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Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
Canberra ACT 2600

via email: economics.reps@aph.gov.au

Dear Sir/Madam,

Inquiry into the implications of removing refundable franking credits

We respectfully make a submission to the above Inquiry.

Australian Foundation Investment Company Limited (“AFIC”) is Australia’s largest Listed Investment Company and has been investing on behalf of its shareholders for 90 years.

We currently invest over $7 billion in predominantly Australian listed securities and have over 130,000 shareholders, 97% of whom are Australian.

Our shareholders are usually retail investors, either in their own names or through their own superannuation funds. The vast majority (over 105,000 or 80%) have less than $65,000 invested in AFIC shares. A $65,000 shareholding equates to a dividend of approximately $2,400 per annum.

AFIC has a policy of open communications with its shareholders, and as such twice a year has a series of information meetings around the country where Directors and senior management discuss the recent performance of the Company and also respond to questions and hear feedback from shareholders. The recent ALP announcement of a policy to remove the refundability of franking credits and effectively levy a 30% tax on many retired individuals of modest savings whose marginal tax rate is either nil or below 30%, has been the single biggest issue of concern amongst them.

As the 2017 ASX Investor Report noted, “wealth creation is important for sustaining quality of life, particularly in retirement. After retiring, individuals rely on their savings as their source of income, and having accumulated more wealth in their working years means a more comfortable retirement.”

The current proposal will deny many of those in retirement much of the income they need and have relied on. It is an attack on one of the original cornerstones of the retirement income system, that of the voluntary saving for retirement.

The refunding of franking credits (which returns individuals, super funds, charities and other bodies to their marginal tax rate) is a critical part of many investors' income.

Shareholders who have invested in shares producing franked dividends on the understanding, long held to be bi-partisan, that they would be taxed on their income at their marginal tax rate, are now faced with having to rearrange their investments into other forms of investment that distribute through methods other than franked dividends (i.e. fixed interest or trusts) or into non-Australian companies where the tax deducted will be less than the 30% rate that applies to Australian corporates. All of these alternatives are expected to produce a significantly reduced income.

Neither option is beneficial to the individual shareholder, the wider Australian capital market or the encouragement of investment in Australian focused businesses.

In our opinion:

1. The proposal attacks the integrity of the current tax settings that states than an Australian taxpayer is subject to tax at their marginal tax rate on all their income, and does not differentiate between the types of income.
2. It is inequitable in that it applies only to two categories of investor - a) individuals and b) superannuation funds, and in effect, only the self-managed super-funds.
3. By the targeting of individuals, it imposes a 30% tax on shareholders who have a low income.
4. It reduces simplicity and adds complexity.
5. It acts as a disincentive to investment in Australia businesses.
6. It discourages individuals to provide for their retirement independently of government assistance.

5 objectives of a retirement income system

Many of our shareholders are retirees. For a large proportion of them, the compulsory superannuation system was implemented too late to form a major part of their retirement planning. In addition, many women now of retirement age were never part of a compulsory superannuation programme.

The current proposal will, for many, act to materially reduce their retirement income.

The 2008 Review of Australia's Future Tax System, commissioned by the ALP Federal Government in 2008, identified 5 objectives of a retirement income system.

The following goes through those and indicates where we believe the current proposal goes against those stated objectives:

1. *It should be broad and adequate, in that it protects those unable to save against poverty in their old-age and provides the means by which individuals must or can save for their retirement*.

The current proposal attacks the means by which individuals can save by reducing the income and that loss of income has a compounding effect. An individual's self-managed super-fund account in accumulation phase consisting entirely of Australian shares receiving franked dividends which is subject to a 15% tax rate will now become a 30% tax rate.

2. *It should be acceptable to individuals, in that it considers the income needs of individuals both before and after retirement, is equitable and does not bias inappropriately other saving decisions*.

The current proposal strikes at the income needs of people post-retirement, particularly in smaller self-managed super funds, when they are unlikely to have other income to offset franking credits against. For the many people who have invested predominantly in Australian shares, this would bias inappropriately other saving decisions (i.e. need to go onto at least a part-pension from the government, move shares from super funds into individual names, bias towards trusts, fixed income and offshore investments with a withholding rate of less than 30%). It also fails the 'equity' test in that it is only individuals and superannuation funds that are impacted. In the case of the latter, the larger industry and retail funds with member contributions to be offset would be largely unaffected.

3. *It should be robust, in that it deals appropriately with investment, inflation and longevity risk.*

Equity investments have over the longer period been shown to counter inflation and longevity risk whereas fixed interest investments, although often higher yielding, do not. A policy that encourages individuals away from countering inflation and longevity risk seems unwise.

