A Fairer Tax System

Ending cash refunds for excess imputation

The global economy is improving, and the Australian economy has continued its run of uninterrupted growth. Despite these improving conditions, the Commonwealth budget remains in a weak structural position.

The deficit in 2017-18 is estimated to be $24 billion, eight times the deficit forecast in the first Coalition budget. At the same time we have record net debt for the next three years, and gross debt now greater than half a trillion dollars. Of most concern is that the return to surplus continues to rely on a tax hike for middle Australia delivered in last year's budget.

The Government has failed to put forward a credible medium-term budget plan to return the budget to a sustainable surplus position to be able to start paying down debt. Australia is ill prepared for another global economic shock without the fiscal headroom needed to respond.

Much of the budget situation today can be attributed to short-sighted fiscal decisions during the Howard-Costello years. In 2000 the Coalition Government presided over a 1-2% structural surplus. Despite the record terms of trade boom this healthy structural surplus became a structural deficit by the time they left office.

Budget decisions are about priorities. And when it comes to budget repair the Turnbull Government's priorities are clear. Instead of looking at closing down loopholes and reforming tax concessions, they choose to increase income taxes on low and middle income workers. Australia's tax base is under pressure. And working Australians are already being asked to shoulder the heaviest burden of budget repair.

The dividend imputation system introduced by Paul Keating in 1987 was a key plank of the Hawke-Keating economic reforms that has helped underpin Australia's 26 years of recession-free growth. There is no stronger supporter of the original dividend imputation system introduced by the former Hawke-Keating government than the Labor Party. We delivered it. And we support it.

But the Howard Government's decision in 2000 to allow individuals and superannuation funds to claim cash refunds for excess imputation credits is simply unaffordable, and will impede the ability of future governments to pay for good-quality health and other services.

Labor has taken a principled and responsible approach to tax reform – targeting unaffordable and unfair loopholes and concessions in the system to ensure that the Budget is able to provide important services like schools and Medicare.

What's the problem?

The dividend imputation system was introduced in 1987 by Paul Keating to ensure that the profits of companies operating in Australia are only taxed once for Australian investors.

Under the Keating system, imputation credits were attached to dividends equal to any company tax paid on the company's profits. These credits could then be used to reduce an individual's tax liabilities. If someone didn't have a tax liability, or the tax liability was smaller than the imputation credits, the imputation credits went unused. No cash refunds were paid.

> ***"[imputation] credits will not give rise to cash refunds where it exceeds tax otherwise payable"***
>
> *Paul Keating, Ministerial Statement, 19 September 1985*

The dividend imputation system matured and became entrenched in Australia's tax system over a period of strong economic growth.

The Howard Government's approach to budgeting caused a significant worsening of the structural budget position. Despite experiencing record increases in our terms of trade and national income, much of the revenue went to new spending commitments and tax concessions for wealthy Australians – including the refundability of imputation credits.

In the Ralph Review and "A New Tax System" reforms, the Howard Government changed the dividend imputation laws to allow individuals and superannuation funds to claim cash **refunds** for any excess imputation credits that were not used to offset tax liabilities.

That is, when an imputation credit was greater than their tax liability, they received a cheque at tax time. The purpose of dividend imputation was to reduce tax paid, and now individuals – many wealthy individuals – were getting a cash bonus.

Imputation (franking) credits – An explainer

Imputation was introduced by the Hawke-Keating Government in 1987.

Before then, company profits were taxed at the company income tax rate, and when those taxed profits were distributed to shareholders as dividends, the shareholders were required to pay personal tax on their dividend income. In effect, the company profits were taxed twice: once as company income and again as personal dividend income.

For example, if a company made $100 profit and paid $30 tax (30% company tax rate x $100 profit), then it has $70 left it can pay out as dividends. Shareholders then were subject to tax on that $70 at their own tax rate.

The original dividend imputation system removed this double taxation of company profits.

