29 October 2018

Mr. Stephen Boyd
Committee Secretary
Standing Committee on Economics
PO BOX 6021
Parliament House
Canberra ACT 2600

Email: economics.reps@aph.gov.au

Dear Mr Boyd,

SMSF ASSOCIATION SUBMISSION ON THE IMPLICATIONS OF REMOVING REFUNDABLE FRANKING CREDITS

The SMSF Association (SMSFA) welcomes the opportunity to make a submission to the House of Representatives Standing Committee on Economics on the inquiry into the implications of removing refundable franking credits.

We strongly oppose the current Australian Labor Party (ALP) proposal to remove refundable franking credits on the basis that the policy is flawed and inequitable to many Australians.

The submission highlights throughout:

- The SMSFA believes the dividend imputation system was designed to 'impute' the tax paid at the corporate level to the company's owners.
- The implementation of the policy inequitably targets SMSFs as a retirement saving structure.
- The revenue estimated by the ALP is unlikely to be collected by government through the policy.
- The expected behavioural changes from individuals responding to the policy change will have significant impact on retirement savings, government revenue and capital markets.

The true intention of the dividend system

The SMSFA supports the current policy settings for the dividend imputation system. The current system prevents double taxation of company profits and ensures shareholders are taxed on company profits at their marginal tax rate. Under this system a shareholder in a company is in the same economic position as a sole proprietor who earns the same profit from their business activities.

Dividend imputation effectively makes company tax a withholding tax on corporate profits until they flow to the company's shareholders or are retained in the company.

The imputation system for taxing shareholders' dividend income was introduced in Australia in July 1987 following a Tax Summit and Treasury White Paper which sought to avoid the double taxation on incorporated enterprises through company and individual tax.

Following the 1998 Review of Business Taxation, the Howard Government accepted recommendations to make franking credits fully refundable. Legislation in 2000 allowed for the rebate of unused franking credits to Australian resident recipients. This had significant consequences for future government revenue following the introduction of legislation in 2006 removing tax on earnings of superannuation funds in pension mode. The change in 2000 was designed to ensure that dividend income should be taxed in the same as way as other income received by individuals, at the taxpayer's marginal tax rate. This ensured that the tax system did not favour one form of corporate financing over another.

This policy rationale was explained in the explanatory memorandum accompanying the New Business Tax System (Miscellaneous) Bill 1999[1] which amended the taxation law to allow fully refundable franking credits. Relevant extracts from the explanatory memorandum include:

- *The current treatment means that low-income earners and certain other taxpayers may pay tax on dividend income at a rate higher than their marginal tax rate. This is because the company distributing the dividends may have already paid tax (at the company tax rate) on profits before distributing them as dividends.*
- *The Review considered that resident individuals and superannuation funds and like entities should be taxed at their appropriate tax rates, rather than at the company tax rate. Therefore, it recommended that excess imputation credits be refunded to these taxpayers*.

In addition, this policy rationale was explained in the Review of Business Taxation final report published in August 1998:

- *Refunds are not available to resident taxpayers who have insufficient non-dividend income to absorb all the imputation tax credits attaching to their company dividends. This disadvantages low income shareholders, including self-funded retirees. They may face the company tax rate on dividend income rather than their own marginal tax rates.*
- *The refunds of excess franking credits would provide a fairer outcome for low income people - in a way consistent with the original objectives of the full imputation system. The overall tax paid on profit distributed by a company or trust to low income resident individuals would reflect their marginal tax rates. They would not be disadvantaged simply because tax was first paid on the profit by the company or trust.*
- *That would ensure that the imputation system operates as it should - imposing overall tax on distributed profits at the marginal tax rates of resident individual taxpayers. And this would be of major benefit to low income earners, including self-funded retirees, who are unable to fully utilise imputation credits because they have insufficient taxable income to absorb them.*

Therefore, when a company pays tax on profits that are distributed to those on low taxable incomes, they are entitled to a refund of that tax that is paid on their behalf. The same applies for those on high

[1] https://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id:%22legislation/ems/r977_ems_a04d4c9c-f5ce-441f-a1ce-990607034faa%22

taxable incomes as they must pay the difference between their marginal tax rate and the company tax rate.

This is the basis for which the SMSFA supports the current policy settings for the dividend imputation system as it ensures that income is taxed only once.

