Impact of proposed franking credit changes on investment income

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Australian Labor Party's proposed tax reform—excess franking credits

On 13 March 2018, the Australian Labor Party (ALP) announced their intention to reform the dividend imputation credit system, removing cash refunds for excess imputation credits, starting from 1 July 2019. If these changes were to take effect, the ALP forecasts it would save the budget $11.4 billion in tax revenue over four years, which it would use to fund personal tax cuts and social policy expenditure. The ALP has proposed these changes as it believes that the current arrangements are distortionary, contributing significantly to the 'home bias' Australian investors have towards domestic equities and that their proposal will reduce these distortionary effects and encourage greater diversification in Australia's retirement savings pool.

In this article, Lonsec overviews the prospective impact on a range of Australian equity products should this proposal take effect as announced. Lonsec is not explicitly, or implicitly, commenting on the policy itself.

A short history of dividend imputation

Dividend imputation was introduced in Australia in 1987 by the Hawke-Keating Labor Government to prevent double taxation of dividends paid by Australian companies. It entitled shareholders to tax credits on dividends equivalent to the tax already paid by the company. Previously, Australia had a dual taxation regime under which earnings were taxed at both the company rate and at the applicable personal income tax rate for each receiving shareholder. In 2001, the Howard-Costello Liberal Government allowed franking credits to be fully refundable, so that if a shareholder had tax credits in excess of tax liabilities, they would be entitled to receive the excess credit as a cash refund. Australia is one of five OECD countries to have a full imputation system and the only one that has a cash refund for excess credits.

What is the impact of the proposed franking credit changes on investors?

It is important to note that these announcements are only proposals and that a number of events are required before they can be legislated. Firstly, the ALP would have to win the next Federal election. Then its proposals would have to pass both the House of Representatives and the Senate, where significant changes could be made if it were to pass.

The ALP's policy proposes to abolish cash refunds of franking credits for all Australian investors other than charities, endowments and some welfare recipients. Under this proposal, the system of dividend imputation will not change, franking credits will still exist and still be used to offset tax payable. The change will only remove the ability to claim cash refunds on excess imputation credits.

The impact to investor groups is unclear, however estimates from the ATO's Taxation Statistics have been given that about 33% of cash refunds go to individuals, 60% to SMSFs (mostly in pension phase) and 7% to APRA regulated funds. As part of the APL's justification for this change, they estimate around 50% of cash refunds to SMSFs go to the top 10% SMSFs.

Individuals, SMSF and APRA regulated funds that rely or maximise cash refunds for returns (such as SMSF that pay defined benefit pensions or retirement strategies based around maximising franking credits) are most at risk.

What is the potential impact to Lonsec's peer group?

The three Australian Equities sub-sectors most affected by this proposed change are Income Specialised, Income Dividend Focused and Listed Investment Companies (LIC). As the potential impact will depend on investor circumstances, we have outlined the maximum franking credits at risk for a zero percent tax payer.

The charts below show the Average Yield and Franking Benefit for each individual fund/company over the three years from FY14 to FY17. The Franking Benefit represents the additional return (or yield) from excess franking credit cash refunds for an Australian 0% tax payer. Lonsec considers this measure to provide a simple and effective guide to the annual increase in distribution a zero percent tax payer can currently receive from a year-long investment in the fund/company.

