



FINANCIAL
SERVICES
COUNCIL

Refundable Franking Credits

Submission to House of Representatives Economics
Committee Inquiry



Summary

Franking credit refunds are important to many Australians who are members of super funds, particularly retirees, and other managed funds.

This is shown in data from Treasury and the PBO. In 2015–16, refunds were worth \$235m to large super funds, with 50 funds receiving refunds, or 21% of funds. The average refund was \$4.7m per fund. There were 2.6 million accounts in these funds, so **up to 2.6 million Australians benefited from refunds in these funds — and up to 3.5 million in 2014–15.** This is in addition to the benefits of refunds to individuals and Self Managed Super Funds.

A survey of large super funds by the FSC shows the benefit of refunds for some fund members is substantial:

- There are about 66,000 retiree accounts in surveyed funds, if retirees received the benefit of franking credit refunds, their average benefit was \$850 per year.
- There are 73,000 member accounts in surveyed funds where the average member balance is below \$100,000. The average benefit of franking credit refunds across all members of these funds is 26 basis points (0.26%, or \$195 per member).
- There are 33,000 member accounts in funds where the average benefit of refunds to all members is more than 30 basis points (0.3%). The average balance in these accounts is only \$94,000.
 - For a typical full time worker, an increase in yearly super returns of 0.3% over a 46 year working life would boost retirement savings by 6.6% or \$55,000.
- Across all surveyed funds, there were 331,000 member accounts and an average balance that is fairly low at about \$198,000. This implies that many retiree members may be part pensioners as well as receiving the benefit of franking credit refunds.

Based on PBO figures, over 80% of small APRA-regulated funds (SAFs) received refunds in 2015–16. The value of refunds SAF per member is estimated to be large, increasing yearly returns by up to 4.2% on average. The average dollar benefit was \$19,100 in 2015–16 and \$5,100 in the previous year. If SMSFs with Age Pensioner members are allowed franking credit refunds, but SAFs and large APRA funds with Age Pensioner members are not, then this will place SAFs and large APRA funds at a disadvantage.

The value of franking credit refunds is also substantial for managed funds outside super – one data source indicates about 47% of managed funds invest in Australian equity, or 33% weighted by value, while total ownership of shares by Australian managed funds is \$170bn. About 19% of managed funds had a very high exposure to shares (more than 85%) – the value of these funds is \$124bn, or 10% by value of all managed funds. These funds will be substantially affected by changes in franking credit refunds. Almost half a million Australians are estimated to invest in managed funds and receive refunds of franking credits.

If franking credit refunds are changed, then investors will adapt over time. If investors make more adaptations, then the revenue raised by any changes to refunds will be lower, but the long-term impact on investors will be smaller. Conversely, if investors don't adapt then the revenue raised from changes will be greater, but the impact on investors will be larger. Historical data suggests the behavioural response to a change could be quite large.

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About the Financial Services Council

The FSC is a leading peak body which sets mandatory Standards and develops policy for more than 100 member companies in Australia's largest industry sector, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing almost \$3 trillion on behalf of more than 14.8 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

Introduction

The Financial Services Council (**FSC**) has previously stated that franking credit refunds are important to many Australians, particularly retirees, and expressed concerns about proposals to remove these refunds.¹

Franking credit refunds enable investors in Australian shares to be taxed at the same effective tax rate as if they invested in other Australian assets. The imputation or franking system means that tax paid at the company level is able to offset personal tax, so profits are effectively taxed at an individual's personal tax rate. This is the same tax rate that the individual pays on other Australian investments. If an individual is on low or zero tax rate, this principle will also work if refunds of excess franking credits are available.

Similarly, the imputation system means super funds are taxed on investment in shares at the same tax rate as other investments, as long as refunds of excess credits are available.

If refunds are no longer available, this will mean:

- some individuals and super funds face the same tax rate on shares and other investments, while
- other individuals and super funds face a higher effective tax rate on shares, and a lower tax rate on other investments.