For example, an individual who runs a sole trader business that has an income of $17,500 does not have a tax obligation. In the same position, the imputation system ensures an individual who owns shares in a company that provides an income of $17,500 is taxed the same. In this scenario the company will pay tax at 30% and the remainder will be distributed to the shareholder as dividend. The individual will receive a dividend of $12,250. Under the current system, the individual will also receive a franking credit for the $5,250 tax paid at the company level. The dividend income which will then be grossed up to $17,500 and assessed at the individuals marginal tax rate, in this case zero, resulting in the full $17,500 being received by the individual as if the individual was a sole trader. Without this imputation, the shareholder would effectively pay $5,250 in tax on their income merely because of the company structure when their tax rate is zero.

The ALP's proposed policy seeks to target a 'loophole' which the ALP believe exists as low income taxpayers are paying no tax and are also receiving a refund of tax paid at the company level. **However, it is in fact the current policy imputation system that ensures that those individuals are not paying tax by getting the refund.** The proposed policy will actually place a tax on these individuals at up to 30%, rather than restore their tax rate back to nil.

This is because the current dividend imputation system imputes the tax to the shareholders, who are the owners of the company and therefore owners of the profits. The imputation system, therefore provides a tax credit for tax already paid by the company on their behalf. This is similar to the PAYG system for individuals. It corrects the tax collected on the shareholders behalf to the correct amount of tax that should have been paid in the first place.

The ALP policy should not confuse the imputation system, with any concern for the fact that superannuation funds have a taxation rate of 15% for earnings in the accumulation phase (including where individuals have assets in excess of $1.6 million and are retired), and, zero per cent for superannuation funds in pension phase. These have been the tax policy settings for an established period of time and support Australia's retirement income system by providing appropriate incentives to save and compensation to savers for locking their money into superannuation where it cannot be accessed until retirement.

If it is the low tax rate of superannuation funds that is the problem, this should be addressed on a more equitable and holistic basis, not via the distortion of the imputation system.

Policy changes to the imputation system should not be used to introduce an inequitable and excessive taxation structure targeted at certain low tax payers (especially, SMSFs and self-funded retirees). All taxpayers who have a zero tax rate should be treated the same and those who have a zero tax obligation should not be forced to pay tax.

The SMSFA acknowledges a contrasting rationale for the company tax system could be that it is a final tax on corporate profits (rather than a withholding tax paid on behalf of shareholders), meaning that government does not need to refund taxpayers for having tax "overpaid" when they are a low rate taxpayer.

However, if this is the case, then the ALP should justify why taxpayers with low tax rates should pay higher taxes on corporate profits than on other income they earn. Furthermore, removing the refundability of franking credits would effectively means taxpayers with a zero marginal tax rate are worse off than those who pay some tax.

Following on from the previous example of a taxpayer receiving a $17,500 dividend payment, where they have a zero tax rate and do not receive a refund for the franking credit under the proposed ALP policy, they end up with a net income of $12,250 paying an effective 30% tax rate on the dividend income. However, if they were to receive the same income under the ALP policy and have a 15% tax rate, then their net income would be $14,875. This is because they benefit from half of the value of the franking credit rather than it having it wasted due to a zero tax rate. This is inconsistent with a premise that the company tax is the final tax on corporate profits.

The SMSFA strongly believes the intention of the dividend imputation system is to avoid excess taxation via ensuring that shareholders are taxed as a shareholder at their marginal tax rate, akin to a sole proprietor who earns the same net profit. The proposed ALP policy undermines this position.

Distorting the imputation policy to target low rate taxpayers is poor policy. Firstly, because low rate taxpayers will effectively be paying a higher tax on their dividends through the loss of franking credits. Secondly, because individuals on higher taxable incomes, will not lose the benefit of franking credits.

Furthermore, as we highlight below, we believe the practical implementation of the ALP's policy is flawed and significantly inequitable to certain parties.

'Flawed' policy intent and design

The SMSFA believe the proposed design of the policy is 'flawed', inequitable and does not meet the policy intent of improving the integrity of dividend imputation for all taxpayers.

Under the proposed policy individuals with the same circumstances, in the same refundable position, will incur a different results depending on the vehicle they choose to hold their shares. Most notably, SMSF members are worse-off under the ALP policy than other superannuation fund members who are in pension phase and benefit from franking credits. The ALP policy proposes that refunds from dividend imputation are appropriate for almost all investors except for SMSF investors and those shareholders with low taxable incomes.

