Backgrounder:

The proposal to remove franking credit refunds

The purpose of dividend imputation is to prevent the double taxation of dividend income. For individual investors the company pays the tax upfront and then the shareholder utilises this “imputed tax”, or withholding tax, when they file their tax return.

Franking credits are added to taxable income for investors, and the tax payer then pays tax at the marginal rate on their total taxable income (including dividends and franking credits). The franking credits are then deducted from their tax liability.

If a shareholder’s marginal rate is above the company rate, the franking credit will not be enough to extinguish the tax liability and they will have to pay more tax. If the shareholder’s marginal rate is below the company rate, and the franking credit is excess to the tax liability, they will receive a refund on the excess amount. Those with a 0% marginal tax rate, will receive a full refund on their franking credits – normally 30% of the gross dividend income on a fully franked share.

This process occurs in four simple steps:

1. A company generates a profit before tax of say $10,000 per share.
2. The company pays 30% tax on that profit, $3,000, to the Australian Tax Office (ATO).
3. The company then pays a “franked” dividend of $7,000 from after tax profit to its shareholders.
4. The ATO either asks for more tax or refunds all or part of the $3,000 in tax collected, based on the individual’s or organisation’s marginal tax rate. For example, if you are a high-income earner with a marginal tax rate of 47%, the 30% pre-paid corporate tax is offset against the tax payable on dividends, so you pay a net 17% personal tax or an additional $1,700 on the dividend income. On the other hand, if you have retired from the workforce or have not joined the workforce and receive income below the tax threshold, that is you have a marginal tax rate of zero, then you are entitled to a refund of the 30% tax already paid on your behalf.

What is being proposed?

In March 2018, the Australian Labor Party proposed the removal of refunds for individuals who are on a marginal tax rate lower than the company tax rate. This would mean low-income workers and retirees would cease to receive compensation for the tax already paid on their behalf at the corporate tax rate of 30%, which is higher than their tax rates. This policy would still ensure that the working professional, in the example above, would continue to receive the full benefit of the franked dividend income by paying only the difference between their rate and the company rate.

What will this policy achieve at such great costs?

Labor claims the removal of full tax refunds will save the Government $55.7 billion over the medium term.

It will inflict hardship on a number of low-income earners and retirees. It will force individuals to take higher risks and lead to companies and individuals changing behaviour:

- Some self-managed superannuation funds (SMSF) may move into industry superannuation funds or SuperWrap Accounts so that they continue to receive the full benefit of franking credits.
- Low-income, low asset base individuals who do not have money within an SMSF will spend assets to qualify for the full or part pension Age Pension. According to our poll conducted in July 2018, 28% of the people that receive refundable franking credits plan to do so, if this policy comes into effect. Not only would these individuals receive social security benefits, but they would also become eligible for the “pensioners’ exemption” and thereby be able to receive their franking credit refunds.
- Wealthy individuals could restructure their affairs to minimise the policy impact. This would benefit financial advisors at the expense of the ATO. As an example, individuals can add up to three children to their SMSF when in accumulation phase, thus fully utilising the benefit of the franking credits. An SMSF trustee could sell down their dividend-paying investments and repurchase them in their individual names to continue to receive the franking credit refunds. Alternatively, they could transfer into an Industry superannuation fund or SuperWrap account, where they receive the full benefits of the refunds.
- Australian companies are likely to increase their debt as equity becomes less attractive to fund growth.
- Over the longer term, Australian companies and global and domestic investors would favour international markets over Australia, resulting in a lower company tax haul domestically, fewer jobs, resulting in lower income tax revenue.

Who are the winners and losers?

As a result of superannuation – almost all adult Australians are shareholders. The removal of refunds on franked dividends would discriminately impact different types of Australians, primarily modest self-funded retirees, particularly the 1.1 million SMSF members, and low-income earners. Using the earlier example of a $10,000 dividend, this policy would result in at least nine winners and losers.

Individual circumstance	Current income	Current adjustment for overpaid tax	After the removal of refunds	Affect
Self-funded retiree with no superannuation	+$3,000	nil	-$3,000	**Pays more tax**
SMSF not receiving a government pension prior to 28 March 2018*	+$3,000	nil	-$3,000	**Pays more tax**
SMSF on government pension prior to 28 March 2018	+$3,000	+$3,000	$0	**No change**
Industry superannuation fund member#	+$3,000	+$3,000	$0	**No change**
APRA regulated retail superannuation fund member	+$3,000	nil to +$3,000	nil to -$3,000	**May pay more tax**
Pensioner or part-pensioner holding shares in their own name	+$3,000	+$3,000	$0	**No change**
Working individual on the lowest marginal tax rate (19%)	+$1,100	nil	$1,100	**Pays more tax**
Working individual on the top marginal tax rate (47%)	-$1,700	-$1,700	nil	**Uses the franking credits to pay tax at their marginal rate. No change**
Eligible income tax exempt organisations, such as universities	+$3,000	+$3,000	nil	**No change**

*Retiree with a fund balance of less than $1.6 million
#Assuming tax payable in accumulation phase is greater than franking credits received

Why is the impact so different?

Because this policy is flawed. Individuals on a high tax rate continue to receive the benefit of franked dividends by continuing to "top up" the amount of tax already paid by the company on their behalf. Meanwhile, individuals on a lower tax rate will effectively pay the company tax at a rate of 30%, which is higher than their marginal tax rate. These individuals and families include retirees who have worked, paid tax and saved under a well established set of rules that is almost 20-years old. They include low-income earners who have been saving for retirement through supporting the domestic economy investing in Australian companies and will now effectively pay tax at a greater rate than their marginal tax rate. On average, women have smaller pools of retirement savings than men, and will therefore suffer more.

Who would be left behind?

Because tax is complex, and in the case of this policy, highly inconsistent, only those who can afford financial advice will adjust their positions. Those who are unable to work around the policy, modest self-funded retirees and low-income earners, will bear the brunt of the policy.

So low-income earners and modest retirees would be collateral damage to a policy that will not raise the expected amount?

That is correct. This policy is regressive, inequitable and will not benefit the taxpayer. We believe it should be abandoned, as do over 30,000 signatories to our petition calling on all the Federal Government and Opposition to maintain the current dividend imputation system.

If you would like to speak to us about this issue, call us on:

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