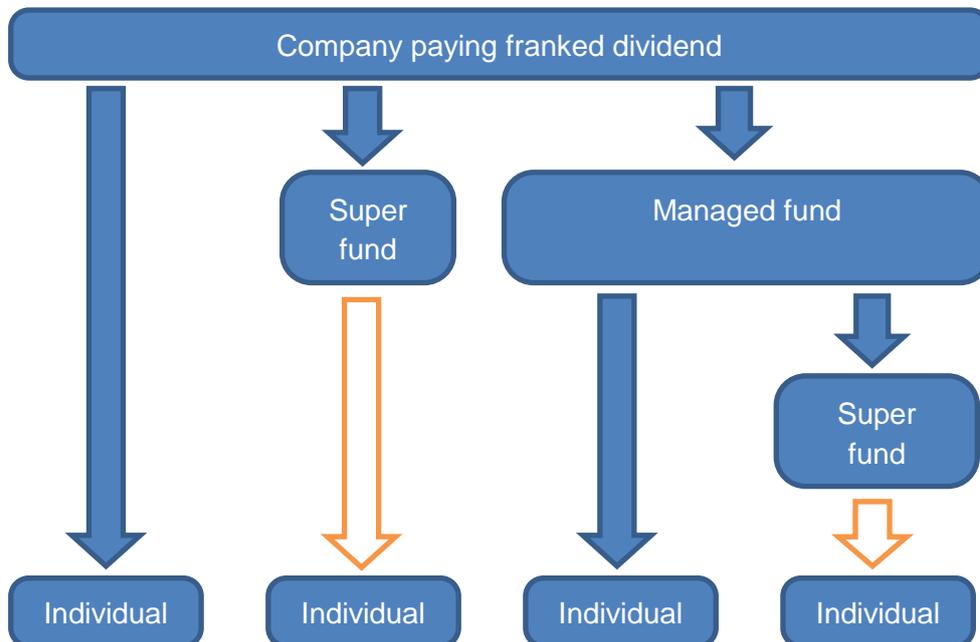
The variety of flows of franking credits relevant to this submission are shown in Figure 1 below. The solid blue lines show the flow of franking credits from companies to super funds and individuals, and the flow of credits *through* managed funds. The unfilled orange lines show that the ultimate beneficiaries of franking credits paid to super funds are the individuals who are members of the funds.

Managed funds outside of super do not receive refunds of franking credits – instead they act as conduits of franking credits to final investors who potentially receive the refunds, as shown in Figure 1 below (in this submission, 'managed funds' is used to mean funds outside super).

In all cases in Figure 1, individuals ultimately receive the benefit of franking credits and refunds of credits.

¹ See: <https://www.fsc.org.au/entity/annotation/c4399065-5d26-e811-8142-70106fa11a21>

Figure 1 – flows of franking credits



This submission focusses on the importance of franking credit refunds to individuals who are members of APRA-regulated super funds and investors in managed funds.

Franking credit refunds and superannuation

Background information

This submission uses a classification of super funds based on the following grouping used by the Australian Government:²

- Large super funds regulated by APRA, of which there are four types: corporate; industry; public sector; and retail.
- Small APRA-regulated super funds (**SAFs**), which have fewer than five members.³
- Self Managed Super Funds (**SMSFs**), which are regulated by the ATO and have fewer than five members.
- Exempt public sector funds – these are called ‘exempt’ because they are not subject to superannuation regulation by the Federal Government.

² For more detail see <https://superfundlookup.gov.au/Help/FundTypeDefinitions> and <https://www.moneysmart.gov.au/superannuation-and-retirement/how-super-works/choosing-a-super-fund/types-of-super-funds>

Pooled superannuation trusts are excluded from table to prevent double counting. Single member Approved Deposit Funds (ADFs) are counted with small APRA Funds and multi member ADFs are counted with retail funds, consistent with the approach used in this Government website:

<https://superfundlookup.gov.au/Help/FundTypeDefinitions>

³ A different definition of SAF is used in part of Tables 3 and 4, as explained in the text supporting that table.

Table 1 below shows relevant data on total member benefits held in superannuation accounts, the total number of super funds, and the total number of members of each type of fund, split by the different types of fund. The focus of this submission is on small and large APRA funds, shown in rows 4–9 of Table 1.

