SUBMISSION TO THE INQUIRY INTO THE IMPLICATIONS OF REMOVING REFUNDABLE FRANKING CREDITS

About Per Capita

Per Capita is an independent progressive think tank, dedicated to fighting inequality in Australia. We work to build a new vision for Australia based on fairness, shared prosperity, community and social justice.

Our research is rigorous, evidence-based and long-term in its outlook. We consider the national challenges of the next decade rather than the next election cycle. We ask original questions and offer fresh solutions, drawing on new thinking in social science, economics and public policy.

Terms of Reference

The Standing Committee on Economics will inquire into and report on the use of refundable franking credits, their benefits and the implications of their removal, including:

- *analysis of who receives refundable franking credits, the opportunities it provides to offer alternative savings and investment vehicles to low and middle income earners, and the impact it has on lowering tax bills*
- *consideration of how refundable franking credits support tax principles, particularly implications for tax neutrality, removal of double taxation and fairness*
- *if refundable franking credits are removed; who it would impact and how and the implications from expected behavioural change by investors, including for*
    - *increased dependence on the pension*
    - *stress and complexity it will cause for Australians, including older Australians to adjust their investments*
    - *if there are carve outs applied, what this might mean for additional complexity, uncertainty and fairness*
    - *reduced incentives to save and distortions to which asset classes are invested in and funds are used, and*
    - *the reliability of providing a sustainable revenue base over the longer term.*

Executive Summary

Australia's dividend imputation system was introduced by then-treasurer Paul Keating in 1987. Its purpose was to eliminate double taxation on dividends from company profits.

In 2000, the Howard-Costello Government created a concession within the system that allowed some individuals and superannuation funds to reduce their tax liability beyond zero (as originally allowed) and into negative territory, so that the government owed them money and would provide them with a cash payment from the Australian Taxation Office (ATO) if their imputation credits exceeded the tax they owed.

Under the system as it operates now, shareholders can use imputation credits to reduce their overall tax liability as far as possible into negative territory. While the current corporate tax rate is 30 per cent, individual taxpayers pay a stepped rate ranging from zero to 47 per cent. If someone owns shares in a company they are required to pay tax on the income from those shares at their personal marginal rate. If their personal tax rate is more than 30 per cent, they will have to pay the difference; if their personal tax rate is less than 30 per cent, they will receive a credit. This also applies to superannuation funds and is greatly utilized by high-worth self-managed superannuation funds (SMSFs).

Put simply, for some shareholders, a dividend imputation credit is money the government pays them for owning shares.

Because of the change to the system in 2000, Australia is the only country in the OECD with a fully refundable dividend imputation credit system.

In March this year, the Australian Labor Party announced a policy that would see an incoming Labor Government introduce changes to the way dividend income is treated when an individual who owns shares does their personal tax return.

The ALP policy is simply winding back a concession that has grown rapidly over the last 18 years and now costs the budget more than $5 billion dollars in forgone revenue per annum. Doing so will close a tax loophole that is unfair and unsustainable.

The ALP policy to close this tax loophole after almost two decades is a strong and responsible proposal to increase equity in our taxation system and secure revenue to fund essential services.

How do refundable franking credits work?

When you own shares in a company you own some capital. You hope the price of the shares will rise over time and give you a "capital gain". The company may also pay you out cash in the form of dividends.

A dividend is a per share amount paid by a company to its shareholders that (generally) reflects its profits. A "fully franked" dividend is one where the company tax has already been deducted.

In 1987 Paul Keating introduced Australia's most significant package of tax changes since the Second World War, including changes to income tax, corporate tax, capital gains tax and the introducing the Fringe Benefits Tax.

Keating also changed the tax treatment of dividends for individuals. Prior to 1987, if you received a dividend it was simply counted as normal income, added onto whatever else you earnt that year, and taxed accordingly. So, effectively, you were required to pay tax on money that had already been taxed at the company level.

Keating introduced dividend imputation for Australian shareholders. This means that when you receive a dividend, it's still subject to personal income tax when you do your tax return, but you get a 'credit' for the tax already paid by the company. You pay the difference between what the company paid and your marginal tax rate (the rate paid on the last dollar you earned from your job(s). In other words, the company effectively pays part of the income tax you owe on your dividends.

Importantly, under the Keating system if you didn't pay personal income tax, you couldn't claim the credits from the tax paid on your dividends as you had nothing to claim it against. This is what's called an "excess franking credit".

Partly because of these imputation credits, companies that regularly pay significant, regular dividends are popular investments for self-funded retirees, who often aim to live off the dividend income and retain their capital.

In 2000, the Howard-Costello Government, in a measure designed to distribute a share of the budget surplus to taxpayers who were also company shareholders (who, by definition, are relatively wealthy compared to PAYG taxpayers on low and middle incomes), extended dividend imputation to people not paying any personal income tax.

Under the system introduced in 2000 and still in place today, if you were paid a dividend and had insufficient other taxable income to pay personal income tax during the same financial year, you receive cheque from the ATO refunding the tax the company paid.