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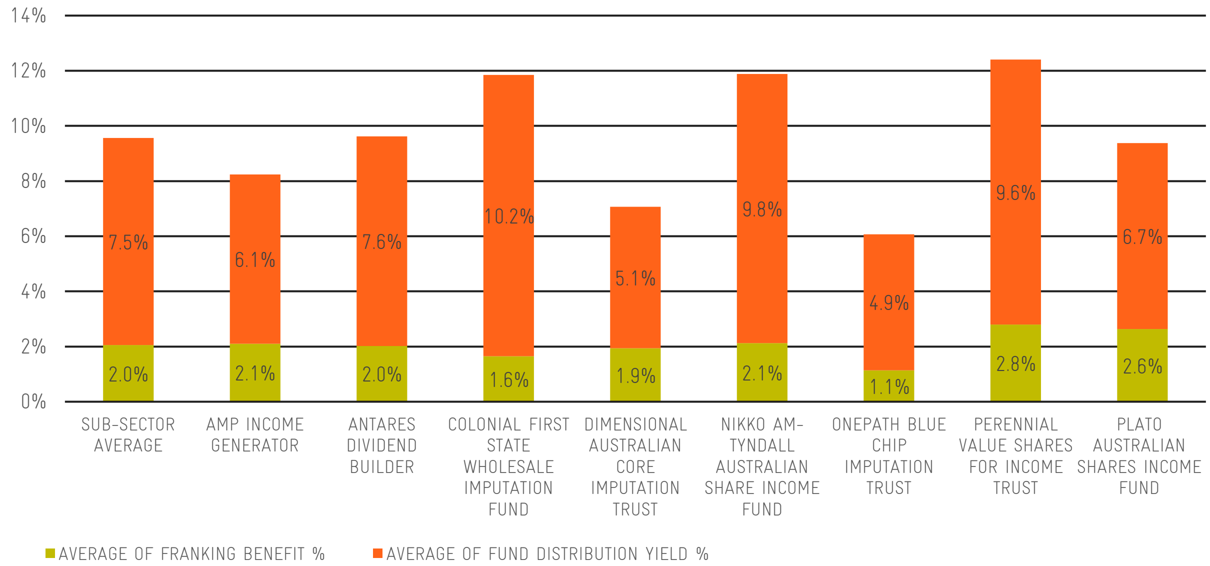
Charts 1 to 3 show that each of the sub-sectors have, on average, delivered higher than market yields and franking benefits. For comparison, the broader Australian equity market roughly delivers a yield and franking benefit of 4.3% and 1.6% respectively on an annual basis. Lonsec notes that when comparing the distribution yield between managed investment trusts and LICs, distributions for the trusts will include income and capital return components and are likely to be cyclically inflated by manager participation in the current cycle of off-market buy-backs. This compares to dividend focused LICs, which are managed in a very low turnover fashion, in part, to maintain their 'capital account' election, which allows them to pass on capital gains tax concessions to shareholders in the form of 'LIC capital gains dividends'.

It is worth noting that in comparison to global standards, Australian companies' dividends are high, which in part reflects the effect on tax policies, particularly Australia's dividend imputation system. The impact of the removing excess cash refunds is less clear but likely to be of a marginal impact on payout ratios over the long term. That said, in recent weeks calls have been made by institutional investors to company boards to release excess franking credits to shareholders in anticipation of a change in franking rules. So far this year some of the more well-known dividend focused LICs, including Australian Foundation Investment Company (AFIC), BKI Investment Company (BKI), and Mirrabooka (MIR), have announced special dividends in response to this issue.

Chart 1: Income Dividend Focused (FY14 to FY17)