Using the same example, suppose a company generates a profit of $100 and under current company tax arrangements pays $30 in tax (30% company tax rate x $100 profit). The company decides to pay out the full $70 out in dividends to shareholders. Because the company has already paid $30 in tax on this company income, it attaches $30 worth of "imputation credits" (often referred to franking credits) in addition to the $70 dividend. This means the shareholder now has $70 cash, plus $30 of imputation credits – a grossed up dividend of $100.

Under the original dividend imputation system, the $30 imputation credit could be used by a shareholder to reduce their tax liability which ensured that tax would not be paid a second time on this income.

Importantly, under this original system, cash refunds could not be claimed if any imputation credits exceeded someone's tax liabilities.

Refundability was then introduced by the Howard-Costello Government in 2001

Under the Howard-Costello changes, using the same example, shareholders who received this $30 imputation credit could use it to reduce their tax liabilities at tax time (as under the original dividend imputation system), but they could also claim it as a cash refund if the value of their imputation credits exceeded their tax liabilities.

The ability to claim cash refunds has become particularly attractive to self-managed superannuation funds because in pension phase assets are already tax free, which typically means the total value of any imputation credits received can be claimed as cash refunds.

Note: Foreign shareholders do not receive the same benefit of imputation credits available to Australian residents.

Fiscal context

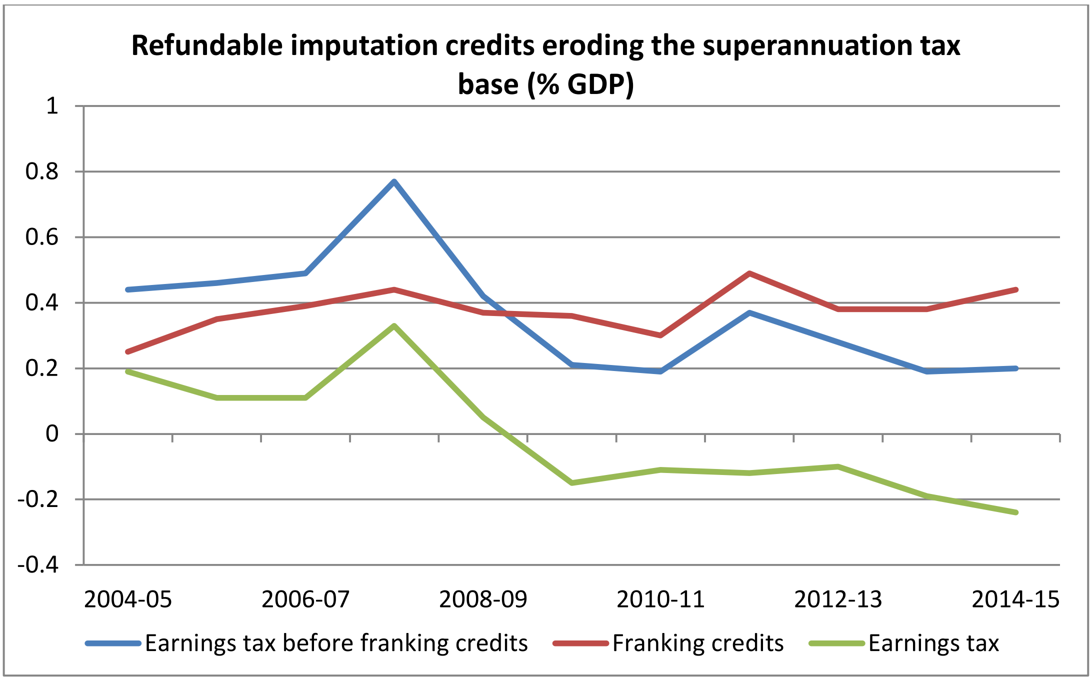
This policy decision – like much of the largesse of the Howard era – created a fiscal time bomb. When the Howard Government introduced cash refunds its estimated cost was just $550 million a year.