If the ALP believes that franking credits should only be claimed by those who individuals who pay tax, then the policy should be designed to ensure refunds to all individuals who pay no tax are removed, not only those individuals who choose to utilise a SMSF or some low income earners.

Additionally, due to the introduction of the transfer balance cap (TBC) to the superannuation law on 1 July 2017, the policy does not appropriately target wealthier SMSFs as intended by the ALP.

Unfairly affects SMSFs

Not only does the proposal unfairly tax those individuals who are self-sufficient in retirement, the proposed policy also unfairly disadvantages individuals who have an SMSF compared to individuals who are members of large superannuation funds. Large superannuation funds can ensure that the full value of franking credits received by the fund are utilised against income derived by younger members who are still in accumulation phase and have taxable earnings and contributions. Members in retirement phase who would be entitled to a refund for franking credits can have their after-tax return increased by reallocating earnings of their fund to them equivalent to the value of the franking credit to the accumulation phase member.

In effect, retirement phase members 'sell' their proportional entitlement to franking credits derived from Australian shares supporting their superannuation account to accumulation members in the fund, ensuring the full value of franking credits is captured.

Therefore, an individual in retirement phase in a large superannuation fund with the same balance and same allocation to listed equities as an individual in an SMSF will be substantially better off due to still receiving the full benefit of franking credits. This can result in a large difference in retirement incomes and balances over the long term and unfairly impacts those equivalent individuals in SMSFs. This is a clear departure from the principle of horizontal equity in the taxation system.

The change would single out SMSF members as one of the few groups of taxpayers who will have the profits of companies they own taxed higher than their marginal tax rate. Instead, SMSF members in retirement phase will have company tax paid on their share of a company's profits when none should be paid at all.

We expect many SMSF members could change their retirement savings strategies to minimise the impact of the proposed policy by either shifting their Australian share holdings to other types of assets or to large superannuation fund member direct investment accounts or no longer utilise an SMSF for retirement savings.

Unfairly affects the wrong SMSFs

The ALP has stated that the proposal will target the wealthiest 10% of SMSFs, to which 50% of the benefit of refundable franking credits accrues. However, the introduction of the $1.6 million TBC on 1 July 2017 has severely limited the amount of refundable franking credits that would have been paid to this 10 per cent.

In fact, the largest 10 per cent of SMSFs which encompass funds with assets over $2.4 million will now be paying tax at 15% on earnings on assets over the $1.6 million limit and in many circumstances will still receive the majority value of their franking credits as they use them to reduce the tax liabilities on their earnings. Earnings on the assets over $1.6 million are taxed at 15% in superannuation funds.

SMSFs with assets below $1.6 million, whose members have worked hard to provide for a reasonable retirement and do not receive the Age Pension, will lose 100% of their franking credit refunds and approximately 10% of their income.

For example, under the ALP policy:

SMSF with $900,000 in pension phase (40% allocation to Australian shares)	***SMSF with $1.6 million in pension phase and $8.4 million in accumulation phase. (40% allocation to Australian shares)***
Total SMSF income: $45,000 (5% return)	Total SMSF income: $500,000 (5% return)
Tax payable: $0	Tax payable: $63,000 (15% tax rate on the taxable phase of the SMSF)
Franking credits used: $0 (now $7,700)	Franking credits used: $ 63,000 of ($85,700)
Tax paid: $0	Tax paid: $0
Total: $45,000 (now $52,700)	Total: $500,000 (now $522,700)
Income lost: 14.6%	**Income lost: 4.3%**

The policy clearly more severely impacts SMSFs who are not the wealthiest, but the middle class and below. The case study above does not take into account that the wealthiest SMSF trustees will most likely re-structure their fund to use franking credits more effectively.

The budget can afford franking credit refunds

The ALP has stated that the proposal will reform an unfair revenue leakage that puts a greater tax burden on low and middle incoming working Australians and that the current arrangements are unsustainable and will increasingly undermine the medium- and long-term fiscal position.

The SMSFA queries how the budget cannot afford cash refunds, on which many self-funded retirees have built their retirement strategies for nearly two decades, but can afford the tax offsets (which is estimated to be upwards of $30 billion) that every shareholder, particularly wealthy individuals, APRA superannuation funds and large SMSFs will continue to enjoy. The distinction between revenue lost to government from ensuring taxpayers only pay their marginal tax rate through an offset rather than a refund is arbitrary and unfair.