Table 1: Superannuation assets & members by fund type, June 2017

Type of fund	Member benefits	% of total	Number of Funds	Number of Members
<i>unit</i>	<i>\$ billion</i>	<i>%</i>	<i>Number</i>	<i>Thousands</i>
Large APRA funds				
Corporate	55.2	2.3%	26	329
Industry	511.3	21.3%	40	11,272
Public sector	410.4	17.1%	18	2,657
Retail	582.8	24.3%	125	12,313
<i>Total large APRA funds</i>	<i>1,559.7</i>	<i>65.0%</i>	<i>209</i>	<i>26,571</i>
Small APRA funds	2.1	0.1%	2,080	4
SMSFs	669.7	27.9%	596,516	1,124
Exempt public sector	167.8	7.0%	19	913
Total	2,399.3	100.0%	598,824	28,612

Source: APRA Annual Superannuation Bulletin 2017.⁴

Table 2 below shows various averages for each of the categories of fund listed above, based on the data in Table 1. These two tables show:

- SMSFs and Small APRA funds are quite similar, which is consistent with the target market of both of these types of funds being similar — specifically super fund members who wish to have substantial control over their investments.
- Most superannuation accounts are held in large APRA funds but with low average balances. Given the skewed distribution of super balances, the median balance of these member accounts would be lower than the average balance.⁵

⁴ The approach in this submission to Pooled Superannuation Trusts and Approved Deposit Funds is explained in footnote 2.

⁵ See Page 10 of https://www.superannuation.asn.au/ArticleDocuments/359/1710_Superannuation_account_balances_by_age_and_gender.pdf.aspx

Table 2: Superannuation fund averages by fund type, June 2017

Type of fund	Average		
	Number of members per fund	Member balance	Fund size*
<i>unit</i>	<i>Number</i>	<i>\$</i>	<i>\$m</i>
Large APRA fund			
Corporate	12,654	167,781	2,123
Industry	281,800	45,360	12,783
Public sector	147,611	154,460	22,800
Retail	98,504	47,332	4,662
<i>Average large APRA funds</i>	<i>127,134</i>	<i>58,699</i>	<i>7,463</i>
Small APRA fund	1.9	525,000	1.0
SMSFs	1.9	595,819	1.1
Exempt public sector	48,053	183,790	8,832
Average	48	83,856	4.0

* Average fund size = average member benefits per fund

Source: FSC calculations based on APRA Annual Superannuation Bulletin 2017.

Value of franking credit refunds to members of APRA-regulated super funds

The value of franking credit refunds to individuals who are members of APRA-regulated super funds is provided in official data in Tables 3, with FSC calculations based on this data in Table 4. In summary:

- Franking credit refunds were received by 50 larger APRA funds in 2015–16. Just over 20% of large funds received refunds, with the average refund of \$4.7m per fund.
- For members of large super funds, the average refund per member is not large. However, there are many members of large funds that receive a substantial benefit from refunds, as shown in the results of a survey conducted by the FSC, discussed later in this submission.
- For small APRA funds (SAFs, which have fewer than 5 members), over 80% received refunds in 2015–16, with the average refund per fund of about \$37,700. Based on average membership of SAFs, this implies the value of refunds per member was \$19,100 in that year.
 - The value of refunds per SAF member is estimated to be \$5,100 in the previous year 2014–15 which is still a very significant figure.
 - Refunds had a very large impact on the average investment returns for SAFs, adding 4.2% to average returns in 2015–16 and 1.0% in 2014–15.
- For all APRA funds (large and small), the number of member accounts in these funds was 2.6 million in 2015–16. As a result, up to 2.6 million Australians who are members of APRA funds could benefit from franking credit refunds.⁶

⁶ The 2.6m figure is an upper limit due to duplicate accounts – but individuals with several affected accounts would receive a greater benefit from franking credit refunds.

- In the previous year (2014–15), the number of Australians who benefited from refunds in APRA funds was potentially much larger: up to 3.5 million people benefited from refunds in that year.
- This is in addition to other groups who benefited from refunds: In 2014–15, there were 1,110,000 individuals who benefited from refunds, and up to 370,000 through an SMSF.⁷
- This means that it is likely that the largest group of people benefiting from franking credit refunds are in APRA regulated super funds.

Figures for the previous financial year, 2014–15, are reasonably similar, with the exceptions noted above.

Table 3: Franking credit refunds claimed by APRA funds

	Year	
	2014–15	2015–16
Large APRA funds		
Number of large funds claiming refunds (as % of total large funds)	94 (34%)	50 (21%)
Total refunds claimed by large funds	\$285.1m	\$235m
Average refund per fund	\$3.0m	\$4.7m
Small APRA funds (SAFs)		
Number of SAFs claiming refunds (as % of total SAFs)	2,092 (83%)	1,963 (83%)
Total refunds claimed by SAFs	\$18.7m	\$74m
Average refund per fund	\$8,939	\$37,697
All APRA funds (small and large)		
Number of funds claiming refunds (and % of total)	2,186 (78%)	2,013 (77%)
Number of member accounts in funds that claim refunds	3.5m	2.6m
Total refunds claimed by all APRA funds	\$303.8m	\$308.8m

