

POLICY PAPER

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DIVIDEND FRANKING CREDIT REFUNDS: PRINCIPLE VS REVENUE

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Contents

Introduction.....	1
Consideration of taxation principles.....	1
How refundability came about	2
Impact on shareholders.....	3
Strategies to compensate for the impact.....	4
Impact on markets	5
Revenue considerations	5
Conclusion.....	6
Endnotes	6



Introduction

Since 2000, under Australia's dividend imputation system of taxation, taxpayers whose franking credits exceed their tax liability have been paid a cash refund of the excess. The Labor opposition's policy is to continue with the imputation system but to abolish cash refunds of excess franking credits, subject to a carve-out for some age pensioners. This has aroused a storm of controversy and led to the establishment

of an inquiry into the proposal by the House of Representatives economics committee.

This policy paper discusses the issues of taxation policy at stake, the history of refunds, and the impact abolition would have on taxpayers, markets and revenue. The paper is based on a submission to the House of Representatives committee in November 2018.

Consideration of taxation principles

The basic justification for refundable franking credits is that they are a logical feature of a dividend imputation system.

The essential purpose of imputation is to prevent double taxation of dividends – once on the company profits from which dividends are paid, and again in the hands of recipients as personal income tax or superannuation fund earnings tax. It achieves this by counting both the dividend and the company tax paid on the source profits (the 'franking' or 'imputation' credit) as taxable income of the recipient, but then allowing a credit against tax payable in the amount of the company tax paid.

The effect is that in the tax system viewed as a whole, franked dividends are taxed at recipients' marginal rates – no more, no less. The role of company tax in this scheme is essentially that of a pre-payment of the tax to be paid by the shareholder. If the 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; if it is below, the franking credit is more than enough and they will receive a credit for the excess.

The issue under consideration by the committee is what should happen when this excess is more than the shareholder's overall tax liability? Should the

shareholder receive a cash refund from the ATO, or should the credit be capped at the amount of the tax liability?

Opponents of full refundability argue it is perverse for the system to generate a cash refund to a shareholder even if the shareholder has no tax liability (such as a pension-paying self-managed super fund) or one that is less than the franking credit. If the shareholder has no tax liability, how can it be said that 'double taxation' has taken place? What is it that is being 'refunded'?

However, this view overlooks the function of company tax as a pre-payment of the shareholder's own tax, and that the imputation system views the company tax and the shareholder's tax (whether it be personal income tax or super fund tax) in combination as the full and final tax obligation of the shareholder. Thus, if a zero taxpaying super fund for example is denied a refund of franking credits, it is no longer a zero taxpaying entity because its dividends have been taxed at the company tax level. The principle that system-wide taxation results in the shareholder paying their marginal rate – no more; no less – would be violated.

Denial of refunds has the effect of imposing a minimum tax of 30% (the current company tax rate) on dividends paid to zero taxpaying entities and constitutes an arbitrary truncation of the imputation system. Taxpayers between 0 and 30% may in part avoid the 30% minimum by absorbing their 'surplus' franking credits into tax payable on income other than franked dividends. This creates a perverse outcome in that zero taxpayers end up paying more tax on franked dividends than some taxpayers. It should also be noted that other forms of income such as interest and rent are not subject to such a minimum and are tax-free in the hands of a zero taxpaying entity.

For these reasons, full refundability is entirely consistent with the logic and principles of the imputation system. While legitimate issues have been raised by tax experts about whether imputation continues to be the best basis for company tax in Australia, that is a different matter. For as long as imputation remains in place, refundability should also remain. To deny refundability while keeping imputation in place would create a logical inconsistency in order to raise more revenue.

How refundability came about

When dividend imputation began in 1987 franking credits were not refundable. It is not clear why refundability was not allowed at that time, other than revenue considerations.

A change to refundability was considered in the tax system review of 1997-98 that led to the New Tax System (ANTS) white paper of August 1998.¹ While introduction of the GST was the cornerstone of the white paper, it contained many other proposals including the introduction of franking credit refundability. This was endorsed by the Ralph Review of Business Taxation in 1999 and implemented with effect from 1 July 2000.²

The ANTS white paper explained that refunds of excess imputation credits were an essential feature of a 'full franking' model. It stated:

Both resident individual taxpayers and complying superannuation funds would be eligible for refunds of excess imputation credits where other tax payable cannot absorb them. 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.

