Mr Shorten's proposal - the short and the bad of it

The leader of the Opposition has proposed that excess dividend imputation credits should not be refundable to superannuation funds and that he intends, if he forms Government after the next election, to implement that proposal.

The imputation system was introduced as part of the 1985 tax reforms to address the limitations of taxing companies as separate legal entities and then taxing shareholders on their dividends paid from those taxed companies. Without the imputation system, the taxable income of the company is taxed twice – the first time when the company pays tax and the second time when the shareholders receive dividends.

The imputation system avoids this double taxation by "imputing" to the shareholder the taxable income of the company (by grossing up the dividend). It then allows the tax paid by the company to be treated as a credit against the tax payable by the shareholder on the taxable income which has been distributed to the shareholder by way of a dividend.

If the shareholder has a lower tax rate than the company then the tax credit exceeds the amount of tax arising from the dividend income, and so the excess can be offset against the tax on other income of the shareholder, or even refunded to the shareholder where the tax on the other income is sufficient to exhaust the imputation credit.

The imputation system has the effect that the tax paid by the company is effectively a pre-payment of the tax which is payable by the shareholder on the distributed taxable income of the company.

Where the shareholder is not an individual but a complying superannuation fund, the imputation system operates in a very similar way. As the company tax rate is generally 30% (or 27.5% for certain companies) and the tax rate for complying superannuation funds is 15%, then the imputation credits may exceed the tax liability of the fund giving rise to "excess imputation credits" which excess is then paid to the fund. If the fund is in pension phase, so that the applicable tax rate is 0%, then all of the imputation credits will give rise to a cash payment to the fund.

It is important to understand that excess imputation credits are not "moneys belonging to the Government" but an overpayment of tax by the shareholder – whether individual or superannuation fund – on the taxable income of the company.

Given this background a number of critical comments can be made about the proposal:

FIRST

The cash refund of excess imputation credits is not the Government's money – it is an over-collection by the Government (by imposing tax on the company at 30% (or 27.5%)) compared to the tax rate applying to the shareholder which could be 0% (if the shareholder is a superannuation fund which is in pension phase), 15% (if the shareholder is a superannuation fund which is in accumulation phase) 0% (an individual within the tax free threshold) or 19% (an individual on the first marginal tax rate).

SECOND

The impact of the proposal will, perversely, have the greatest impact on retirees whose retirement balance is $500,000 or even $1.6m compared to a retiree whose retirement balance is $3.2m or $6.4m.
A retiree whose retirement balance is $500,000 (so that the entire balance is in tax free pension phase) will, under the proposal, have no entitlement to imputation credits – so 100% of their imputation credits will be wasted.
A retiree whose retirement balance is $1.6m (so that the entire balance is in tax free pension phase) will, under the proposal, have no entitlement to imputation credits – so 100% of their imputation credits will be wasted.
A retiree whose retirement balance is $3.2m (so that half of their retirement balance is in tax free pension phase and the other half is in accumulation phase) will, under the proposal, have no entitlement to imputation credits – so 15% of their imputation credits will be wasted.
A retiree whose retirement balance is $6.4m (so that a quarter of their retirement balance is in tax free pension phase and the three quarters is in accumulation phase) will, under the proposal, have no entitlement to imputation credits – so 62% of their imputation credits will be wasted.

NUMERICAL EXAMPLES

Assume the super fund consists entirely of listed securities, a 30% company tax rate and 5% cash dividend rate fully franked.

For the $500,000 fund the cash dividend is $25,000. This will be grossed up to $35,714 and included in the income of the fund. The fund is entitled to an imputation credit of $10,714.

Current Position: *the tax liability of the fund is Nil and the fund will be entitled to a $10,714 cash refund of excess imputation credits.*

Proposed Position: *tax liability of the fund is Nil and therefore the entire $10,714 will not be paid as it exceeds the tax liability of the fund. Consequently 100% of the original credit will be wasted.*

For the $1.6m fund the cash dividend is $80,000. This will be grossed up to $114,285 and included in the income of the fund. The fund is entitled to an imputation credit of $34,285.

Current Position: *the tax liability of the fund is Nil and the fund will be entitled to a $34,285 cash refund of excess imputation credits.*

Proposed Position: *tax liability of the fund is Nil and therefore the entire $34,285 will not be paid as it exceeds the tax liability of the fund. Consequently 100% of the original credit will be wasted.*

For the $3.2m fund the cash dividend is $160,000. This will be grossed up to $228,571 and included in the taxable income of the fund. The fund is entitled to an imputation credit of $68,571. The taxable income of the fund will be $114,285 (being 50% of grossed up figure). This will give rise to a tax liability of $17,142.

Current Position: *This tax liability of the fund will be reduced to zero and there will be a cash refund of $17,142 to the Fund.*

Proposed Position: *The tax liability of the fund will be reduced to zero and there an excess imputation credit of $17,142 which will not give rise to a cash refund. Consequently the 15% of the original credit will be wasted.*

For the $6.4m fund the cash dividend will be $320,000. This will be grossed up to $457,142 with an imputation credit of $137,142. The taxable income of the fund will be $342,856 (75% of the grossed up income) with a tax liability of $51,428.

Current Position: *This tax liability of the fund will be reduced to zero and there will be a cash refund of $85,714.*

Proposed Position: The tax liability of the fund will be reduced to zero and there will be an excess imputation credit of $85,714. Consequently, the 62% of the original credit will be wasted.

THIRD

Retirees with modest retirement balances may be better off transferring their balances from retirement phase to accumulation phase, to be entitled to a refund of imputation credits (up to the value of the tax liabilities of the fund). Lump sum payments from the fund will be tax free (assuming they are over age 60) and will cease to be subject to the minimum pension drawdown requirement.

FOURTH

Retirees who will be materially affected by the proposal may invite accumulation members into the fund so that the fund's tax liability arising from the acceptance of concessional contributions can offset against imputation credits which would otherwise have been lost.

FIFTH

Retirees who will be materially affected by the proposal may transfer their retirement balances to retail and industry funds. These funds are likely to have a very significant tax liability against which the otherwise excess (and lost) imputation credits can be offset. The retirees would have to be confident that they received the benefit (or most of the benefit) of the otherwise excess imputation credits. Additionally, this response would only be feasible if the transferred balance consisted entirely of cash or listed securities.

Summary

In short this proposal is not justified. Making excess imputation credits refundable is a natural and rational consequence of the imputation system – where for taxation purposes the company's taxable income and the tax paid on that income is attributed to the shareholder.

The reduction in the Government expenditure generated by this proposal is likely to be materially lower than the Federal Opposition Leader expects as affected retirees will re-arrange their superannuation arrangements in order to eliminate or reduce the adverse impact of the proposal.

Finally, the proposal will have a comparatively bigger impact on self managed superannuation funds than other types of superannuation funds. This is an example of a policy which, on its face, is non-discriminatory but which has a materially discriminatory indirect impact.

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