SUBMISSION

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Committee Secretary

House of Representatives Standing Committee on Economics

PO Box 6021

Parliament House

Canberra ACT 2600

Via email to: economics.reps@aph.gov.au

Dear Committee Secretary

Inquiry into the implications of removing refundable franking credits

The Association of Superannuation Funds of Australia (ASFA) is pleased to provide this submission to the Committee's inquiry into the implications of removing refundable franking credits.

ASFA is a non-profit, non-political national organisation whose mission is to continuously improve the superannuation system, so all Australians can enjoy a comfortable and dignified retirement. We focus on the issues that affect the entire Australian superannuation system and its $2.7 trillion in retirement savings. Our membership is across all parts of the industry, including corporate, public sector, industry and retail superannuation funds, and associated service providers, representing over 90 per cent of the 15.6 million Australians with superannuation.

If you have any queries or comments in relation to our submission, please contact Ross Clare, Director of Research, on (02) 8079 0809 or rclare@superannuation.asn.au.

Yours sincerely

Dr Martin Fahy

Chief Executive Officer

General comments

ASFA’s primary focus is on policy initiatives that improve the Australian superannuation system.

However, as we stated when this policy was announced, we are concerned in regard to the impact that the removal of refunds for franking credits would have on some low-income retirees who have exposure to Australian shares.

ASFA considers that if there is a concern about individuals with large retirement savings receiving the benefit of refundable franking credits then imposing an appropriate cap on the benefits of refundable franking credits should be considered.

At this stage only the broad parameters of the proposal have been announced and, if the measure were to proceed, important questions would relate to how the mechanism is designed and what would be the impact on retirement incomes. ASFA, at that stage, of course would undertake further analysis to determine the potential impact of the proposal.

However, we have undertaken some preliminary analysis on the impact of the proposal on members in APRA-regulated funds and it would appear the impact is not likely to be significant, with the exception of funds that cater exclusively to members with accounts in the tax free retirement phase, some Eligible Rollover Funds, certain closed defined benefit funds and some smaller corporate funds. ASFA does not hold direct information on particular funds that might be affected.

In ASFA’s view, tinkering with policy settings ultimately undermines confidence in the superannuation system, at a time when we want to encourage more people to be self-funded in retirement.

The system has a $1.6 million cap in the retirement phase and we consider that a period of stability is needed to ensure that recent reforms to superannuation and the retirement funding system are bedded down and working.

More details of ASFA’s analysis at this stage follow. The focus of our analysis is the impact on superannuation funds and superannuation fund members.

Detailed comments

Refundable franking credits and tax principles

The basic rationale for franking credits and refundable franking credits is that the level of tax collected from a business activity should be the same regardless of whether the business is conducted by an individual, a partnership, a trust or a company. Based on this approach, company tax should be regarded as a withholding tax. Where the ultimate beneficiary's taxable income attracts a personal tax liability, which is less than the amount of tax attributable to the company tax payment, the argument goes that a refund should be paid.

The classical system of company taxation, which treats companies as taxable entities in their own right with no credit to shareholders for company tax that has been paid, can result in both equity and efficiency problems. For example, it provides a disincentive to incorporate, distorts corporate financing decisions by providing a bias towards debt and provides an incentive for companies to retain profits.

While this argument has a certain logic, only some countries have dividend imputation arrangements and far fewer have refundable franking credits. Providing franking credits for foreign shareholders is an even more rare practice.

There are a number of reasons for these tax design choices. Australia in fact started off with what could be regarded as a dividend imputation scheme with only retained profits being taxed at the company level. However, revenue requirements during World War II resulted in a move to the classical system for taxing companies with these arrangements remaining in place from 1940 to 1986. Revenue needs appeared to dominate over other design criteria.

When the imputation system was introduced in 1986 it did not cover foreign shareholders. Overseas jurisdictions generally do not make imputation credits available to Australian residents and Australia in any event is a large importer of capital.

Analysis of who receives refundable franking credits

While the Australian Taxation Office (ATO) publishes a range of taxation statistics there is only limited publicly available information on the characteristics of superannuation funds that receive a refund from the ATO because their entitlement to a franking credit exceeds their tax liability based on taxable income.

Some information on recipients of excess franking credit payments has been provided by the Parliamentary Budget Office (PBO) in response to a request from Senator David Leyonhjelm[1]. The analysis was completed on 4 May 2018, but much of the data relates to 2014-15. That was the most recent year for which data apparently were available. Tables relevant to superannuation funds in that analysis are reproduced below.

