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Committee Secretary
Standing Committee on Economics
PO Box 6021
PARLIAMENT HOUSE
CANBERRA ACT 2600

Subject: Submission to Inquiry into implications of removing refundable franking credits

I am an Investment Professional who provides financial advice to retirees (and has done so for over 20 years). Personally I will not be impacted by the proposal to remove franking credits as I will be able to use the franking credits. It is in my capacity as a financial adviser to retirees, who most certainly will be impacted by this proposal, that I offer this submission.

Summary

I am of the view that the ALP proposal as it currently stands, to scrap cash refunds from franking credits, is very poor for the following reasons:

1. This proposal is inequitable across different sections of the tax base. Bill Shorten has argued that scrapping cash refunds from franking credits is aimed at the 'big end of town'. He then realised the reality is that it impacted the lower classes and he has since spared those receiving age pensions. The reality is that the high income earners and high net worth individuals are unlikely to be materially impacted by this proposal. Those who will pay the largest proportional price seem to be mainly 'middle class' retirees, while those at the higher and lower end are likely to be unaffected.
2. This proposal is highly likely to encourage retirees to spend their capital and become more dependant upon the welfare system.
3. This proposal provides a significant disincentive to save for the majority of Australians.
4. This proposal adds further complexity to the taxation system, with accompanying compliance costs, that also rely on Centrelink's systems for its integrity toward the exemptions. I wonder whether the additional compliance costs have been included in the modelling of savings.
5. This proposal changes the goal posts retrospectively to middle class retirees who do not have the option to build further capital to compensate for such material changes to their income.
6. Retirees in our client base, already dealing with the changes to Asset Test for Age Pension effective 1st January 2017, are extremely anxious about further changes to their retirement income which materially impact their level of disposable income.

This is taking place at a time of record low interest rates and low prospective rates of return in financial markets.

7. This proposal may also result in retirees taking additional investment risk to achieve higher income returns to offset the loss of franking credits. This could raise the prospects of capital loss, which could result in them becoming dependant upon welfare at a later stage, at a cost to the Government.

Examples of impact of proposal

Example 1 – Retiree Couple

To best illustrate the impact of this proposal I will demonstrates the outcomes on a retired couple aged 68 with investment assets of $820,000 who own their own home, with personal effects worth $30,000. Their assets disqualify them for age pension under the assets test. We have many clients in this situation.

One can hardly define a couple with $820,000 as the ‘big end of town’ or ‘rich’ considering that an investment portfolio might deliver an average income return of around 4%pa, which equates to an income of $32,800pa. This level of income is less than the full rate of Age Pension that a married couple on full welfare would receive.

Assumptions:

Investment Portfolio held in joint names
Australian Shares pay dividend of 4%pa – 100% franked
International Shares pay dividend of 4%pa – 100% franked (via listed investment companies)
Fixed Interest rate of income 3%pa
Infrastructure and Property Trusts rate of income 6%pa
Couple pays no tax – as their income is below the effective tax free threshold

Below is an example of how this couple may have their investments structured:

Table 1 – Couple with $820,000 – no franking credit refund

Investment	**Investment Capita**	**Income %pa**	**Income $pa**	**Franking CR**
Fixed Interest	$150,000	3%pa	$4,500	NIL
Aust Shares	$270,000	4%pa	$10,800	$4,628
International Shares	$300,000	4%pa	$12,000	$5,142
Infrastructure Property	$100,000	6%pa	$6,000	NIL
Age Pension			NIL	NIL
Total	**$820,000**		**$33,300**	**$9,770**

Table 1 results in a total loss of franking credits worth almost $10,000pa, so the couple would be receiving an annual income of $33,300pa – less than the full rate of age pension for a married couple.

This puts the retiree couple’s income at marginally above the poverty line for a couple with no children after housing costs. (source ACOSS Poverty in Australia report 2016 – which was using 2013/2014 numbers)

If this couple were to spend $50,000 on an overseas holiday and reduce their investment capital to $770,000 their situation would be as follows:

Table 2 – Couple with $770,000 – full franking credit refund as receiving part pension

Investment	Investment	Income %pa	Income $pa	Franking CR
Fixed Interest	$100,000	3%pa	$3,000	NIL
Aust Shares	$270,000	4%pa	$10,800	$4,628
International Shares	$300,000	4%pa	$12,000	$5,142
Infrastructure Property	$100,000	6%pa	$6,000	NIL
Age Pension			$3,740	
Total	**$770,000**		**$37,040**	**$9,770**

The couple now receive a part age pension of around $3,740pa in addition to also receiving ALL of their franking credits under the pensioner exemption. Their net annual income is now $46,810pa.

