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Abolish the cashing out of franking credits:

INQUIRY INTO THE IMPLICATIONS OF REMOVING REFUNDABLE FRANKING CREDITS

Submission

David Richardson

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Introduction

The Australia Institute welcomes the opportunity to respond to the House of Representatives Economics Committee's invitation to make a submission to the inquiry into the implications of removing refundable franking credits.

Dividend imputation was introduced by the then Treasurer Paul Keating in 1987 with the aim of eliminating the so-called double taxation of company income.

Under dividend imputation the individual who receives dividend income is taxed but receives credit for company tax paid by the company. Company tax paid by the company is imputed to the shareholder and the shareholder is taxed at the appropriate tax rate. Credit is given to the taxpayer for company tax deemed to have been paid on behalf of the taxpayer. This is said to eliminate the double taxation of investment income. It is based on the view that the company is just a community of shareholders and that investing as a shareholder should be treated equivalently to running a business as an individual.

The view that the company is an extension of the individual shareholder is somewhat quaint in a world in which even very rich individuals rarely have a significant share of the larger companies in which they invest. By the same token the modern corporation has outgrown its ultimate owners. Natural persons own less than 10 per cent of Australia's listed shares for example.[1]

In 2014 the Senate Community Affairs References Committee inquiry into the extent of income inequality asked the Australia Institute for supplementary information on dividend imputation. Much of the background detailed in the present submission is based on that publication.[2] Some of the data below may be dated but the orders of magnitude should be similar. If the Committee wishes we could update any data that is of particular interest.

DOUBLE TAXATION OF DIVIDENDS

The aim of dividend imputation was to remove the double taxation of company income – not to eliminate the tax altogether which is what cash refunds do in effect. The proposal to refund excess imputation credits was raised by the Howard Government as part of *A New Tax System*, the set of measures that included the introduction of the GST. This sought to give a cash refund for excess imputation credits for:

[1] TAI calculations based on ABS (2018) *Australian National Accounts: Finance and Wealth, Jun 2018*, Cat no 5232.0, 27 September.

[2] See Richardson D (2014) *Submission: How the government loses 48 per cent of company tax: Dividend imputation and franking credits. Supplementary information on dividend imputation*, 17 October.

- individuals,
- trustees assessed for a resident beneficiaries share of a trust,
- superannuation funds, approved deposit funds and pooled superannuation funds,
- life assurance companies, and
- some other registered organisations.

These were to apply to dividends paid on or after 1 July 2000. Given the circumstances the GST received most of the attention at the time and there was little discussion of the impact of cashing out unused franking credits.

As it now applies: If your total tax offsets exceed your basic income tax liability, and some of those offsets are subject to the refundable tax offset rules, you may get a refund instead of paying income tax. Excess franking credits are now eligible for refunds. All of this is outlined mainly in sections 63 and 67 of the *Income Tax Assessment Act* and related provisions.

THE DISTRIBUTION OF FRANKING CREDITS IS EXTREMELY SKEWED

We found that of those people who lodged a tax return the top 1.4 per cent who earned $250,000 or more received 37.1 per cent of all the franking credits. The average value of franking credits rises rapidly as we examine higher and higher income earners. Our analysis confirmed that the richest households had disproportionally more wealth in shares than all other households. Shareholdings of the top 20 per cent were $638 billion or 84 per cent of the total ($758 billion) and the top 20 had 106 times the value of the bottom 20 per cent ($6 billion). Super funds and trusts also received franking credits. We cannot allocate those directly to individuals or households but we showed that the holdings of trusts and super are also very skewed towards the rich.

In the discussion below we consider the value of the imputation system in Australia. However, it is important we understand who receives franking credits. That allows us to consider who would win or lose if there were to be any changes to the present imputation arrangements.

The tax office figures related to 2014-15 and give total income as well as franking credits. Those figures are summarised in Table 1.