The words "ensure that the imputation system operates as it should" deserve emphasis; they imply that from 1987 to 1998 the system had not been operating as it "should" have.

Refundability has remained in place for the past 18 years. It should not go unnoticed that the comprehensive tax review led by then Treasury Secretary Ken Henry (Australia's Future Tax System review) in 2008 and 2009 had the opportunity to recommend abolition of imputation credit refunds but did not do so. That review did raise concerns with the imputation system in general, but did not recommend any changes to it. It recommended:

Dividend imputation should be retained in the short to medium term, but for the longer term, consideration should be given to alternatives as part of a further consideration of company tax arrangements.³

In 2014 the Financial System Inquiry made various observations regarding the tax system and referred them to the tax white paper review then in process.

The Inquiry did not make an in-principle case against refundability but made the following observation:

For investors subject to low tax rates, the value of imputation credits received may exceed tax payable. Unused credits are fully refundable to these investors, with negative consequences for government revenue.⁴

The white paper review referred to by the Financial System Inquiry began but was terminated in 2015 before it was completed. It should be noted that the issues paper for the review did not present a case for abolishing refundability:

Refundability ensures that the final tax on company tax reflects each shareholder's tax rate at the time the profits are distributed. Arguably, this provides for greater neutrality between different types of investments and

removes a penalty that would otherwise apply to shareholders who have a lower tax rate (for example, retiree shareholders on relatively low incomes). However, as noted above, domestic shareholders may receive higher returns on domestic shares compared to global rates of return on equities, because of imputation. There are some revenue concerns with the refundability of imputation credits.⁵

In view of this history, it can hardly be said that refundability was introduced on a political whim or as a generous mistake by the government of the day. To the contrary, it was introduced as part of a rigorous tax system review process and has withstood further rigorous review since then. No convincing case based on tax policy principles has been made for abolishing refundability now. The motive for abolishing it would appear to be purely revenue raising.

Impact on shareholders

The withdrawal of refunds would affect different categories of shareholder differently: as individual taxpayers under the personal income tax system; as self-managed superannuation funds (SMSF); or as institutional funds. In any of these categories, the shareholding may be by way of direct ownership or indirect through a managed fund which passes on franking credits to unitholders.

An account of the numbers of people in these categories was recently provided by Robert Gottliessen writing in *The Australian*.⁶ According to Gottliessen, using 2014-15 data, 840,000 individuals outside superannuation and another 420,000 in SMSFs would have been affected. However, some of the latter group would have been removed from refund status by the transfer balance cap restriction imposed on tax-free status in 2017. In addition, Gottliessen points out there is an unknown number of people in small corporate superannuation funds that will be affected.

The impact of withdrawal in any particular case depends on the applicable tax rate and the proportion of franked dividends in total income. In general, the lower the tax rate and the higher the proportion of franked dividends, the greater the impact of the policy of removing franking credit refunds.

The most affected would be (a) SMSFs in pension mode with no funds in accumulation mode and no new taxable contributions being received; and (b) individuals on low to middle incomes that include a sizable component of franked dividends, particularly if they benefit from the pensioner tax offset. Institutional superannuation funds are unlikely to be affected as they would pay enough tax on members'

contributions and income on accumulation assets to absorb franking credits before refunds become an issue for them. This may change in the long-term as the balance of assets shifts from accumulation to pension.

The historic average dividend yield on ASX-listed companies is 4.2%. Not all dividends are fully or even partly franked, and the yield in the case of franked dividends is probably higher because of the influence of the banks, which have a history of full franking and above-average yields. However, if we assume the same average 4.2% yield for franked dividends, then the grossed-up yield is 6.0% and the loss of refunds would slice up to 1.8 percentage points from the return to shareholders. This is a substantial impact given the historic total return on ASX-listed companies is around 11% (including franking credits).⁷

Some examples will help illustrate the potential impact on individuals.