Overstatement of revenue benefit

The ALP anticipates the Budget will receive $55 billion from the implementation of the policy over a decade.

However, this overstates the revenue benefit due to the likely shifting of asset allocations, the impact of the $1.6 million TBC and transition to retirement income streams (TRIS) changes, individuals rolling out of SMSFs, and SMSFs including more members to generate income which franking credits can be offset against.

The SMSF Association has strong concerns regarding the reliability of the $55 billion in additional tax revenue forecast. Over the longer term, it is highly likely that investors will transition to strategies where their franking credits are utilised and thus render the revenue estimates inaccurate.

Change in asset allocation

The proposed change to dividend imputation will force SMSF trustees to reconsider their asset allocations with an incentive to move away from Australian listed shares. SMSFs have significant ownership of Australian Stock Exchange listed companies (estimated to be between 13 to 14% of the market) as they are attracted to the liquidity and yield these companies provide for individuals in retirement.

As at June 2018, SMSFs invested $229 billion of the $749 billion or 30.56% of their assets to listed shares, the largest of any asset allocation. This indicates that the proposal will have significant effect on SMSFs because listed shares form a significant part of their portfolios. Furthermore, when analysing SMSFs in retirement phase, they tend to have a 10% higher allocation to listed shares as they seek the liquidity and income which is appropriate for trustees entering retirement.

Therefore, there is no doubt trustees will look to non-company investments (e.g. trust vehicles), foreign investments and property to seek the same after-tax returns offered by listed companies but no longer applicable to those individuals in retirement phase. This may lead to funds having a higher risk allocation in the retirement phase to achieve income, distort Australian share prices and weaken the domestic supply of capital to Australian companies.

An expected significant shift in the movement of SMSF asset allocations will substantially impact the intended revenue the ALP forecasts.

2016 Superannuation changes

Furthermore, as highlighted, the introduction of the $1.6 million TBC will severely limit the amount of excess franking credits that would have been paid to SMSF members. Large SMSFs with more than $1.6 million will be paying tax at 15% on earnings on assets over the $1.6 million limit and are likely to restructure their holdings and in many circumstances will still receive the full value of their franking credits as they use them to reduce tax liabilities on their accumulation earnings. In addition, changes to the taxation rates for TRISs have ensured more superannuation fund assets are taxable, and less franking credits are refundable.

Class Pty Ltd's 2018 June Benchmark Report[2] has highlighted the substantial increase in taxable superannuation earnings due to the 1 July 2016 changes. As at June 2018, Class data revealed the asset value in accumulation phase was $422 billion, a 90% increase from March 2017 when the asset value in accumulation was $222 billion. The dual forces of the TRIS change and the TBC has reduced the amount of assets in tax free pension phase from 31% to 14% over the same period.

Assuming a modest return of 5% on assets for the 2018 financial year, Class predicts a significant uplift of $1.5 billion in the tax due on SMSF earnings to $3.2 billion. They state given the impact of the reforms, that the proposed ALP policy to further increase the tax burden on self-funded retirees by

[2] https://cdn2.hubspot.net/hubfs/2621735/Benchmark%20Report/SMSF_Benchmark_Report_June_FINAL.pdf

reducing imputation credits for SMSFs is inappropriate, especially if it disproportionally impacts SMSFs compared to APRA funds.

Given that the Parliamentary Budget Office (PBO) conducted statistical forecasts using 2016 Australian Taxation Office (ATO) data, while stating they have taken into account the 2016 policy changes, these results may be significantly higher than expected and accounted for by the PBO and ALP.

Wind-up of SMSFs

Most importantly, for those individuals who do not change asset allocation, and are significantly affected by the 1 July 2016 policy, there is a clear incentive to move out of SMSFs into large superannuation funds. Understanding that that their retirement incomes will not be affected if they are part of a superannuation fund which has the taxable earnings needed to utilise the value of their franking credits will likely invoke a rational decision to leave. This will further impact on taxation revenue.