Table 1: Taxpayers and franking credits (2014-15)

Income	Share of franking credits (%)	Share of taxpayers (%)
Non-taxable and below $10,000	2.2	10.31
$10,000 to 50,000	14.6	47.11

$50,000 to 100,000	17.4	30.3
$100,000 to 150,000	12.0	7.44
$150,000 to 250,000	**16.6**	**3.53**
$250,000 and above	**37.1**	**1.35**
Total	100.0	100.0
Memo item: Taxpayers $1m plus	15.0	0.08

Source: Australian taxation office (2014) Taxation statistics, 2014-15, at https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2014-15/?page=3#Statistics

Table 1 provides some interesting data and our main interest here is the franking credits received by the highest income earners. Of those people who lodged a tax return there were 1.4 per cent who earned $250,000 or more but they received 37.1 per cent of all the franking credits. The next highest bracket, $150,000 to $250,000, accounted for 3.5 per cent of the taxpayer population and received almost 17 per cent of the franking credits. If we sum up all those with income over $100,000 we have 12.3 per cent of the population receiving 65.7 per cent of the franking credits. Not shown above but separately calculated we find that the top 20 per cent of taxpayers had 72 per cent of all the franking credits.

For those earning $1 million or more it is interesting to note that they were just 0.08 per cent of taxpayers, or 11,128 people, but earned 15 per cent of the franking credits!

We can also show the average value of franking credits by income group. Those figures are given in Table 2. The figures are the average franking credits of those who claim them.

Table 2: Average franking credits within income ranges.

Income	Average value of franking credits $
Non-taxable and below $10,000	581
$10,000 to 50,000	1,301
$100,000 to 150,000	3,765
$150,000 to 250,000	8,528

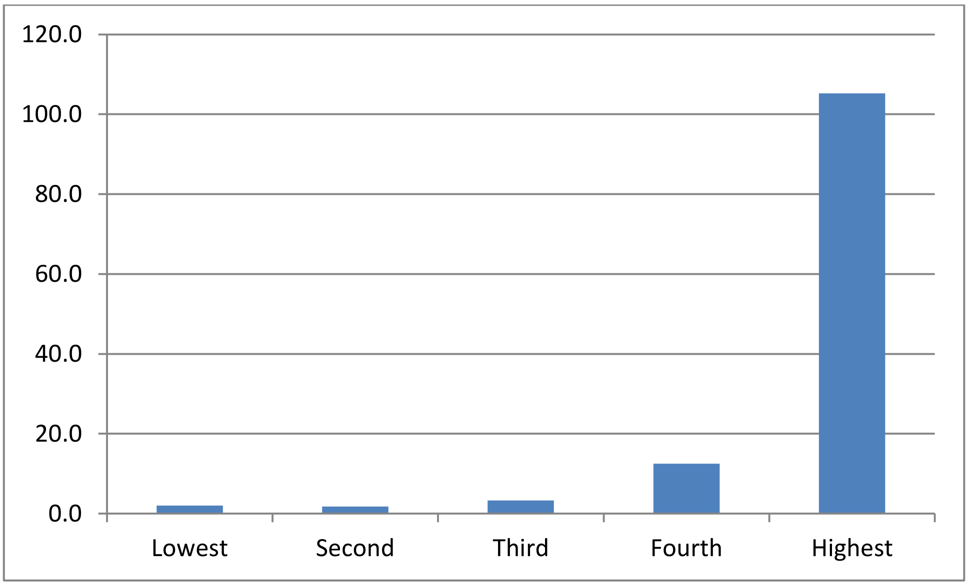
$250,000 and above	37,891
Memo item: Taxpayers $1m plus	197,213
Average	3,338

Source: Australian taxation office (2014) Taxation statistics, 2014-15, at https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2014-15/?page=3#Statistics

Table 2 confirms that the average value of franking credits rises rapidly as we examine higher and higher income earners. While the data in Tables 1 and 2 show that the payment of franking credits went disproportionately towards the rich, it is important to note that many people receive dividends and the attached franking credits indirectly via trusts, partnerships and super funds for example. It is not possible to determine exactly how those fit into the income or wealth distributions. However, ABS figures show that the holding of 'shares and other equity' is heavily skewed towards rich households.