There have been a number of developments since 2014-15. There have been strong investment returns and net contributions leading to higher fund balances while at the same time the introduction of the transfer balance cap has limited the amount of assets in pension mode subject to a zero rate of tax.

[1] Parliamentary Budget Office (PBO) costing response Dividend imputation credit refunds (PR18/00145), Option 2 (Make franking credits non-refundable for individuals and superannuation funds, excluding Australian Government pension and allowance recipients), publicly released on 8 May 2018 by Senator Leyonhjelm.

There have also been a number of closures and mergers amongst APRA regulated funds with more than four members, with the number of such funds falling from 255 in June 2015 to 228 in June 2017. Smaller funds not receiving contributions would be more likely to claim refundable franking credits and a number of such funds have closed down between 2015 and 2017.

The data clearly indicate that the biggest impact (both in terms of number of funds and the amount of refundable franking credits in aggregate) relate to Self-managed superannuation funds (SMSFs) and Small APRA Funds. Table C6 in the PBO document (reproduced below) indicates that in 2014-15 just over 200,000 SMSFs claimed excess franking credits, totaling $2,595 million. Around 70 per cent of these refunded franking credits related to SMSFs with a fund balance over $1.5 million with average excess franking credits in excess of $15,000 for such funds.

Nearly 50 per cent of SMSFs have all or some of their members in pension mode, which is consistent with around 200,000 of a total population of around 500,000 SMSFs claiming excess franking credits.

The proposed Pensioner Guarantee would be likely to lead to many of the funds with balances below $600,000 being able to continue to receive excess franking credits given that members of such funds may be able to qualify for at least a part Age Pension. However, that aspect of the proposed measure only applies to SMSFs with at least one pensioner or allowance recipient before 28 March 2018.

Table C6: Self-managed superannuation funds (SMSFs) — Distribution by fund balance in 2014-15

Decile	Fund balance range	Number of funds claiming excess franking credits	Percentage claiming excess franking credits	Average excess franking credits claimed ($)	Total excess franking credits claimed ($m)
1	$0 to $90,276	8,616	17.9%	1,391	12.0
2	$90,277 to $181,089	9,503	19.8%	1,137	10.8
3	$181,090 to $279,252	11,866	24.7%	1,900	22.5
4	$279,253 to $402,090	15,349	31.9%	2,890	44.4
5	$402,091 to $558,140	18,554	38.6%	4,088	75.8
6	$558,141 to $762,242	21,902	45.5%	5,611	122.9
7	$762,243 to $1,044,621	24,734	51.4%	7,532	186.3
8	$1,044,622 to $1,497,218	27,208	56.5%	10,468	284.8
9	$1,497,219 to $2,443,843	29,946	62.2%	15,652	468.7
10	$2,443,843 and over	33,761	70.2%	40,468	1,366.2
Total SMSFs		**201,439**	**41.9%**	**12,880**	**2,594.5**

Table C8 below (again from the PBO document) indicates that 2,186 APRA regulated funds received refunds of franking credits in 2014-15. Given that there were only a few hundred APRA regulated funds with more than four members, the great bulk of these funds were necessarily Small APRA Funds with four or less members. Most of the APRA funds concerned (around 85 per cent) had assets of less than $1.6 million. The larger institutional APRA funds all have aggregate assets far in excess of such an amount. On the other hand, the great bulk of the refunded credits related to funds with assets over $1.6 million. The aggregate refunded credits paid to APRA regulated funds were only just over 10 per cent of the aggregate refunded credits paid to SMSFs.

The reason for this is that the larger APRA funds (those with more than four members each) are generally receiving sufficient taxable contributions from employers and the self-employed and together with tax liabilities in regard to investment earnings (associated with assets in the accumulation stage) have a net tax liability (even after the benefit of franking credits).

APRA regulated funds with more than four members also tend to have lower asset allocations to Australian shares than do SMSFs. This is in part because APRA regulated funds invest proportionally more than SMSFs in overseas shares and alternative investments such as infrastructure.

The latest available figures indicate that APRA regulated funds have on average around 23 per cent of assets invested in Australian listed shares. The comparable figure for SMSFs is 30.5 per cent, with another 10 per cent of assets in listed and unlisted trusts, where a substantial part of those assets would also attract franking credits.