The bottom line is that this couple could, by spending $50,000, (most likely on an overseas holiday – where the money is spent outside of Australia) stand to increase their income by around $13,500pa. Not a bad return on investment for spending $50,000 on an overseas holiday. Lets not forget that the Australian Government would then be out of pocket by a further $3,740pa in Age Pension payments.

Key points:

1. This case study shows a material incentive for those retirees near the threshold, to structure their affairs so that they can receive age pension, thereby earning the right to retain their imputation credits. According to SuperGuide – around 100,000 retirees were close to the assets threshold and lost their age pension due to the asset test changes of 1st January 2017. This means there are a large number of retirees who could be potentially attracted to the strategy of spending to obtain some age pension benefits to protect their imputation credit refund. I would ask whether any changes in retiree behaviour was modelled in the savings projections as the behaviour of 100,000 retirees could materially impact the projected savings.
2. Retiree couple stand to earn $13,500pa in extra after tax income by spending $50,000 on travel – a truly perverse outcome.
3. This couple lost access to around $15,000pa in Age Pension benefits as of 1st January 2017 due to the changes to the asset test. This proposal potentially cuts a further $10,000pa of income in the name of budget repair. I ask, what other group of Australians is being asked to sacrifice such a high proportion of their income to repair the budget than self funded retirees?
4. This is a disincentive for Aspirational Australians to self fund for retirement, as unless they can achieve ultra high net worth, they are likely receive a similar income (or less in cases) to those on welfare. It very much promotes the notion of spend what you have and then take support from the Government as a retirement strategy.

Example 2 – High Net Worth Individual with $20m in their SMSF

In this example I demonstrate how an individual with $20m in a SMSF is largely unaffected by this proposal.

Assumptions

$1.6m of SMSF in pension phase
$18.4m of SMSF in accumulation phase
For the purpose of comparison I assume a similar asset allocation to the above example

Table 3 – SMSF with $20m

Investment	Investment	Income %pa	Income $pa	Franking CR
Fixed Interest	$3,500,000	3%pa	$105,000	NIL
Aust Shares	$6,600,000	4%pa	$264,000	$113,142
International Shares	$7,000,000	4%pa	$280,000	$120,000
Infrastructure Property	$2,900,000	6%pa	$174,000	NIL
Total	**$20,000,000**		**$823,000**	**$233,142**

Tax calculations

8% of the fund is considered tax free (pension phase) and 92% of the fund is taxable.

Taxable Income of Fund in total is $1,056,142

Tax payable on 92% of income @ 15% = $145,747
Franking Credits $233,142

Loss of Franking Credits $87,395 which is 0.4% of the value of the fund.

Key points

1. This SMSF could potentially join a new member who was in receipt of age pension as of the date of the ALP proposal in order to protect imputation credit refunds. This could lead to other detrimental estate planning impacts.
2. The surplus of imputation credits would be avoided if this investor simply converted some of the listed International investment companies into a listed investment trust structure offered by the same investment companies. Ie Platinum Asset Management offer listed investment companies and also listed investment trusts. This simple alteration wipes out the potential savings that the ALP is banking on, without impacting the quality of the investment portfolio.

<u>Conclusion</u>

I am of the view that this proposal exempts the low end, and disproportionately penalises middle class retirees. Higher net worth individuals are most likely to be able to rearrange their affairs so that they escape material impacts of this proposal.

This proposal is retrospective in nature, and is aimed at a group who are unable to create additional resources to offset the loss this creates. In my opinion this is likely to increase anxiety and mental health issues among older Australians which comes at a cost. I wonder if this cost has been factored into the modelled savings.

I am alarmed at how often I hear the words “Political Risk” when describing the investment landscape in Australia – this proposal only adds another example of such a risk of the goal posts being moved mid game, when investing in this country.

I am not opposed to tax reform, but am alarmed at the ‘piecemeal’ manner in which tax appears to be dealt with by our political leaders. Rushed policy ideas, based on what appears to be one dimensional modelling are highly likely to result in many unintended consequences.

What matters most with taxation changes is not just the proposal itself, but the investor response to them. This is particularly difficult to model and it would appear that the modelling so far has assumed no change to investor behaviour. This would seem a brave and most optimistic assumption.

I would be very happy to discuss my submission with the committee and am prepared to travel to discuss this in person if required.

Regards

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