Increase in SMSF members

For those individuals who wish to keep their SMSF, they may increase the amount of members in their fund to increase the funds tax liability, especially by adding adult children who are making taxable contributions to the fund. Consequently, there will be a tax liability which franking credits can be used to offset the tax. We anticipate that this will be a likely strategy for some SMSFs who wish to keep their asset allocation to listed equities.

We also explore below that the policy may incentivise drawdowns which will impact negatively on the aged pension and impact the budget bottom line.

Who it will affect?

It has been estimated by the PBO that over 1.2 million Australian taxpayers will be impacted by the ALP.

The SMSFA does not dispute this figure but believes the inadvertent impacts of the policy will affect much of the population. For example, 1.1 million SMSF trustees in 600,000 SMSFs will be impacted by the change in policy. This includes individuals who will lose their franking credit refunds and those individuals who would have started receiving franking credit refunds in the near future due to the tax rate and structure of SMSFs. The pensioner guarantee will apply to those age pensioners in SMSFs at 28 March 2018, but not SMSFs with members who begin to access the pension subsequently.

With over 9.5 million Australians over the age of 45, this policy will affect the choice of superannuation management for very many individuals who are self-funded, whose returns will be impacted if they seek to utilise an SMSF.

The following parties are also affected:

- <u>Individuals over 65 years</u> receive around half ($1.1 billion) of franking credit cash refunds going to individuals, with an average value of around $5000.
- <u>Australian shareholders on incomes less than $65,000</u>: Shares have been a preferred saving vehicle for many Australians under the dividend imputation system. Those on incomes of less

than $65,000 will be adversely affected, including 18 to 65-year-olds running their own business, single parents, and non-working spouses.

- Small APRA-regulated funds: Although 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 2603 APRA-regulated funds received franking credit refunds in 2015-16. Most of these are small APRA Funds.
- Retired small business owners with equity in their companies: The proposal will hurt small business owners who derive retirement income from dividends and franking credits on the equity invested in their unlisted companies. There are about 500,000 incorporated SMEs, although it is difficult to estimate how many will be affected.

Impact on retirement incomes

The SMSF Association believes this policy could have a significant effect on those individuals in and approaching retirement.

Based on the most recent ATO statistics for the 2014/15 financial year 311,121 SMSFs utilised franking credits with an average deduction of $11,577 per SMSF and a median value of $5,155 per SMSF.

More specifically, as of June 2016, 47% of funds are in retirement phase or 267,000 funds. With 60.7% of SMSF members aged over 55, there is approximately 677,000 members either currently affected or will be in the coming 10-15 years as they enter retirement phase.

245,392 members have average income streams less than $58,000 and the overall average income stream for these members is $39,936, highlighting that the refund of franking credits may be a significant portion of their income. With the average asset allocation to listed shares at 31% of SMSF assets and the fact that 62% of funds are invested in listed shares, this is a far-reaching issue.

In addition, the higher the allocation to listed shares, the greater the impact will be on retirement incomes. As ATO statistics indicate, SMSFs in retirement phase have an even higher allocation to listed shares than SMSFs in accumulation phase further worsening the impact.

Individuals in retirement phase who have a nil tax rate, will lose 30% of their share income.

As stated, the introduction of the $1.6 million TBC means that SMSFs with member accounts exceeding this amount will still be able to utilise franking credits to offset their tax payable on accumulation accounts. This is because earnings on assets in excess of the $1.6 million TBC will be taxed at 15%, generating a tax liability to use franking credits against. This results in the more typical SMSFs with an average balance to be affected the most.

The following case study indicates a typical SMSF trustee situation.

A couple both aged 70 own their home and have $850,000 in superannuation. They are not entitled to receive any age pension (e.g. self-funded retirees) as their means test assets exceed the $848,000 limit. We assume they have the following simple asset allocation and investment returns:

Asset	Allocation	Return	Income
Cash	$250,000	2.5%	$6,250
Managed Investments	$250,000	5.0%	$12,500
Shares	$350,000	5.0%	$17,500
Franking Credits			$7,500
Current Income			$43,750
		ALP Proposal income	$36,250
Income decrease of 17.14%			

The post-tax return on their assets with refundable franking credits is 5.14%. Without refundable franking credit it is 4.26%. The loss on the share income is 30%.

The income they receive from being self-funded under the ALP policy of $36,250 is only approximately $1200 above the full age pension of $35,048 which can be accessed by a home owning couple with less than $380,500 in assets.