Sources: 2014–15 from PBO and Treasury⁸; 2015–16 from Australian Government.⁹ The definition of 'large' fund and 'small' fund differs between the years.¹⁰

⁷ Source: Tables 1 and 7 of Treasury FOI document on franking credit refunds, available from: <https://treasury.gov.au/foi/2292/>

⁸ See Table C8 of PBO costing, available from: https://www.aph.gov.au/~/_/media/05%20About%20Parliament/54%20Parliamentary%20Depts/548%20Parliamentary%20Budget%20Office/Publicly%20released%20costings/Dividend%20imputation%20credit%20refunds%20-%20PDF.pdf?la=en and Table 7 of Treasury FOI document.

⁹ See: <http://sjm.ministers.treasury.gov.au/media-release/036-2018/> and <https://www.theaustralian.com.au/national-affairs/treasury/labors-375bn-retiree-savings-grab-revealed/news-story/4e7259e134d79e4e3f007f3c17c56b0d>

¹⁰ In 2014–15, large means having total assets of more than \$4.85m. In 2015–16 large means having more than 4 members.

Based on the figures in Tables 2 and 3, the average benefit to fund members from franking credit refunds is estimated in Table 4 below.

Table 4: Estimated benefit of franking credit refunds to APRA fund members

Year	2014–15	2015–16
Large APRA funds		
Number of member accounts in affected funds	3.5m	2.6m
Benefit per member	\$82	\$91
Small APRA funds (SAFs)		
Number of member accounts in affected funds	3,700	3,800
Benefit per member	\$5,100	\$19,100
Boost to investment return from refunds (ie benefit as % of account balance)	1.0%	4.2%
All APRA funds		
Number of member accounts in affected funds	3.5m	2.6m
Benefit per member	\$86	\$119

Source: FSC estimates based upon data in Table 3.¹¹

Key providers of trustee services for SAFs have indicated that the data above matches their understanding of the benefit of franking credit refunds to the SAFs they manage.

Nevertheless, some FSC members have indicated that the figures for large super funds above may underestimate the extent of refunds claimed by these funds today. This is because some funds previously held investments through life companies, and as a result did not directly receive franking credits, but now these funds invest directly and therefore do receive credits (and potentially refunds of these credits).

Survey of value of franking credit refunds to members of large super funds

The FSC has also conducted a survey of a number of large APRA funds to obtain more information about the value of refunds to members of these funds. The results of the survey are as follows:¹²

- Surveys were received relating to 14 large funds that received franking credit refunds, and relate to the financial year 2016–17.
- There were 305,000 member accounts in these funds — so any change to refunds will potentially affect up to 305,000 people.¹³ The average refund per fund was \$4.7m.

¹¹ The FSC estimates of impact per member and as a % of member balances use the average figures shown in Table 2.

¹² Note figures are rounded and may not be provided for individual funds to protect confidentiality – disclosure of membership numbers and balances at individual fund level may allow a particular fund to be identified. Survey results for Pooled Superannuation Trusts are also excluded from this analysis as they do not have individuals as direct members.

¹³ Depending on how many accounts are duplicated across the survey and if the benefit is felt by all members or a subset of members (eg retirees only).

- If the benefit of refunds applies to retirees members only, then the survey results for the funds that provided number of retiree members show:
 - There are about 66,000 retiree members in these funds, and the benefit of refunds is \$850 per year on average for each retiree.
 - For one fund, the average benefit of refunds to pensioners is 54 basis points (0.54%), the greatest percentage benefit to retirees of any fund.
 - There is one fund where the average benefit of refunds is \$5,800 per retiree per year – the highest dollar benefit of refunds for the funds surveyed.
 - There were five funds, with about 32,000 retiree accounts, that had an average benefit of refunds to retirees of more than \$1,000 per year.
 - There are 62,000 retirees in funds with an average retiree balance below \$400,000 – so many retirees in these funds could be receiving a part pension.¹⁴ The benefit of franking credits to retirees in these funds was \$820 per year.
 - In fact, 94% of the surveyed retiree accounts were in funds with an average balance below \$400,000.
- By contrast, if the benefit of refunds is shared equally by all fund members, then:
 - The largest dollar benefit of refunds is in one fund where the yearly benefit per member is \$3,000 on average.
 - There are about 33,000 members in funds with a benefit of refunds of more than 30 basis points (0.3%) on average. The average balance in these funds is \$94,000 which is quite a low balance.
 - As a broad indication, an increase in yearly returns of 30 basis points over a 46 year working life could increase retirement savings by about \$55,000, or 6.6%, for a typical full time worker.¹⁵
 - There were 73,000 member accounts in funds with an average member balance below \$100,000; the average benefit of refunds to members of these funds is 26 basis points (0.26%).
 - As a broad indication, an increase in yearly returns of 26 basis points over a 46 year working life could increase retirement savings by about \$47,500, or 5.7%, for a typical full time worker.
- The average balance across all the members of the 13 surveyed funds is \$198,000. As the funds will most likely have a lower median balance, this means many of the funds receiving refunds of credits will have members on fairly low superannuation balances.