Under this system the dividend is now not taxed at all and other, non-shareholding Australian taxpayers are funding cash payments from the ATO to shareholders living off investment income who do not pay any income tax.

How do recipients of refundable franking credits benefit from the current system?

Australia's unique, fully refundable dividend imputation credit system primarily benefits wealthy, self-funded retirees by encouraging them to minimise their taxable income and maintain their capital by relying on the income from franking credit refunds.

Under our current retirement taxation system, also introduced by the Howard-Costello government, income from superannuation savings in retirement is completely tax free regardless of how much it is. Therefore, self-funded retirees who are not receiving "taxable" income from their superannuation, but are being paid dividends on their shareholdings, are receiving franking credits in cash from the ATO to "refund" the tax the company paid on the fully franked dividend.

Many people with very high value SMSFs - that is, significant private savings - have been getting large "refunds" from the taxpayer as a result of this loophole, despite paying no income tax themselves.

What does the ALP policy propose?

The ALP policy proposes to restore the original dividend imputation system introduced in 1987, and remove the unsustainable concession introduced in 2000.

Under the ALP's policy, which would take effect from 1 July 2019, imputation credits can be used to reduce tax to zero, but not into negative territory to create a cash "refund" for the relatively small number of shareholders who have no tax liability.

While such people will no longer receive a cash payment from the ATO, they will not be paying more tax.

Critically, this is not a return to double taxation. Dividends will still not be taxed twice but will be taxed once.

The relatively small number of shareholders who will be affected by the proposed changes will be able to adjust their investment decisions to limit any impact before the policy comes into force in 2019, and charities, not-for-profit institutions and pensioners are exempt.

After listening to community feedback on its policy, the ALP amended its original proposal to exempt full and part-time pensioners and every pensioner who is a recipient of an SMSF. This exempted more than 300,000 low-income retirees from the policy, tightening the targeting of the measure to wealthy self-funded retirees.

The ALP policy is a strong equity measure

There are many different tax concessions for money in the superannuation system. These concessions allow wealthy people and high-income earners to build up very large super balances. Tax treatment of superannuation under the Howard-Costello government allowed those with the means to sacrifice part of their income to put as much money as they wanted into superannuation, tax free. While there are now some caps in place, these are very high and still allow high-income earners to operate their superannuation funds as vehicles to minimise tax and build up large capital savings.

As a result of such incentives, the aim of many high-income earners has become to build up sufficient savings in superannuation that they are able to live off the earnings of this pool of money (like dividends) during retirement, but retain the capital (IE: not sell assets like shares) and any capital gain from a rise in the value of the asset.

Because your superannuation sits outside your will when you die, superannuation is used as a key part of what is called "estate planning" – that is, saving a significant amount of capital to pass on to your children as an inheritance when you die. As Australia does not have death duties, this wealth is passed down tax free.

For most working Australians who are able to build up a decent super balance, retirement will not just be about living off any earnings on our savings, but about gradually cashing out the assets as well. This is a key justification, and a reasonable one, for tax concessions in super.

However, for the truly wealthy, the system is geared to allow them to retain their assets. That is, if you have enough savings, you can live off the earnings alone and pass the assets along, tax free, to the next generation.

The use of our tax and superannuation systems to create such large pools of capital savings, which are guarded as an inheritance for the offspring of the wealthy and high-income earners, leads to significant intergenerational wealth transfer and, ultimately, reduces social mobility and vastly exacerbates economic inequality.

The current imputation cash refund system is, essentially, a "reverse death duty" – low and middle-income earners are effectively subsidizing the estates of the very wealthy by giving them cash "refunds" from general revenue - that is, from all taxpayers' contributions to the federal budget - so they don't have to draw down on their own savings but can hoard that money for their own kids.

It's both unfair, and at an annual cost of more than $5billion in forgone revenue annually, unsustainable.

Conclusion

The policy to reform dividend imputation by the ALP is a well targeted measure that closes the Howard-Costello loophole from 2000 - a loophole that should never have been opened in the first place.

Labor's proposed changes are projected to raise $10.7 billion in the first two years, and $55.7 billion over a decade.

Given the challenge of funding the National Disability Insurance Scheme, our early childhood education and aged care sectors, the need to increase the rate of Newstart and Youth Allowance by $75 per week and to adequately fund our schools and hospitals, this a sensible and responsible measure by which to raise revenue without imposing higher taxes on low and middle-income earners.

Again, it is critical to remember that this is not a return to double taxation, and that the change affects a relatively small number of wealthy retirees, who, in the worst-case scenario, may be required to draw down on their own savings to maintain their lifestyle in retirement, rather than asking working taxpayers to subsidise their estate planning.

Per Capita wholeheartedly supports the ALP's proposed policy change, which is an essential revenue raising measure and one that is built on fairness and the removal of an inherently inequitable loophole in our taxation system.

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02 November 2018