In Figure 1 we present total holdings of shares for households ranked by their equivalised net worth quintiles. These are the total amounts held by each quintile.

Figure 1: Distribution of shareholdings by quintile, 2014-15, $'000

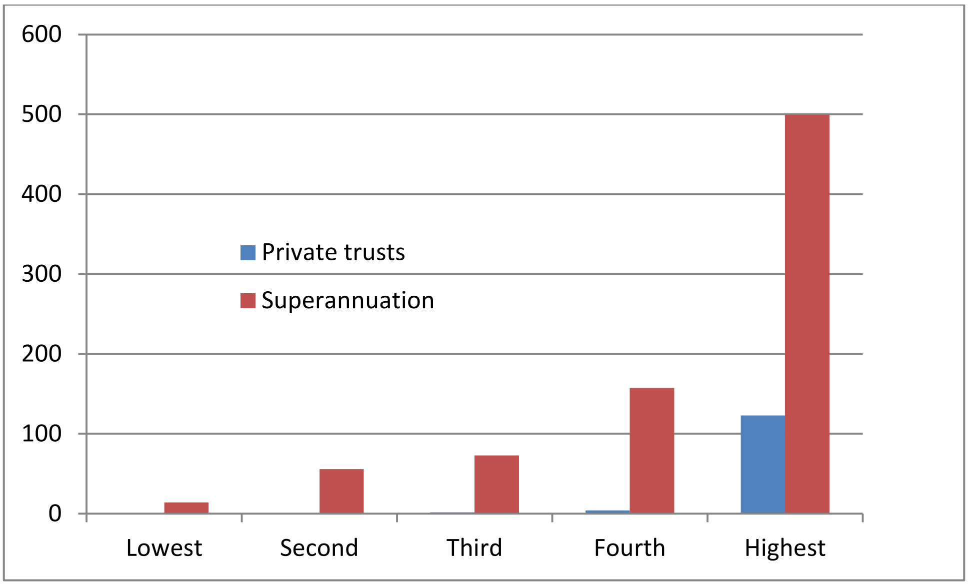


Source: ABS (2015) Australian National Accounts: Distribution of Household Income, Consumption and Wealth, 2003-04 to 2014-15, Cat no 5204.0.55.011, 26 November.

The data in Figure 1 confirms that the richest households have much higher shareholdings by value than all other households. The visual impact of Figure 1 is impressive and shows that the shareholdings of the top 20 per cent was $638 billion or 84 per cent of the total ($758 billion) and the top 20 had 106 times the value of the bottom 20 per cent ($6 billion).

We suggested above that franking credits are received by super funds and trusts in addition to individuals. We cannot allocate those franking credits to the individual or household data bases but we can note that the holdings of trusts and super are also very skewed towards the rich. Figure 2 is based on ABS data and shows the degree to which holdings in trusts and super are also much skewed towards the rich.

Figure 2: Average holdings in trusts and super by household quintiles, $'000



Source: ABS (2015) Household Income and Wealth, Australia, 2013–14, Cat no 6523.0, 16 December.

Figure 2 clearly shows that the holdings of super and trusts by value are much skewed towards the rich. Indeed, a visual examination of the graph shows the holdings in trusts are barely visible until we reach the topmost quintile.

How much is involved?

This section is also based on our 2014 submission and refers to our attempt to estimate how much dividend imputation costs and hence how much could be saved by abolishing it.