Note that individual super funds may fall into multiple categories in the groupings above.

The surveyed funds received franking credit refunds because they received substantial franking credits and in addition:

- Had many retiree members who are not subject to tax;
- Received substantial non-concessional contributions which are exempt from the contributions tax; and/or

¹⁴ See: <https://www.humanservices.gov.au/individuals/enablers/assets/30621>

¹⁵ FSC estimates based on assumptions used in the Productivity Commission's draft report into Superannuation efficiency and competitiveness (see Box 1.6).

- Contained many superannuation accounts that acted solely to provide life insurance – known as ‘risk only’ super accounts.

Impact of removing refunds

The figures in Tables 3 and 4 above are for the historical benefit of franking credit refunds. The impact of proposed changes to refunds will be different because it will occur in later years, so needs to be adjusted for inflation, growth in dividends and so on, and will need to take into account any adjustments that funds and fund members make as a result of removing refunds (this is known as the ‘behavioural response’).

The PBO analysis indicates that 5.8% of refunds claimed in 2014–15 were claimed by larger APRA funds, 0.4% were claimed by small APRA funds, and 6.2% by all APRA funds.¹⁶ As a broad assumption, this could be applied to the revenue impact in 2020–21 of removing all refunds;¹⁷ to provide an estimate of the impact of removing refunds by fund type:

- The impact on larger APRA funds is broadly estimated to be \$301m in 2020–21;
- The impact on small APRA funds is broadly estimated to be \$20m in 2020–21; and
- The impact on *all* APRA funds, both large and small, is estimated to be \$320m in 2020–21.¹⁸

The impact does depend on the assumed behavioural response which is discussed in more detail later in this submission.

The numbers of people affected by any change to refunds has not been estimated for APRA funds, however a broad estimate would be that at least 2.6 million accounts could be affected by the removal of refunds, given the figures in Table 3.

The Parliamentary Budget Office has estimated the number of individuals affected by removing refunds (except for pensioners) in 2020–21 would be 840,000 and estimated that 210,000 SMSFs would be affected. This suggests 399,000 individual members of SMSFs could be affected.¹⁹

It therefore seems very likely that the largest group who will be affected by any changes to franking credit refunds will be Australians who are in APRA-regulated super funds.

Comparing SMSFs with other super funds

SMSFs are similar products to small APRA funds (SAFs), and also share some similarities with wrap products offered by larger super funds. All of these products allow fund members

¹⁶ The percentage of credit refunds received in 2014–15 is from Tables C4 and C8 of the PBO costing.

¹⁷ Estimated cost of proposal in 2020–21 is from Table 2 of PBO costing. As there was no Age Pensioner exemption in 2014–15, and no Age Pensioner exemption is proposed for APRA funds, this estimate uses the PBO costing without an Age Pensioner exemption. Treasury has not provided a costing without an Age Pensioner exemption.

¹⁸ Note figures do not add due to rounding.

¹⁹ Using the average number of SMSF members of 1.9 from Table 2.

a very wide range of investment choices, providing substantial freedom and personal control over their investments.²⁰

Therefore, there are good arguments for treating SMSFs, SAFs and wraps similarly in relation to franking credit refunds. If SMSFs are allowed to receive refunds because they have Age Pensioner members, then there is a good case for SAFs and wraps in similar circumstances to receive refunds.