Source: Lonsec

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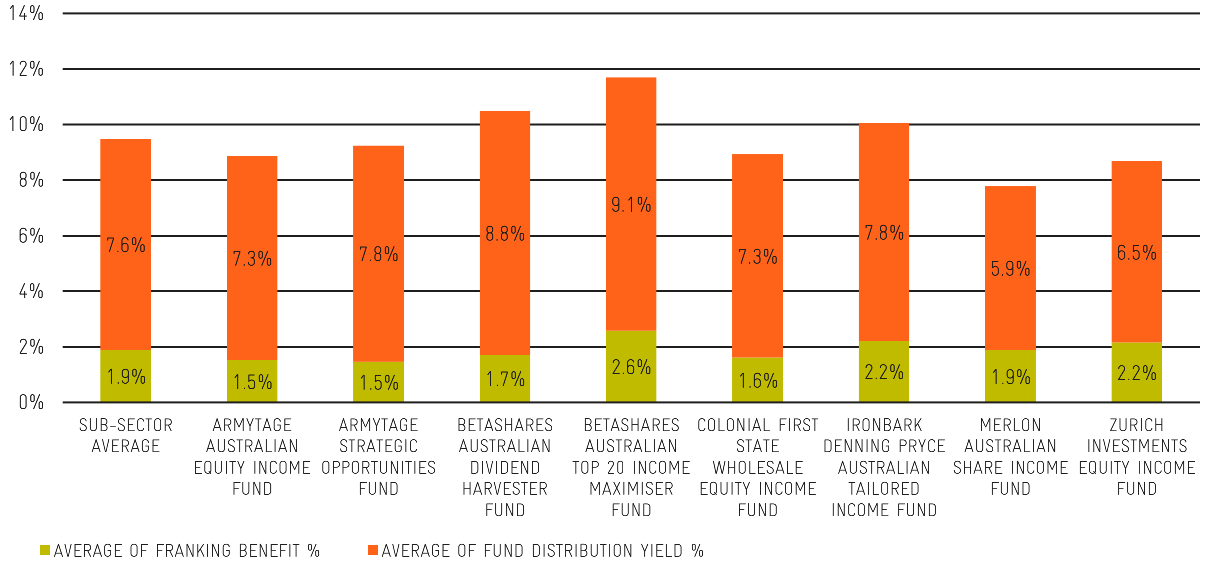
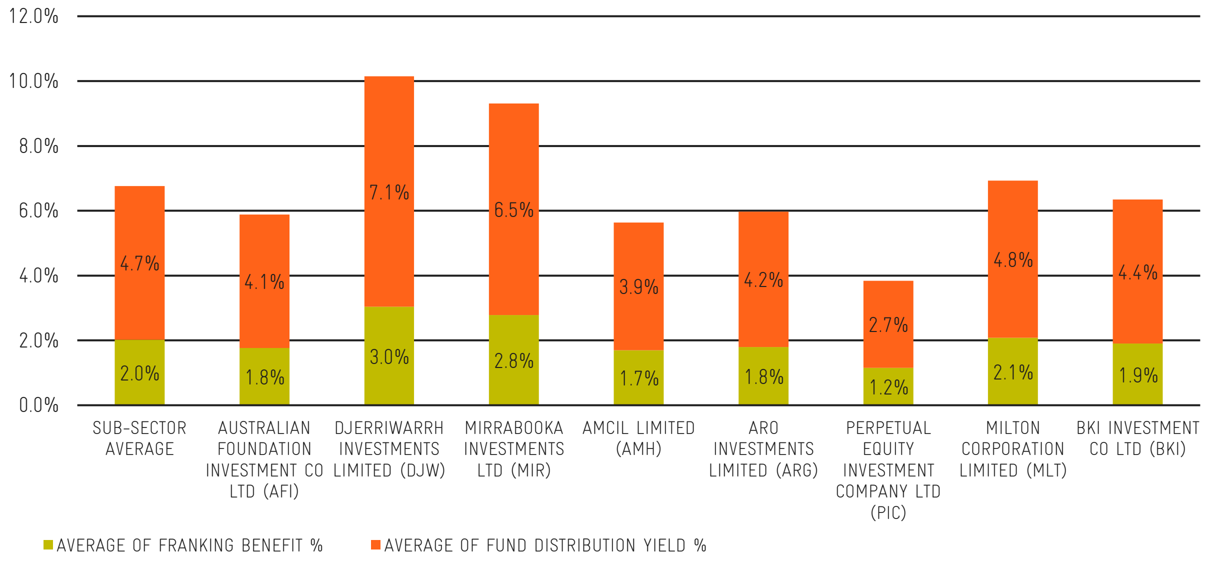
Chart 2: Income Specialised (FY14 to FY17)



Source: Lonsec

Chart 3: Listed Investment Companies (FY14 to FY17)



Source: Lonsec

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Observations and final thoughts

The impact of ALP's proposals will vary significantly depending on individual investor circumstances, however for Australian zero percent taxpayers, there is the potential for meaningful reductions in total yields and income. This is particularly true for products which seek to maximise franking credits and have higher than average Franking Benefit such as Plato Australian Shares Income Fund, Betashares Australian Top 20 Income Maximiser Fund, Perennial Value Share for Income Trust, Djerriwarrh Investments Limited (DJW), and Mirrabooka Investments Limited (MIR).

The extent to which these proposals become law is still uncertain and dependent on a wide range of variables, however the climate and general sentiment around franking credits has certainly changed over the past year. There has been increased scrutiny of 'dividend or franking credit stripping' strategies by the Australian Tax Office. Three Lonsec rated strategies have been directly impacted - the Macquarie Dividend Run-up Fund as well as the Pendal Imputation and Geared Imputation Funds. Uncertainty around the granting of future taxation rulings was a determining factor in Macquarie terminating its strategy and for Pendal to suspend a part of its investment process (its focused dividend derivative overlay).

Finally, while it is difficult to make a full assessment of the impact of these proposed changes, Lonsec notes that the removal of franking credit refunds may lessen the 'home bias' that is prevalent in our market. This may encourage diversification in Australia's retirement savings pool by incentivising investors to have greater allocations in alternative yield asset classes like REITs and global assets. However, the frequent tinkering and politicisation of superannuation and retirement, structured to be long-term in nature, nevertheless has the potential to increase complexity and impact confidence in Australia's retirement system.

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Lonsec believes that professional financial advisers need informed opinions on the best investment strategies and financial products to provide real value for their clients. To meet this need, Lonsec has in place an experienced research team, which draws on a robust research process to undertake in-depth assessment of managed fund products.

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