In 2014-15 the Australian government collected $68,420 million in company tax. Tax office statistics show that in that year $25,581 million in franking credits were credited to the taxpayers who received dividends from Australian companies. On this basis our examination of the tax office figures suggests that 37.4 per cent of the company tax is given away as franking credits. Compare that with the theoretical maximum, if all after-tax profits were paid out as dividends and all dividend recipients were Australian taxpayers then the amount of franking credits would be equal to 100 per cent of the value of company tax collections. In that theoretical world all company tax collections would be returned to Australian taxpayers as franking credits. In practice the amount of franking credits claimed by taxpayers need have little correspondence with the tax paid by companies. This is important. If the company pays out in dividends an amount less than the value of its after-tax income then it will accumulate franking credits. Likewise if it pays dividends to people or entities unable to utilise franking credits some of the latter will be wasted.

Table 3 shows the company tax paid and the estimates and/or projections for company tax collections through to 2020-21. However the budget papers do not include the value of franking credits. Instead the value of franking credits is included in individual tax collections and has the effect of reducing the latter. In Table 3 an estimate of franking credits is given. We know the value of franking credits claimed in 2014-15. The value of franking credits, in Table 3, over subsequent years is based on the assumption that the ratio of franking credits to company tax remains at the 2014-15 rate of 37.4 per cent. Those figures are also included in Table 3.

Table 3: Company tax and franking credits

	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
	$m	$m	$m	$m (est)	$m (est)	$m (proj)	$m (proj)
Company tax	68,420	62,897	67,800	77,800	84,600	91,600	95,000
Franking credits	25,581	23,516	25,349	29,088	31,630	34,248	35,519

Source: TAI calculations based on Australian taxation office (2014) Taxation statistics, 2014-15, at https://data.gov.au/dataset/taxation-statistics-2014-15

On the basis of the data in Table 3 we estimated that overall some $130 billion would have been given back in franking credits over the then forward estimates (2017-18 to 2020-21) including $29.1 billion in 2017-18. By the end of the forward estimates the value of franking credits given to taxpayers will be just above $35 billion per annum or approximately nine per cent of total taxation.

Incidentally, we can compare the franking credits worth $25,581 million in 2014-15 with the ATO figures for the total franked dividends paid of $110,812 million in that year. Grossing up those dividends and working out the maximum possible franking credits gives $47,491 million. That implies that the difference is $21,905 million or 46.1 per cent of the possible total are not used for various reasons. Of course the main reason is that the recipient is not an Australian resident taxpayer eligible to use franking credits to offset Australian tax liabilities.

If dividend imputation were to be abolished franking credits would no longer apply and so the row in Table 3 headed 'Franking credits' can be used as an estimate of the likely savings. Those savings would be reflected in upward revisions of the estimates of tax collections from individuals.

The fact that companies do not pay out all of their after-tax profit as dividends means that they can build up substantial unused credits in their franking accounts. At the end of 2014-15 Australian companies had franking account balances of $317.6 billion. The government could be called upon to spend this, or part of this, at any time if companies decide to increase dividends, for example, as part of a special dividend designed to return capital to shareholders. As an example it is reported that BHP plans to make a special dividend to shareholders in part to utilise accumulated franking credits to head of the Labor Party plans to 'tighten franking rules'.[3] To put the franking account balances into perspective, Australia's net government debt was $285.7 billion at the end of June 2016. This suggests that to some extent the stability of the tax revenue depends on corporate payout decisions.

ABOLITION OF REFUNDS OF FRANKING CREDITS

The present inquiry is limited to the abolition of refunds of franking credits, one of the options we put in our 2014 submission. Cash refunds are now given to those whose tax liabilities are less than any franking credits they have. The then Treasurer Peter Costello expanded the operation of franking credits in 2000 to give cash refunds when franking credits more than covered the taxpayer's tax liability.

We argued that dividend imputation has never been well understood and there is only a small group of very wealthy Australians who would miss it. Yet our estimates suggested its abolition could save the government around $35 billion per annum by the end of the forward estimates (2020-21).