If the current arrangements are allowed to continue, future governments will be faced with an $8 billion annual hole in the budget over the medium term. Losing $8 billion a year in revenue is equivalent to more than Commonwealth spending on Australia's public schools this year.

The decision to introduce cash refunds for excess imputation credits came at a time when the budget was in structural surplus of 1-2% GDP, and when superannuation assets in retirement were not tax free.

The current arrangements are unsustainable and will increasingly undermine the medium- and long-term fiscal position. This is clearly evident in how the refundability of imputation credits is eroding the superannuation tax base.

Analysis undertaken by the Parliamentary Budget Office shows that despite the superannuation and retirement income systems maturing with more people entering retirement and superannuation assets topping $2.5 trillion, **superannuation earnings taxes are now a net drain on the budget**.



Source: Parliamentary Budget Office based on 2014-15 Tax Statistics data

As the Grattan Institute has observed: "The effective tax rate on superannuation fund earnings in the benefits phase is negative since funds pay no tax on earnings but receive full refunds on any unused dividend imputation credits".[1]

With an ageing population and a maturing superannuation system, the cost of allowing cash refunds for excess imputation credits will continue to grow. In 2016 there were 3.7 million Australians aged 65 and over. By mid-century there will be 8.7 million.[2]

There is a growing awareness that Australia's current fully refundable dividend imputation system is fiscally unsustainable.

"There are some revenue concerns with the refundability of imputation credits"

Re-think: Tax Discussion Paper, 2015

"….our current system of full, refundable dividend imputation is likely to be too generous to domestic Australian investors"

Tax and Transfer Policy Institute, 2017

"The refundability of imputation credits should be addressed. This was introduced for some taxpayers many years after the imputation system commenced"

Deloitte, submission to Tax Discussion Paper, 2015

[1] https://grattan.edu.au/wp-content/uploads/2015/11/832-Super-tax-targeting.pdf

[2] https://www.aihw.gov.au/reports/older-people/older-australia-at-a-glance/contents/demographics-of-older-australians/australia-s-changing-age-and-gender-profile

"The first is that Australia is a substantial outlier internationally here. It is the only country with a refundable franking credit system"

Grant Wardell-Johnson, Partner KPMG, August 2017

"I think the bottom line is that in economic terms, it [cash refunds] doesn't make any sense at all"

Professor John Hewson, Mckell Institute lunch, March 2018

Furthermore, Australia is now one of only a few OECD countries that have a dividend imputation system and **is the only country with fully refundable imputation credits.**

Refundable tax credits are an anomaly in the Australian tax system, as most tax concessions in Australia are non-refundable tax offsets. Tax offsets such as the Low Income Tax Offset (LITO) and the Seniors and Pensioners Tax Offset (SAPTO) can be used to reduce tax liabilities, but cannot be claimed as cash refunds.

Australia benefits greatly from a large diversified pool of superannuation savings, which helped avoid the worst effects of the global financial crisis. However, we are now seeing a decline in diversification partly because of the strong incentive to maximise imputation credit cash refunds, particularly in SMSFs. A less diversified pool of national savings leaves Australia more vulnerable to financial shocks.

This is also why Labor announced last year it will ban limited-recourse borrowing in SMSFs because increased leverage in superannuation funds increases the probability of large losses, which in turn create an unacceptable risk to the financial system more broadly.

Who benefits from the current arrangements?

