own retirement especially when governments cannot keep their hands off people's retirement nest eggs. Already the number of people who think it is the individual's responsibility for funding their own retirement represents a small minority

As stated in the introduction we do not support, piecemeal changes to the current imputation system without more holistic reform options been considered. We asked our members whether they support a change in policy to deny refunding of excess franking credits and the results are as follows:

Do you support a change in policy to deny refunding of excess franking credit refunds for superannuation funds and individuals?

Answered: 171   Skipped: 0



ANSWER CHOICES	RESPONSES	
Yes	4.68%	8
No	95.32%	163
TOTAL		**171**

Please feel free to contact us directly should you require further clarification on any of the issues raised or other questions related to our submission.

Yours sincerely

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