Currently this couple do not access the age pension as they are above the $848,000 threshold. If they wanted to maintain their income level and draw down on their SMSF capital they would fall below the $848,000 part pension assets test threshold and start accessing the age pension.

As shown in the example, if SMSF members do not shift their asset allocation the ALP proposal has a significant impact on their retirement income.

It must also be noted that retirement incomes will also be affected by any consequent share price declines from the effect the proposal will have on capital markets as many individuals shift away from Australian equities.

This potential reduction has the potential to trigger a number of behavioural effects which are mentioned throughout this submission, including:

- Changing asset allocations within the SMSF to non-corporate investments (e.g. direct property, real estate investment trusts, managed funds, etc.).
- Changing asset allocations within the SMSF to foreign or unfranked shares.
- Shifting some or all assets to large superannuation funds to obtain the full benefit of franking credits.
- Drawing down on capital more quickly in retirement phase to supplement income and/or access the age pension.
- Introducing family members to the SMSF to generate taxable income to ensure the value franking credits are not wasted.

Effect of the pensioner guarantee

The decision to exempt individuals on the age pension (and other government pensions) from the proposal is a positive for those individuals protected by the guarantee. Nevertheless, the pensioner guarantee exacerbates the policy effect of targeting middle class self-funded retires who utilise refundable franking credits as a source of retirement income.

The Pensioner Guarantee does not protect SMSF members who are self-sufficient and did not already receive the age pension on 28 March 2018. Potentially, these SMSF members are worse off than people with less savings but with access to refundable franking credits and a part pension. The end result is to reduce people's incentive to save for retirement to achieve self-sufficiency.

An example is provided below. (Part Age Pension cease when combined assets exceed $848,000)

Example of impact of ALP policy on self-funded retirees:

	Home-owning couple with $700,000 in SMSF (Pensioner Guarantee)	**Home-owning couple with $900,000 in SMSF – current rules**	**Home-owning couple with $900,000 in SMSF – *ALP proposal***
SMSF income	$35,000	$45,000	$45,000
Franking Credits	$6,000	$7,700	
Part Age Pension	$9,900	$0	$0
Total Income	$50,900	$52,700	$45,000
Assumptions: 40% of assets held in Australian shares; Share yield of 5% per year; other assets returning 5% per year.			

In this scenario the couple with $700,000 is now better off than the couple with $900,000 due to the policy. Furthermore, the couple with $700,000 will have less incentive to save as they will lose the refundable aspect of their franking credits and income from the part aged pension.

The Pensioner Guarantee also creates a two-tiered SMSF system that increases the complexity of the franking credit system. SMSFs with individuals who were on the age pension before 28 March 2018 will receive a different tax treatment to those SMSFs with individuals that receive the age pension after this date.

For example,

Current superannuation regime: (Applied for the Age Pension before 28 March)

Couple owns home and has SMSF worth $500,000.

SMSF income: $25,000

Franking credits: $4,285

Age Pension (part) $26,798

Total: $56,083

ALP's proposed regime: (Applied for the Age Pension after 28 March)

Couple owns home and has SMSF worth $500,000

SMSF income: $25,000

Franking credits: $0

Age Pension $26,798

Total: $51,798

The couple under the ALP's proposed regime despite seeking government support are unable to retain their franking credits unlike the couple who started their age pension before March 28. The later couple is $4,285 better per year

The policy provides no remit for those SMSF members who become age pensioners post this date and therefore will continue to arbitrarily target pensioners who cannot afford to be taxed up to 30%.

Incentivises the drawdown of capital and reliance on the age pension

The policy will also encourage the drawdown of capital and further increase reliance on the age pension. This will place the Federal budget under greater pressure in years to come and contradicts the ALP'S motivation of improving budget outcomes.

An example, of the distortion created by the proposal is highlighted below.

The retirement income incentive for a home owning couple to save upwards of $850,000 is now severely reduced under a non-refundable franking credit proposal when a similar amount of retirement income can be attained by a home owning couple with less than $380,500 in assets.