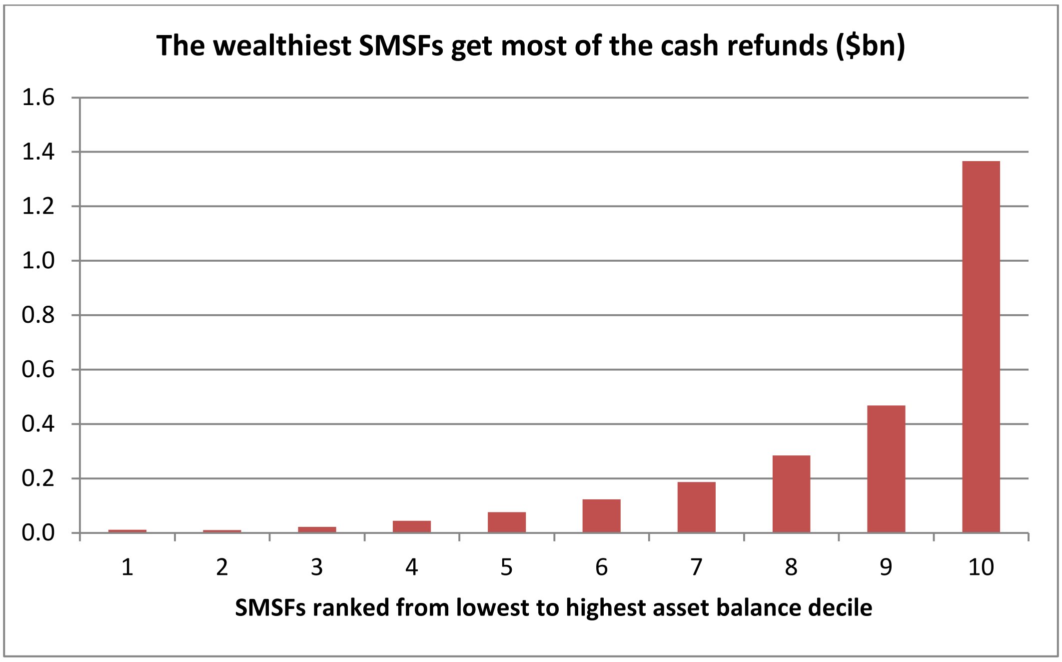
The vast majority of working Australians don't receive cash refunds for excess imputation credits. Working Australians typically go to work and pay their PAYG taxes and if they own shares they use imputation credits to offset their personal income tax liabilities. That is, they pay less tax but don't receive a cash refund.

Analysis from the PBO shows that **92% of taxpayers in Australia do not receive any cash refunds for excess imputation credits**.

Recipients of cash refunds are typically wealthier retirees who aren't PAYG tax payers. These are people who typically own their own home and also have other tax-free superannuation assets.

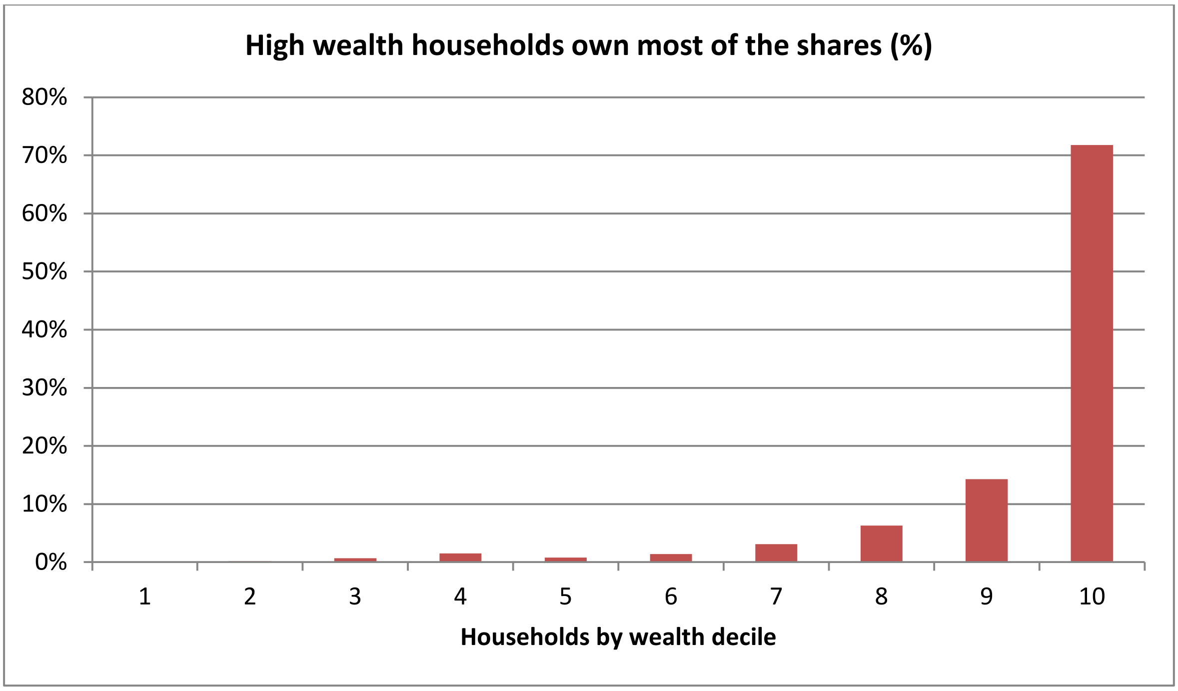
Distributional analysis from the PBO shows that (for the 2014-15 year):