The original motivation for dividend imputation was concern about the 'double taxation' and so the dividend imputation system was designed to make refunds to individual taxpayers to reflect the tax paid by the company and imputed to the individual. In addition to individuals,

[3] Ker P (2018) 'BHP boosts franking to beat Labor', *The Australian Financial Review*, 2 November.

franking credits can also be claimed by some trusts, partnerships and super funds. Companies too can earn imputation credits on any franked dividends they receive from other companies. However, companies can forward any received franking credits to shareholders but cannot utilize franking credits themselves.

When the Howard Government first mooted the cashing out of excess imputation credits the annual cost was thought to be $550 million per annum for 2001-02 and 2002-03.[4] Labor's original plan would have raised additional revenue of $5.6 billion in the first year rising to $8 billion pa in the medium term.[5] That represents a tenfold increase in the cost of the measure since Costello's estimates in 1998. Meanwhile the total tax take in Australia has increased by a much more modest 159 per cent. The original estimate would have been based on a no-change-in-behaviour basis while the present figures would be based on adjustments people have made to take most advantage of the generous cashing out arrangements.

As a footnote to this section Labor subsequently changed its plan so that for people on income support cash refunds can continue. That reduced the revenue gain by $700 million in a two year period or approximately $350 million per annum.[6]

OTHER OECD COUNTRIES

Most other OECD countries do not give taxpayers credit or concession when they receive dividend income. Apart from Australia, full dividend imputation applies in just Canada, Chile, Mexico and New Zealand with partial imputation applying in Korea. The 28 other OECD countries, including the US and European countries, do not have dividend imputation although they may have other arrangements that result in lighter taxation for investment income.

The following provides a brief comparison of the role of imputation in company tax systems of OECD countries in 2000 with the system in 2017. Of the OECD countries that had a full imputation system, Finland, France, Germany, Italy and Norway either dropped it or reduced it to a partial imputation system.

- Italy, for example, has dropped the imputation system and replaced it with a 95 per cent exemption of distributed dividends from personal income tax.
- Spain, Turkey and the UK had partial imputation and abolished it.
- Canada went the other way, from a partial to a full imputation system.

[4] Costello P (1998) *Tax Reform, Not a New Tax; A New Tax System: The Howard Government's Plan for a New Tax System*.

[5] Coory P (2018) 'Labor to end share dividend cash perk in $59b grab', *The Australian Financial Review*, 12 March.

[6] Bowen C (2018) 'Labor's plan to crack down on tax loopholes, protect pensioners, and pay for schools and hospitals', *Chris Bowen MP Media Release*, 27 March.

- The countries that had full imputation in 2000 and still have it in 2012 are Australia, Chile, Mexico and New Zealand.

- Korea introduced partial imputation over that period.

OTHER ARGUMENTS AGAINST DIVIDEND IMPUTATION

For example Australia and New Zealand both operate full dividend imputation systems and there have been proposals that the two countries recognise each other's franking credits.[7] At the moment an Australian who holds shares in a Hong Kong company faces an implied total tax of up to 55.745 per cent. The company pays company tax of 16.5 per cent and if the rest is distributed as dividends the Australian shareholder pays 47 per cent on dividends or 83.5 per cent on pre-tax income. Some may regard that as unfair but it was deliberately built into the Australian dividend imputation system to encourage local capital accumulation with Australian funds. This was made clear by former Treasurer and later Prime Minister, Paul Keating, in a speech to Parliament in 1985 soon after the National Tax Summit. In discussing dividend imputation as then planned he said:

> The Government believes the raising of equity for our continuing national development should be encouraged. [By contrast] While the existing tax system provides a positive incentive for some people to channel income through companies, it effectively discourages most investors from buying shares altogether. [Keating said the Opposition] had no appreciation of the needs of investment in the community and no appreciation of the need to raise equity in the community.[8]

For these reasons foreign residents were explicitly excluded from any tax credits at the time. Nevertheless it may be argued that things are now different and the policy needs review.

