

Dividend imputation and the impact on self-funded retirees

One of the more controversial measures announced by the ALP is the reforms to the dividend imputation credit system to remove refundable franking credits from shares. The measure, as announced, would apply to individuals and superannuation funds, and exclude Australian Government pension and allowance recipients, and tax-exempt bodies such as charities and universities. SMSFs with at least one pensioner or allowance recipient before 28 March 2018 will also be exempt from the changes. The policy is intended to apply from 1 July 2019.

How does the system currently work?

A dividend is a shareholder's share of a company's earnings (profits). When a dividend is paid from an Australian company's after-tax profits, these are known as franked dividends and include a franking credit (imputation credit), which represents the amount of tax already paid by the company on the underlying profits that are being paid out in the form of a dividend.

An Australian resident shareholder pays tax on dividends they receive (as dividends are treated as income). If the dividend received is a franked dividend, the shareholder includes the franking credits in their income (i.e., a gross-up occurs) but they can then use the franking credit attached to the dividend to reduce their tax liability. If the credit exceeds their tax liability for the year then they receive a cash refund for the excess amount.

For example, an SMSF owns shares in a company. The company pays the SMSF a fully franked dividend of \$7,000. The dividend statement says there is a franking credit of \$3,000. The \$3,000 represents the tax the company has already paid on its profits. This means the profit, before company tax was subtracted, would have been \$10,000 (\$7,000 + \$3,000). The SMSF must declare \$10,000 worth of income, and will receive the \$3,000 as an offset.

The dividend imputation system was introduced in 1987 by the Hawke/Keating Government to remove the investment bias against shares which taxed interest income once but dividend income twice (once at the company level on profits and the second time at the taxpayer level on income). In 2001, the Howard Government amended the rules to enable franking credits to be paid as a cash refund where the taxpayer

paid less tax than the company tax rate. In the absence of refundability, the taxpayer pays tax up to the company tax rate and any surplus franking credit is wasted.

The sensitivity of the issue

The sensitivity of this issue is how the dividend imputation system interacts with the way superannuation is taxed. Currently, income an SMSF earns from assets held to support retirement phase income streams (i.e., a pension), such as dividends from shares, is tax-free. That is, a self-funded retiree in some circumstances pays no tax on the income they earn from dividends. If they pay no tax, then any franking credits are paid as a cash refund.

If the ALP policy comes to fruition, these self-funded retirees lose this cash payment unless they are also Australian Government pension and allowance recipients. The policy effectively unwinds the Howard reforms and returns the imputation system to its original Hawke/Keating design.

Who will be impacted by the change?

Based on information from Treasury, 85% of the value of franking credit refunds go to individuals with a taxable income below \$87,000. That is, 97% of taxpayers receiving refunds have a taxable income below \$87,000. And, more than half of those receiving a franking credit refund have a taxable income below the tax-free threshold of \$18,200. Around 40% of SMSFs receive a franking credit refund.

Around 1.1 million individuals received a franking credit refund in 2014-15 with more than half of these over the age of 65. And, more than two thirds of refunds to SMSFs are to those whose fund balance per member is greater than \$1 million. However, this figure is likely to be diminished by the 1 July 2017 reforms that imposed a \$1.6m cap on retirement phase superannuation accounts and tax earnings on accumulation accounts.

The Parliamentary Budget Office has also outlined what behavioural changes they expect to see in the market as a result of making franking credits non-refundable. These include:

- **Individuals** - shifting from shares to alternative investment arrangements (including to investments within superannuation), and couples shifting the ownership of shares from the lower income earner to the higher income earner such that the higher income earner can utilise the franking credits as a non refundable tax offset.

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- **Superannuation funds** - rolling assets from a fund with negative net tax to a fund with positive net tax, changing funds' asset portfolio allocations, or changing the membership structure of the fund, in order to maximise the utilisation of franking credits.
- **Companies** - changing the amount of dividends distributed (and profits withheld) or the level of dividend franking due to the decrease in the value of franking credits for some shareholders.

The most significant behavioural change is expected to be from SMSF trustees: *"The assumed behavioural response for SMSFs in 2019-20 is equivalent to these funds, in aggregate, moving around a quarter of the value of their listed Australian shares into APRA-regulated funds that are in a net tax-paying position."*

The alternative, of course, is for SMSFs to change their composition of Australian shares to reduce their holding. The Parliamentary Budget Office also notes that one potential outcome is that SMSFs will increase the number of taxpaying members. *"For instance, a couple with an SMSF in the pension phase could invite two additional working-aged children into their fund, allowing them to use their excess franking credits to offset the contributions and earnings tax payable on the assets owned by their children."*

More information

- ALP - [Ending cash refunds for excess imputation](#)
- Treasury – [FOI 2292 Refundability of franking credits](#)

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