Example 1: Self-managed super fund in pension mode

ABC super fund has a balance of \$1 million and two members aged 65 both drawing the minimum pension of 5% of the balance and no longer making contributions. The fund holds \$500,000 in Australian equities, \$400,000 of which pays franked dividends of \$16,800 a year. Refunded franking credits are \$7,200. The total income of the fund excluding any realised capital gains is \$49,200 including the franking credit refunds. The loss of these refunds will reduce the income of the fund by \$7,200 a year or 14.6%. The fund's expected total annual return is reduced from

7.4% to 6.7%. The present value of the lost franking credit refunds projected for 20 years, assuming no growth and a discount rate of 4%, is \$98,000 or 9.8% of the fund's value. This can be thought of as the lump sum the fund would need to receive up-front to compensate for the loss of franking credits.

Those figures describe the impact on the fund. The impact on its members is different because pensions from a SMSF are not directly related to the concurrent income of the fund but to its balance. At age 65 the statutory minimum pension is 5% of the balance, although members can opt for a larger percentage. Assuming the members of ABC fund maintain their pension at 5%, the impact of the loss of franking credits would evolve gradually as the loss of refunds led to slower growth in the balance of the fund. The longer the period, the larger the gap that opens up between the actual pension paid and what it would have been with refunds. Members could offset this impact by taking a superannuation pension rate above the statutory minimum, but their funds would then run out more quickly and they would have to rely on the public age pension sooner (or their bequest would be smaller).

Example 2: Individual shareholders

The couple in example 1 could have chosen to self-fund their retirement by owning assets in their own names rather than having a SMSF. Provided their combined taxable income is below \$58,000 they would pay no tax (as a result of the Seniors and Pensioners Tax Offset) and would receive a full refund of franking credits. The impact of the loss of franking credit refunds on their assets would be the same as in example 1, but the impact on their income would be more immediate and direct. Assuming this couple relies on the income from their assets for their day-to-day living expenses, they would experience an immediate loss of income of \$7,200 a year or 14.6%. To compensate, they would need to sell assets each year, leading to a more rapid depletion of their retirement assets and earlier resort to the public pension.

These two examples relate to entities that pay no tax and therefore experience the maximum impact of the loss of franking credit refunds. Endless other examples could be provided of entities that experience a lesser or no impact by virtue of having other taxable income — and other examples where the impact is much larger because the holding of shares paying franked dividends is larger.

Strategies to compensate for the impact

The opportunities for entities to avoid the impacts described above by changing asset allocation are very limited.

In the case of non-tax paying entities, they would need to increase the expected rate of return on their assets other than Australian shares paying franked dividends. They may be able to do this, but only by accepting considerably higher investment risk which means the expected higher return may never be realised within their lifetime. For retirees it is far too risky to have a high-growth portfolio. It would be most unfortunate if the impact on investors from the loss of franking credit refunds were to be compounded by capital losses resulting from excessive risk-taking in a futile search for higher rates of return.

Members of SMSFs in pension mode could abandon their SMSFs and join large industry or retail funds that have sufficient tax liabilities to absorb their franking

credits. However, they would lose at least some of the freedom of investment choice they currently have — and presumably value. Also, while large funds do pay members in pension mode higher rates of return to reflect their taxpayer status, it is not clear this fully replicates their zero tax status and receipt of franking credits in a SMSF structure.

In the case of tax paying entities, they could reallocate assets to incur a higher tax liability to absorb their franking credits, but they would still be worse off than when they received refunds. Alternatively, they could target a higher expected return on other assets, but the same risk considerations may apply as in the case of non-tax paying entities. If they were maximising their risk-adjusted return in the first place, there is no scope to increase it further to offset the loss of franking credit refunds.

Impact on markets

Some commentators have argued that the loss of franking credit refunds would reduce the attraction of Australian equities to such an extent that prices would be driven down. This would compound the negative impact on those affected by the loss of franking credits and spread the impact to a much larger investor population. However, it is not clear that those affected by the loss of franking credits constitute a large enough segment of the market to have such an impact. They are likely to be price takers rather than price makers. The price makers are institutional and foreign investors, who would likely increase their allocations to Australian shares in response to any withdrawal by small investors who lose franking credits.