The first point to make is that no other country extends dividend imputation to non-residents. Franking credits or their equivalent from other countries cannot be used in Australia and foreign residents cannot benefit from Australian franking credits. Similar arrangements apply in all jurisdictions. Having said that it should be noted that foreign residents may obtain some benefit from Australia's dividend imputation system since

[7] See Australian Government (2015) *Rethink: Tax discussion paper*, March.

[8] Keating PJ (1985) 'Reform of the Australian taxation system: Ministerial Statement', *House of Representatives Hansard*, 19 September.

dividends paid overseas may attract dividend withholding tax[9] but do not if they are franked dividends. Even though foreigners cannot benefit from the credits they benefit through zero withholding tax rates.[10]

The more substantial point is that investors generally tend to have a strong **home country bias** which means they invest in companies resident in the same country. For example it is well known that there is a strong ‘home equity bias’ as it is referred to in the economic literature. The home equity bias refers to the tendency for investors to bias investment towards their own economy. A prominent textbook on international finance says ‘there is clearly an equity home bias puzzle as it has become known. Investors around the globe are not fully availing themselves of international diversification opportunities; they hold fewer foreign securities than would be representative of the world portfolio’.[11] From Australia we can see this very clearly. Australia accounts for about two per cent of the world economy and would be expected to issue about the same share of the world’s financial assets/debt. However, most Australian fund holders would have only a small share of their portfolio in foreign assets. Australian industry super funds for example had $432 billion in funds under management at December 2015 and, of that, only 32 per cent were in international assets.[12] Australian super funds would hold 98 per cent of their funds in international assets if they were not biased towards Australian assets. The home country bias is even stronger among Australian households who appear to only hold four per cent of their financial wealth in those assets issued in the ‘rest of world’ as the ABS defines it.[13] That figure seems surprisingly given the large number of recent migrants in the Australian population and the business migration program that attempts to attract rich migrants.[14]

[9] Dividend withholding taxes are amounts withheld by companies on unfranked or partially franked dividends on payments to an entity outside Australia. The amounts withheld are then paid to the tax office. Withholding taxes may apply to other classes of income.

[10] The issue becomes even more complicated because not all non-franked dividends paid overseas would necessarily attract withholding tax.

[11] Levi MD (2005) *international Finance: Fourth Edition*, London: Routledge, p 335.

[12] APRA (2016) *Quarterly Superannuation Performance*, 23 February.

[13] Calculations from ABS (2016) *Australian National Accounts: Finance and Wealth, Sep 2016*, Cat no 5232.0 15 December.

[14] The latest incarnation of this type of migration is outlined in Australian Government () Migration to Australia, at http://www.australia.gov.au/information-and-services/immigration-and-visas/migration-to-australia

THEY GO UNUSED

Despite the value of franking credits to shareholders, companies often hold huge franking credits that are unused. At the end of 2014-15 franking credit balances were $318 billion and they increased by $17.0 billion that year. From the shareholders' point of view that is a waste—idle franking credits do not earn interest and can only be used against dividend payments. On the other hand managements seem to prefer to retain as much of the profits in the company as they can rather than give them out as dividends to shareholders.

THEY NULLIFY INCENTIVES THROUGH TAX CONCESSIONS

It is important to note that in principle company tax concessions are worthless with imputation. Treasury estimates for 2017-18 show there were some $10 billion in tax concessions for businesses in Australia. For example there were simplified depreciation provisions for small businesses worth some $1,010 million in 2017-18. For an unincorporated business that concession will result in a lower tax bill. The same is true for a company but a lower company tax bill means an equal reduction in franking credits for the shareholders when the profit is distributed. Hence there might be no advantage at all for a company that distributes all its profit.

This implies that to the extent business is in the hands of corporations then any attempt by the legislature to encourage certain behaviour (more investment etc) through tax concessions will be nullified under dividend imputation.

BIAS

Others argue that dividend imputation biases companies in favour of making more dividend payments to shareholders than they might otherwise. If so then this could be detrimental to the accumulation of retained earnings on the part of companies and, since retained earnings are an important source of investment funds, there may be a negative impact on investment.