- 90% of all cash refunds to superannuation funds accrued to SMSFs (just 10% go to APRA regulated funds) despite SMSFs accounting for less than 10% of all superannuation members in Australia;
- Of all excess imputation credits refunded to SMSFs, **50% of the total benefits go to the wealthiest 10% SMSF balances (which have balances in excess of $2.4 million);**
- The top 1% of SMSFs received a cash refund of $83,000 (on average) – an amount greater than the average full time salary; and
- Some SMSF funds received cash refunds of up to $2.5 million.



Source: Parliamentary Budget Office based on 2014-15 Tax Statistics data

Wealthier retirees are more likely to claim a cash refund because share ownership is highly concentrated amongst wealthier households. ABS data shows that **10% of the wealthiest households own nearly three quarters of the value of all shares in Australia.**



Source: Parliamentary Budget Office based on the 2015-16 Household Expenditure Survey and Survey of Income and Housing

Some individual retirees who receive cash refunds of imputation credits are classified as having "low taxable incomes" – otherwise they wouldn't get a refund. These retirees are typically "high wealth, low income" and have other wealth in addition to their share portfolios, such holding other assets in tax free superannuation funds.

Low wealth households typically don't benefit from the current taxation arrangements – they have little capacity to accumulate the wealth needed to do so. The recent ABS *Household and Income Wealth* report indicates that low-wealth retiree households receive virtually all (96%) of their income from government pensions and allowances.

What will Labor do?

Labor will unwind the 2000 Howard Government decision that introduced cash refunds for excess imputation credits for individuals and superannuation funds.

This means that imputation credits for individuals and superannuation funds will no longer be a refundable tax offset, and will return to being a non-refundable tax offset consistent with the tax treatment of most other tax offsets. Cash refunds will not arise if excess imputation credits exceed tax liabilities.

Labor's policy <u>will only apply to individuals and superannuation funds</u>, and therefore will not apply to bodies such as:

- ATO endorsed income tax exempt charities; and
- Not-for-profit institutions (e.g. universities) with deductible gift recipient (DGR) status.

The PBO estimates that Labor's policy:

- will not affect the vast majority (92%) of individual taxpayers; and

- will affect around 200,000 SMSFs;

Given most APRA regulated superannuation funds are typically not large beneficiaries of the current refundability arrangements this policy will have only a small impact on these funds.

The policy will begin on 1 July 2019. This policy will save $11.4 billion over the forward estimates from 2018-19 and $59 billion over the decade to 2028-29.

Implementation

Labor will consult with the Australian Taxation Office, Treasury and tax experts on the implementation of this policy. Labor has already announced it would provide substantial new resources to the ATO to ensure its policies are implemented effectively.

	2018-19	**2019-20**	**2020-21**	**2021-22**	**Forward Estimates**
Total financial impact (UCB)	-2	-1	5,600	5,800	11,397