For home-owning couples that have a superannuation balance between $500,000 and $800,000, the increased taper rate since 1 January 2017 creates a "black hole" where their assets above the asset test free amount causes them to be worse off in terms of income. This is caused by the taper rate of the equivalent of 7.8 per cent per annum reducing their pension entitlement at a rate in excess of the income they earn from their superannuation balance above the asset free area

This creates an unfairly high effective marginal tax rate on superannuation assets that are in excess of the asset test free amount. This actively discourages middle income earners from saving for retirement and has other detrimental behaviour effects, such as providing an incentive to shift investments from assets that are included in the means test (e.g. superannuation) to those that are excluded (e.g. the family home). This is an example of how retirement income policy changes can have detrimental effects when they have not been appropriately evaluated or integrated with other policy settings.

The impact of the Pensioner Guarantee also exacerbates the effect on SMSF members who have saved to avoid relying on the pension. Individuals who were ineligible on 28 March 2018 will have a further incentive to exhaust their capital and receive the age pension to substitute their income.

If these actions are taken up by self-funded retirees, the savings the policy intended to recover may be further eroded by individuals further relying on the age pension. When individuals are not incentivised to utilise superannuation concessions it will put a greater tax burden on low and middle income working Australians.

Effect on capital markets

The proposed changes in dividend imputation policy will also significantly impact capital markets. As noted, if retirees shift away from Australian shares to less appropriate assets, it will weaken our domestic capital market. SMSFs currently hold more than 12% of listed Australian shares.

As stated, other forms of growth assets will be utilised and bought in place of Australian companies. The impact on capital markets away from Australian listed equities depends on the value of franking credits to investors.

Analysis from Michael Rice[3], based on Professor Kevin Davis' report[4] into dividend imputation and the Australian Financial System, believes the removal of refundable credits would likely see a fall in the value of Australian shares and an increase in the cost of capital for Australian companies. This is because of the benefit garnered for domestic investors and the unknown relevant market power of international investors.

Additionally, we believe another advantage of the dividend imputation system is the discipline it imposes on corporate Australia and its capital management processes. Dividend imputation encourages corporates to distribute profits as dividends, and to go through the discipline of seeking additional capital from shareholders if required through further equity raisings. In the absence of dividend imputation, there would be an increased tendency for firms to retain earnings for capital initiatives and possibly increased use of borrowings and retained earnings. Also, the inclination to distribute profits as franked dividends promotes compliance with tax obligations for Australian companies.

It has also been noted, this policy may result in a reduction in share buybacks by Australian companies. Typically, a proportion of the proceeds from a share buyback are deemed to be a return of capital, with the remainder a fully franked dividend. As these dividends will become less attractive under the proposed policy change, Australian companies may reduce share buybacks.

Finally, potential losses to all shareholders from consequent share price declines must be considered.

Long term instability in superannuation and long term strategies

The ALP's policy further reduces the Australian population's trust in the superannuation system. The proposed policy does not align with the suggested primary purpose of superannuation to ensure individuals are more self-sufficient in retirement. Individuals have undertaken long term strategies regarding allocations of assets only for the rules to change time and time again.

Further, after a period of significant change it is important that stability follows so that superannuation fund members can have confidence that their retirement savings will not be at the whim of Budget policy or more tinkering with superannuation laws.

We believe any changes to dividend imputation require long transitional timeframe to enable retirees to respond and other savers to revise plans. Ad-hoc strategies to curb the impact of franking credit reform, particularly to individuals who are nearing retirement or retired, may involve certain financial risks, asset exposures and capital gains tax implications which are not appropriate.

[3] Removing the refundability of franking credits, Rice Warner, 2 May 2018

[4] Dividend imputation and the Australian Financial System: What have been the consequences? Kevin Davis October 2015.

It will no doubt be difficult and costly for older Australians who are in or nearing retirement to seek financial advice and significantly restructure their financial affairs. Furthermore, the material loss of income which is received annually will be distressing for many retirees.

If you have any questions about our submission, please do not hesitate in contacting us.

Yours sincerely,

John Maroney
CEO
SMSF Association

ABOUT THE SMSF ASSOCIATION

The SMSF Association is the peak professional body representing SMSF sector which is comprised of over 1.1 million SMSF members who have $750 billion of the funds under management and a diverse range of financial professionals servicing SMSFs. The SMSF Association continues to build integrity through professional and education standards for advisors and education standards for trustees. The SMSF Association consists of professional members, principally accountants, auditors, lawyers, financial planners and other professionals such as tax professionals and actuaries. Additionally, the SMSF Association represents SMSF trustee members and provides them access to independent education materials to assist them in the running of their SMSF.