4. *It should be simple and approachable, in that it allows individuals to make decisions which are in their best interests.*

Many of our shareholders made investment decisions based on the fact that in retirement they would be subject to their marginal tax rate on their income. The current proposal removes that, putting in a floor of 30% on franked dividend income and forcing them to consider investments that may not be in their best long-term interest, simply to make up for the lost income.

In the worst-case scenarios, people may be forced to sell-down their investments to replace the lost income, reducing amounts available for care in their later years and forcing them to rely on relatives or government support. These are very real concerns that have been expressed to us by our investors.

5. *It should be sustainable, in that it is financially sound and detracts as little as possible from economic growth.*

As we note elsewhere, the attractiveness of the imputation system that allowed an individual Australian investor to be taxed on all of their income at their marginal tax rates has led to large proportions of share ownership, participation in capital raisings and support for Australian corporates. All of these outcomes are financially sound and detract as little as possible from economic growth.

The current proposal actually disadvantages Australian corporates and, in our opinion and from what shareholders have been telling us, will lead to a move away from investing in Australian equities to off-shore investments or other instruments, detracting from economic growth.

Who receives franking credits and what opportunities does it provide?

Australia has a comparatively high proportion of share ownership amongst its population.

The ASX Investor Study of 2017 indicates that nearly a third (31%) of Australian **adults** own shares.

A 2009 survey of global share ownership from the University of Bath showed comparative figures of 15% for the UK, 20% for Switzerland, 21% for the United States and 23% for Hong Kong.

The ASX survey showed that 75% of share owners only invested in Australian shares. The attractiveness of the imputation system is, we are told by many of our shareholders, the primary reason for this.

Refundable franking credits for low income earners, including retirees, does not only provide additional income. It can also have a compounding effect and increase the amount of capital available for future use. This is done in two ways – firstly, if all of the income is not used then the surplus can be reinvested to grow capital to provide for future needs (e.g. aged care). Secondly, the additional income reduces the need to sell the invested capital to meet day-to-day living expenses.

As noted above, AFIC alone has over 130,000 shareholders, 97% of who are Australian.

80% of them earn dividends from us of less than $2,400.

In terms of issued capital, just under 80% (77%) of dividends and franked income goes to those who have less than $623,000 (at current prices) invested. This equates to, at that top level, a dividend at current share prices of $24,000 per annum, before franking credits.

Of our larger shareholders, many are charities or trustees/nominees for a group of smaller shareholders.

Recipients of franking credits cover a broad range of investors. Interactions with our shareholders suggest, for us, a concentration amongst those who rely on the income for retirement living.

The tax principles behind refundable franking credits

The current imputation system treats corporate tax paid by Australian tax-paying corporate entities as a pre-payment of tax by the actual owners of the shares.

Tax returns require taxpayers to include franking credits as part of their gross income for assessment.

Therefore, an investor who has a marginal tax rate of nil or 15%, for example, has initially had tax paid out of their share of their investment's earnings.

Refundability of imputation means that this principle is respected. Regardless of the type of investment or income that an individual had they would only be taxed at their marginal rate.

Overpayment of tax is rectified by a refund. This is the case where too much tax has been paid via PAYG, or because certain deductions have not been included or, under current policy, because the company has pre-paid an investor's tax at 30% when their marginal rate is below that.

This system has meant that an investor's choice of investable assets is largely tax-neutral.

Consequences of the removal of refundable franking credits

Changes to this system will mean that an investor with a marginal tax rate of less than 30% is disadvantaged by investing in Australian shares that under this policy will have an effective income tax rate of 30%.

There has been heavy retail demand in the past for capital raisings such as those required by the major financial institutions to recapitalise their balance sheets. The attraction and value of franking credits encouraged many individuals to invest and therefore provide a stable and liquid capital base. The increase in the effective tax rate for those distributions for many retail shareholders will make them, and other Australian companies, less attractive to many individual retail investors.

It should not be the policy of any Australian government to disadvantage Australian corporates at the expense of off-shore companies.

The argument that other countries do not have an imputation system ignores the interplay that other taxes and allowances have. For instance, the US has no imputation system but treats capital gains tax differently, with no tax paid below certain income levels and reduced rates above those. The UK has a ‘tax-free’ CGT allowance and reduced rates for gains above this amount, coupled with a tax-free dividend allowance.

In the longer term, it is likely that many franking credits that are currently refunded will eventually end up with those that can use them, as they do have an economic value.

This will result in larger super funds and other organisations not targeted by this measure increasing their shareholdings at the expense of many retail investors who had been saving for their own goals or retirement. The re-allocation of franking credits will result over time in very little “saving” to the government from this measure.

