Self Managed Super Fund Association

THE IMPACT ON THE SUPERANNUATION SYSTEM: LABOR’S IMPUTATION CREDIT POLICY

Dividend imputation system distorted

The SMSF Association supports the current policy settings for the dividend imputation system. The current system prevents double taxation on company profits and ensures shareholders are taxed on company profits at their marginal tax rate. A shareholder in a company is therefore in the same economic position as a sole proprietor who earns the same net profit.

In this vein, 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 paid on their behalf. The same applies for those on high taxable incomes as they must pay the difference between their marginal tax rate and the current company tax rate of 30%.

Removal of cash refunds for excess franking credits distorts the dividend imputation system. Firstly, because low taxable income individuals will be effectively paying a higher tax on their dividends through losing the benefit of refundable franking credits. Secondly, because individuals on higher taxable incomes, will not lose the benefit of franking credits. Accordingly, the Labor proposal therefore draws an arbitrary distinction between a cash refund of imputation credits and the use of imputation credits that reduce other taxation liabilities.

Impact on retirement incomes

The effect of removing the refundability of franking credits is material during retirement phase when looking at the income derived from an SMSF. Our calculations show it will cut about $5000 of income from the median SMSF retiree earning about $50,000 a year in pension income.

The impact is most significant earlier in retirement due to the larger amount of capital generating franking credits. This amount of capital is depleted over time as the retiree draws on both income and capital.

Pensioner Guarantee

The decision to exempt those on pensions is a positive for those individuals but further exacerbates the policy’s effect of singling out SMSF members who rely on refundable franking credits as a source of retirement income.

The Pensioner Guarantee does not protect SMSF members who are self-sufficient and do not already receive the age pension. 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.

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

	Home-owning couple with $700,000 in SMSF	**Home-owning couple with $900,000 in SMSF – current rules**	**Home-owning couple with $900,000 in SMSF – *Labor 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.			

The Pensioner Guarantee also increases the complexity of the proposal with SMSFs who have a member receiving the age pension on or before 28 March 2018 receiving different tax treatment to those that have a member begin receiving the age pension after this date.

Asset allocations

The proposed change to dividend imputation will also 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.

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.

Drawdown of capital and reliance on the age pension

The policy also encourages the drawdown of capital and increased reliance on the age pension.

For example, a home owning couple in retirement phase who has $850,000 in superannuation and a 40% allocation to Australian listed equities will result in an income decrease of around 17%. Further to this, the income they receive from being self-funded under the Labor 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.

The Pensioner Guarantee exacerbates the effect on SMSF members who have saved to avoid relying on the pension, resulting in a further incentive to exhaust their capital and receive the age pension to substitute their income.

In this sense, the savings the policy intends to recover may be eroded by individuals further relying on the age pension.

Overstatement of revenue benefit

Following on from the previous two points, changes to SMSF asset allocations and encouraging the drawdown of capital, will likely result in an overstatement of revenue forecast in Labor's policy announcement. If SMSF trustees reallocate their portfolios to assets which do not attract franking credits, there will be less revenue generated by forgone refunds. In addition, any savings from the policy may be offset with increased reliance on the age pension.

Furthermore, the introduction of the $1.6 million transfer balance cap will severely limit the amount of excess franking credits that would have been paid to individuals. In fact, large SMSFs with more than $1.6 million will be paying tax at 15% 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. The SMSF Association has strong concerns regarding the reliability of the $55 billion in forecast additional tax revenue.

Comparison with large superannuation funds

Not only does the proposal unfairly target those individuals who are self-sufficient in retirement, the proposed policy also unfairly disadvantages individuals who have an SMSF or own shares directly to individuals in large superannuation funds. Large superannuation funds can ensure that the full value of franking credits are utilised against income derived by younger members who are still in accumulation phase. 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 franking credits to accumulation members in the fund, ensuring the full value of franking credits is captured.

Therefore, an individual in retirement phase in 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 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.

Uncertainty of super

Labor'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.