It is also claimed that dividend imputation biases Australian companies against companies with foreign source income because they cannot generate Australian franking credits.[15]

[15] Taylor CJ (2005) 'Dividend Imputation and Distributions of Non Portfolio Foreign Source Income: An Evaluation of Some Alternative Approaches', *Journal of The Australasian Tax Teachers Association*, Vol 15.

Options for cutting or reducing dividend imputation

There are a number of options that we pointed to in our 2014 submission. First of course is immediate abolition of the dividend imputation system that would save the value of the franking credits worth an estimated $29.1 billion in 2017-18 and $130 billion over the forward estimates. These figures seem big but should be compared with the budgeted $77.8 billion in company tax collections in 2017-18 and $349 billion over the forward estimates. Only a relatively small proportion of company tax collections are passed on to Australian taxpayers as franking credits and so the savings from abolishing dividend imputation is limited to that small proportion of company tax collections.

Labor's plan

Of course there are few serious proposals at the moment to abolish dividend imputation entirely. The Opposition has chosen to announce the abolition of cash refunds except in the case of people on government income support. Since single pensioners can earn up to $52,120 a year and still receive a part pension ($79,050 for a couple)[16] this concession seems quite generous. As mentioned above this plan would raise an additional $5.6 billion in the first year rising to $8 billion pa in the medium term. That figure might now be $5 billion to $7.4 billion as pensioners and others are allowed to continue receiving cash refunds.

We believe this level of savings is only possible because of the significant numbers of people who have so arranged their affairs that they pay no tax and receive a cash refund. So an important part of the argument for the Opposition plan is to counter the artificial arrangements designed to attract the cash refund.

Equally anyone hurt by this plan can most likely rearrange their affairs to minimize the impact of the change. To regain full access to franking credits anyone adversely affected need only change the composition of their portfolio in favour of assets that generate taxable returns against which the franking credits can be applied. Any investment plans are unlikely to be set in stone. It is very easy for an affected investor to switch towards an income stream that gives unfranked returns against which they can use their otherwise wasted franking credits. Indeed, subject to the 45 day rule they can sell shares that give franked dividends prior to their ex-dividend date and buy them back ex-div at a later date.

One thing has to be made clear. Generally even with dividend imputation company income is taxed. First in the hands of the company and second, if there is a distribution to the

[16] Power T (2018) 'Age Pension changes: More Australians entitled to payments since September 2018', *SuperGuide*, 20 September.

shareholder then it is again taxed in the hands of the shareholder with credit given for the implied share of the original tax. Now if the shareholder is not liable for tax then, until 2001, at least the company tax remains intact. After 2001 a cash refund of the company tax means that part of the company's income is effectively tax-free, it is exempt from tax. We do not think any corporate income should escape the tax provisions for that reason or any other for that matter.

We have mentioned some of the other arguments against dividend imputation generally. While the Opposition plan does not completely abolish dividend imputation it is certainly a step in the right direction.

Conclusion

The present proposal by the Opposition would deny the cashing out of excess franking credits to everyone other than recipients of government pensions and benefits. This proposal should be supported if only because it closes a gap whereby a large amount of company income is effectively not taxed at all when anything collected is returned as cash to the shareholder.

The magnitudes involved suggest that since the cash refund was introduced people have arranged their affairs to take advantage of it. The evidence is that franking credits go overwhelmingly to high and very high income individuals. Like any anti-avoidance measure this proposal should be supported for that reason alone. The Opposition plan makes a concession for pensioners and beneficiaries. Even with that concession the measure is likely to bring in revenue of $5 billion in the first year.

We recommend the Committee agree to the plan to abolish cash refunds for unused franking credits for all but those on income support.

In an earlier submission The Australia Institute recommended abolishing dividend imputation altogether. If Australia did that it would then conform with almost all the rest of the world that maintains a classical taxation system whereby companies and individuals are taxed separately.