Conversely, allowing SMSFs to receive franking credit refunds because they have Age Pensioner members, while disallowing refunds for SAFs and wraps even if they have Age Pensioner members, will create an unlevel playing field between SMSFs on one hand and SAFs and wraps on the other, noting the earlier point that SMSFs, SAFs and wraps are similar. We note the Budget cost would be minimal to allow SAFs with pensioner members to receive franking credit refunds.²¹

More broadly, providing franking credit refunds to Age Pensioners who are members of SMSFs only, but not other super funds, will create an unlevel playing field. Many of the large funds that benefit from refunds have a substantial number of retiree members (see survey results above), and some of these retirees will receive the Age Pension. These pensioners would be treated differently from Age Pensioners who are members of SMSFs.

- As noted above, there are 62,000 retiree accounts in large APRA funds with average retiree balances below \$400,000, which means many members of these funds could be receiving the Age Pension.²² These pensioners would not benefit from a policy that only provides franking credit refunds to SMSFs with Age Pensioner members.

Managed funds outside super

A managed fund – in most cases a Managed Investment Trust (**MIT**) – might receive franking credits from shares; the fund does not use these franking credits, or receive refunds from the credits, but passes the credits onto investors who may be individuals or super funds that can make use of the credits. This is consistent with the view of managed funds as being tax transparent, or flowthrough vehicles (see introduction).

Therefore, investors in managed funds value franking credits — and refunds of credits — just like investors into shares.

²⁰ For more discussion of these types of funds see: <https://cuffelinks.com.au/self-managed-supers-best-kept-secret-2/>
<https://www.intheblack.com/articles/2013/12/04/whats-the-difference-between-smsfs-and-small-apra-funds>
<https://www.afr.com/personal-finance/superannuation-and-smsfs/why-small-apra-super-fund-is-a-good-alternative-to-an-smsf-20151101-gko7r2>

²¹ This is because SAFs are a small share of the total market (see Table 1) and the average balance of SAFs is about \$525,000 (see Table 2), so few SAF members are likely to be receiving the Age Pension.

²² See: <https://www.humanservices.gov.au/individuals/enablers/assets/30621>

The evidence suggests franking credits are important to managed funds: based on a confidential data set provided to the FSC, as at August 2018:²³

- About 47% of Australian managed funds had some exposure to Australian equity, or 33% weighted by fund value.
- The value of Australian shares held by managed funds was \$170bn, or 13% of total assets of managed funds.
- About 31% of managed funds had an exposure to Australian shares of more than one quarter of asset value. The total assets in these funds was \$212bn, or 17% of total assets held by all managed funds.
- About 19% of managed funds had an exposure to Australian shares of more than 85% of asset value — it could be assumed that the value of franking credits, and refunds of credits, are particularly important to these funds. The total assets in these funds was \$124bn, or 10% of total assets held by all managed funds.

This indicates that a significant portion of Australian managed funds have a large exposure to the value of franking credits and refunds of those credits. Any change to refunds could have a sizable effect on these managed funds.

Franking credit refunds will also affect many members of managed funds. Many investors in managed funds probably receive franking credit refunds:

- The number of individuals who received refunds in 2014–15 was 1,110,000.²⁴ A proportion of these individuals would be receiving franking credits from managed funds — so a broad estimate is 300,000 individuals who are members of unlisted managed funds receive refunds of franking credits.²⁵ There would also be individuals who invest into listed managed funds but are not included in this figure.
- The number of members of SMSFs that received refunds in 2014–15 was 370,000,²⁶ made up of SMSFs owning shares directly or indirectly (ie through a managed fund). The proportion of SMSFs receiving franking credits from managed funds is estimated to be 41% of SMSFs receiving franking credits,²⁷ so this means a broad estimate is 152,000 people are members of SMSFs that receive franking credit refunds and invest in managed funds.

If there is no overlap between these groups, then 452,000 individuals and SMSF members are both investors in managed funds and beneficiaries of franking credit refunds.

Larger super funds also invest in managed funds. As at June 2018, large APRA funds (with more than four members) had \$766bn invested indirectly through flowthrough managed fund vehicles, or 45% of total investments as shown in Table 5 below. The remaining two types of

²³ Note different data sources can produce different results for this analysis. For example, the data used here is not immediately comparable with the data in Table 5.

²⁴ Source: Treasury FOI.

²⁵ An ASX survey for 2014 found that, of the Australians who own shares directly or indirectly (or both), 27% owned some shares indirectly through an unlisted managed investment, see page 17 of [this report](#). Applying this percentage to 1,110,000 provides the figure in the main text.

²⁶ Source: Treasury FOI.