The proposal is discriminatory to individual and self-managed super-fund shareholders

The current proposal is not a return to a ‘purer’ imputation system.

Under the previous imputation regime all corporate profits were subject to a minimum of (for instance) 30% tax regardless of the marginal tax rate of the investor. This meant, in effect, no refundability of franking credits for any investor – thus no matter the marginal tax rate no investor, whether a charity, individual or super fund, received a refund. This is not what the current proposal does.

The announcement indicates that it will only impact individuals and superannuation funds.

Our shareholders have enquired whether this means that whilst they will be denied a refund of the tax already paid on their income via franking credits, organisations such as the Future Fund, trade unions and universities will continue to be able to ?

Larger, multi-membered super funds will not be impacted by this policy as the franking credits can be used to offset taxes due on member contributions. For many of our shareholders who are in either accumulation or pension-paying phase in self-managed super funds and currently receive a refund, this is not an option. Our shareholders see this as an inequitable attack on the self-managed part of the superannuation industry by vested interests.

Shareholders who are in a pension-paying phase of their super fund or otherwise have a nil marginal tax rate would in effect be encouraged instead to seek non-Australian equity investments to seek out a better return. This removes, as noted above, the current ‘tax neutral’ stance towards choice of investment. In fact, the current system encourages investment in Australian companies by these tax-payers as their income is not subject to withholding tax.

Pension recipients and franking credits

The Labor Party's 'Pensioner Guarantee' announcement will allow recipients of a government pension to claim a refund of franking credits for their individual shareholding, but not in their superannuation fund after 28 March 2018. This is causing much confusion amongst shareholders.

This could be interpreted that any future recipient of any form of government pension will be able to claim full refunds but only if they remove their shares from their self-managed superannuation account (if they did not receive such a pension before 28 March 2018). Of course, should they do so they would be subject to normal rates of tax, including capital gains tax should shares be sold to meet living expenses.

The distinction between those who were in such a position before 28 March 2018 and those who have or will receive a full or part pension after that date, despite in many cases having planned their retirement for many years, is regarded by many of our shareholders as unfair and confusing.

Income levels and asset tests

Some figures quoted in the press indicate that a small minority, by number, of self-managed super funds have in the past been able to claim franking credits worth millions of dollars. However, the Coalition government recently introduced measures to limit this by decreeing a threshold for individual funds in pension phase and a policy that aims to prevent a few benefiting from current legislation should not be used to reduce the income of many.

Such outlying examples as these do not reflect the experience of most of our shareholders.

For instance, the current asset test for a couple who own their own home is (jointly) $848,000.

A couple therefore who has managed over the years to save up $850,000 will therefore not be exempt from the new measure.

If this sum had been invested in AFIC shares at today's prices, this would equate to approximately 137,000 AFIC shares.

For a couple, this would currently produce an income of $16,440 each per year.

With franking added, this is $23,486 each per year.

This is equivalent to $452 per week, which is well below the current minimum wage of $719.20.

Removing franking reduces this annual income by $7,046 a year.

The proposal therefore is reducing the income of people who already earn below the minimum wage level by an additional 30%.

In the case above, the income would be reduced from $452 per week to $316 per week – less than half the current minimum wage !

If an individual was earning from employment under PAYG an income of $120,000 a year, the ATO's simple tax calculator shows them paying a tax rate of 26.7%. Yet this proposal taxes those earning far less than this at a rate of 30%.

Conclusion

Many of our shareholders have told us that they use all their income, including franking credits, to meet living expenses. The removal of the refundability of franking credits is causing severe angst and concern amongst these people who have tried to do the right thing by investing in Australian companies and not seeking to receive government pensions.

Our shareholders feel worried, bitter and betrayed over the announced policy. They feel that they have been let down on the basis that they have tried to invest for their retirement only to have their taxes raised because they are not on a government pension. Even those who are likely to be on a pension and who have started a self-managed super-fund will find that their taxes have gone up, and their standard of living reduced as a consequence.

It is disquieting that when so much attention has been given to low wage growth that a proposal is formed to reduce the income of those who are no longer working, and who would be considered as middle to low income earners.

The proposal attacks the basis on which these Australians invested, and the principle that the tax borne should be their legislated marginal tax rate, and as such should be abandoned.

If the proposal was really aimed at individuals who receive millions of dollars' worth of franking credits, other options exist to target those individuals rather than a broad-brush approach which will leave hundreds of thousands worse off.

Yours faithfully,

Mark Freeman
Managing Director

Andrew Porter
Chief Financial Officer