The proportion of fund assets supporting income streams in retirement also has an important influence on whether a fund is entitled to a franking credit refund. Many SMSFs (36 per cent of all SMSFs) have 100 per cent of their assets in pension mode with around 200,000 SMSFs receiving refundable franking credits. However, this is relatively uncommon amongst the larger APRA funds with around 25 per cent of assets in pension mode on average and only a few funds at most having all their assets in pension mode.

Analysis undertaken by ASFA indicates that a fund generally would need to have more than 70 per cent of its assets in pension mode and be receiving no taxable contributions in order to qualify for a refund of franking credits.

While ASFA does not have information on which specific funds currently are receiving refunds of franking credits, based on APRA fund level data providing details of taxable contributions and investment earnings, the exceptions amongst the larger APRA regulated funds in terms of receiving refunds of franking credits are likely to be:

- Certain funds set up to cater exclusively for members with accounts in the tax free retirement phase
- Some Eligible Rollover Funds which by definition do not receive taxable contributions
- Closed defined benefit funds with all members in the retirement phase
- Smaller corporate funds receiving no or relatively few contributions prior to closure and a successor fund transfer

Table C8: Australian Prudential Regulatory Authority (APRA) regulated superannuation funds — Distribution by fund balance in 2014-15

Decile	Fund balance range	Number of funds claiming excess franking credits	Percentage claiming excess franking credits	Average excess franking credits claimed ($)	Total excess franking credits claimed ($m)
1	$0	174	50.1%	29,929	5.2
2	$1 to $101,068	165	76.7%	854	0.1
3	$101,069 to $205,401	243	86.5%	1,687	0.4
4	$205,402 to $309,472	267	94.7%	2,777	0.7
5	$309,473 to $458,968	252	89.7%	4,057	1.0
6	$458,969 to $650,510	252	89.7%	5,671	1.4
7	$650,511 to $981,296	247	87.6%	6,985	1.7
8	$981,297 to $1,634,549	252	89.7%	11,815	3.0
9	$1,634,550 to $4,851,537	240	85.4%	20,823	5.0
10	$4,851,538 and over	94	33.5%	3,033,446	285.1
Total APRA-regulated superannuation funds		**2,186**	**77.7%**	**138,973**	**303.8**

The impact of the removal of refundable franking credits on investors and retiree investors

Removal of refundable franking credits would have both direct and indirect impacts on investors and retirees.

It is likely that superannuation funds affected would to some extent change the nature of their operations and/or their investment mix.

Proposed changes to the treatment of small and inactive superannuation accounts with more such accounts being transferred to the Australian Taxation Office also mean that the assets and members in Eligible Rollover Funds are likely to decline markedly.

The impact on SMSFs and their members would be more complicated. The Pensioner Guarantee (that has been proposed by the Opposition in regard to the measure) would mean that SMSFs with one pensioner or allowance recipient before 28 March 2018 would be exempt from the changes. Trustees of SMSFs not benefitting from that carve out are likely to consider whether to absorb the impact, or close their fund and transfer assets to a large APRA regulated fund able to fully make use of franking credits, or shift asset allocations more to other forms of investments (given that the financial attractiveness of Australian shares would decrease). It is difficult to quantify the likely behavioural responses but we consider that they would be unlikely to have a material impact on asset prices.

Impact on the takeup rate of the Age Pension and dependence on the Age Pension

The proposed abolition of refundable franking credits would have only a marginal impact on the takeup rate of the Age Pension and the average amount of Age Pension received, at least in regard to its impact on superannuation income streams and superannuation balances.

As previously explained such a policy would have a relatively minor impact on APRA regulated funds with more than four members.

In regard to SMSFs, the proposed Pensioner Guarantee would mean that funds with an Age Pensioner as at 28 March 2018 would not be affected.

The great bulk of the projected increase in revenue related to superannuation funds relates to SMSFs with more than $1 million in assets, with funds with more than $2.5 million responsible for the greater part of the increased revenue. Even if such funds drew down on capital in order to compensate for the loss of refundable franking credits it would be many years or in most cases never before there would be any entitlement to the Age Pension.

The impact on Age Pension entitlement as a result of the running down of capital also is not large, at least in the first year in which capital is run down. For example, over the asset range for which the assets test applies, a reduction of $5,000 in assets (due to refundable franking credits no longer being available) results in an additional $391 a year in the Age Pension. While there would be some increase in Age Pension expenditures due to SMSFs no longer receiving refundable franking credits, the number of individuals affected would not be large and accordingly the increase in Age Pension expenditures would not be large.