Companies could come under pressure from some shareholders to increase dividends so as to help offset the impact. However, shareholders' opinions on this issue would be divided. Australian dividend payout ratios are already high by world standards and in many cases it may not be in the interests of shareholders in general for payouts to be increased further. The lower the proportion of earnings companies retain, the less they have to reinvest in growth options or the more they have to borrow.

However, the disappearance of franking credit refunds could have a disproportionate impact on some forms of corporate finance activity, such as off-market share buy-backs, which are currently structured to appeal particularly to non-tax paying entities.

Revenue considerations

The above discussion makes the case that the proposal to abolish franking credit refunds is based on revenue demands rather than sound tax principle. This raises a number of issues.

The question as to whether policy measures to raise additional revenue are needed is a very broad one going beyond the scope of this paper. Other papers by CIS authors have argued that the budget deficit problem has been one of excessive expenditure rather than insufficient revenue.⁸ There are long-term budget pressures stemming from factors such as population ageing, but it is premature to conclude that these require revenue-raising measures rather than changes to expenditure policies or policies to lift work force participation and productivity growth.

If additional revenue were needed, it is not clear that denying franking credit refunds would be among the best policies to achieve it. Refunds are integral to the dividend imputation system, which in turn exists to promote economic efficiency. Refunds also serve the goal of equity, in that they are necessary to deliver the same tax outcome for people with the same assets and incomes but in different institutional structures.

Labor claims that its proposal, if implemented from 1 July 2019, stands to raise \$11.4 billion in the four years to 2021-22 and in excess of \$50 billion over 10 years. These estimates have been criticised on the grounds they do not allow for the effects of changes in

superannuation rules from July 2017 — in particular, the transfer balance cap (TBC) of \$1.6 billion — or for behavioural responses. The cap had the effect of shifting some superannuation funds from receiving franking credit refunds to paying tax, and therefore reduced the additional revenue available from abolishing refunds.

The Labor figures are based on policy costings by the Parliamentary Budget Office. The PBO has subsequently stated explicitly that although the base year for its estimates was 2014-15, which preceded the TBC, it reset the base to take account of the cap.⁹ The PBO further states that in the absence of the cap its revenue estimate would have been only around 10% higher. It also states that it made allowances for behavioural responses.

It is difficult to make independent revenue estimates for this policy change. As actual franking credit refunds in 2014-15 were \$4.9 billion, the revenue from abolishing them would have been somewhat less under a TBC regime and after allowing for behavioural responses by those affected. Given the uncertainty surrounding such responses, any revenue estimate must be subject to a wide margin of error. The claim of more than \$50 billion over 10 years dramatises the revenue effect (like all aggregations over four or 10 years) and reflects the substantial automatic growth of all revenues over 10 years.

Conclusion

Refundability of franking credits was introduced in 2000 after rigorous review of the relevant tax policy principles and has not been challenged by subsequent review of the tax system. As long as the imputation system remains in place, refundability is a logical component of it and should remain in place. Any move to abolish refundability for revenue-raising reasons would fly in the face of the sound principle on which it is based.

It is not clear how much additional revenue would be raised from abolition of refundability, but whatever the amount it is clear that it would be concentrated on a relatively small number of individuals and funds and would have a large absolute and percentage impact in some cases. The opportunities for taxpayers to rearrange their assets to avoid or minimise this impact are very limited.

Endnotes

- 1 A New Tax System, Australian Government Treasury, Canberra, 1998.
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- 4 Financial System Inquiry Final Report, Appendix 2, Tax Summary, Commonwealth of Australia, 2014.
- 5 Re: Think Tax discussion paper, Australian Government Treasury, March 2015, p 86.
- 6 Robert Gottlieb, *Battlers losers in Labor franking policy change*, The Australian, 29 September, 2018.
- 7 This comprises an historical average real return of around 7%, an assumed inflation rate of 2.5% and an average grossing-up of 1.5% for franking credits (given that not all dividends are franked).
- 8 Michael Potter, *The case against tax increases in Australia: The growing burden*, The Centre for Independent Studies, Research Report 15, June 2016.
- 9 Parliamentary Budget Office, Dividend imputation credit refunds – further information, 20 November 2018 (www.aph.gov.au/pbo/publications/costings)

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Michael Potter, The case against tax increases in Australia: The growing burden, The Centre for Independent Studies, Research Report 15, June 2016.

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