²⁷ SMSF investment in listed trusts, unlisted trusts, and other managed investments was 21% of total assets as at March 2018, while SMSF direct investment in Australian shares is 30.2% of assets. The 41% figure is $21 \div (21+30)$. This is only a broad estimate.

managed investment in Table 5, life company and pooled superannuation trust, are generally not flowthrough vehicles for tax and generally make use of franking credits (and refunds) themselves.

Table 5 – Large APRA funds – direct and indirect investments, June 2018

	\$bn	% of all investments
<i>Indirectly held investments – flowthrough</i>		
Cash management trust	3,750	0%
Listed retail trust	37,326	2%
Unlisted retail trust	149,046	9%
Wholesale trust	471,052	28%
Other indirect investment	104,657	6%
Total flowthrough indirect investments	765,831	45%
<i>Indirectly held investments – not flowthrough</i>		
Life company	135,367	8%
Pooled superannuation trust	146,295	9%
Total non-flowthrough indirect investments	281,662	17%
Total indirectly held investments	1,047,493	62%
Directly held investments	649,717	38%
Total investments	1,697,211	100%

Source: APRA Quarterly Superannuation Performance, Table 1b.

Many of these managed fund investments by larger super funds would be indirectly affected by franking credit refunds provided to the super funds.

Listed investment companies

Franking credits are particularly important to Listed Investment Companies (LICs). While MITs are flowthrough vehicles (as discussed above), LICs are not, and pay tax in their own right. A MIT usually passes through income unchanged to final investors – so rent remains rent, interest remains interest, foreign income remains foreign income, and so on. In most cases, the MIT does not pay any tax on income it receives.

By contrast, a LIC generally pays tax on income it receives, and then distributes this as dividends. This means that rent, interest and foreign income will usually be ‘converted’ into dividends — and be franked to the extent that the LIC has paid tax.²⁸

In broad terms, this means that for a given diversified portfolio, a LIC will pay more tax than a MIT, but distribute more franking credits. Nevertheless, an Australian investor that can fully use franking credits is in broadly the same position investing through a LIC as a MIT.

This means that franking credits are of more value to LICs and any changes to franking credits (including refunds of franking credits) will have a greater effect on LICs than on MITs.

²⁸ See for example: <https://www.smh.com.au/money/tax/listed-investment-companies-under-threat-20180329-p4z6vw.html>

General comments

Behavioural response

As noted earlier, the revenue received from any changes to franking credits will depend on the behavioural response that investors and companies make after the policy change.

Some likely behavioural responses, as noted by Treasury, include investors moving out of Australian equity and managed funds that distribute franking credits into other asset classes; closing down of super funds that are in a refund position; or the merger of affected super funds.²⁹ As noted in some other submissions to this Inquiry, retiree investors facing a change in franking credit refunds may decide to consume assets so that they become eligible for the Age Pension.

There could also be changes in behaviour of companies, including reduced dividend payouts, increased debt funding, and increased funding from foreign equity investors.³⁰

- Changes to franking refunds are likely to mean Australians invest more offshore. To replace the lost domestic investment, this will require an increase in foreign investment into Australia.³¹
- If investors move out of shares as a result of changes to franking credit refunds, this may lead to declines in their investment returns in the longer term, because shares can provide better long-term returns than many other investments.

The PBO and Treasury have indicated that they have factored in behavioural responses in their costings of changes to refunds of franking credits. However, it is difficult to comment on the accuracy of the assumed responses in these costings as the details have not been released. For example, the assumed proportion of Australian shares that are sold by those who no longer receive refunds of franking credits is not known.

Estimating behavioural response

A different way to provide a broad estimate of the behavioural response to removing refunds is to examine the behavioural response to *providing* refunds. The official costing was that introducing franking credit refunds would cost \$550m in 2001–02.³² This figure can be converted into 2020–21 figures:

- Scaled up by actual and forecast growth in nominal GDP, this revenue impact becomes \$1.5bn.³³

²⁹ See Treasury costing.

³⁰ The PBO has not included any assumed behavioural change for companies, see Page 4 of PBO costing. Treasury has assumed only limited behavioural changes from private companies, see page 2 of Treasury costing.

³¹ If the replacement foreign investment does not occur, then Australian investment will decline, harming Australia's growth potential.

³² Source: Costello (1998) *Tax Reform: Not a new Tax, a New Tax System*, page 128, available from: <http://archive.treasury.gov.au/documents/167/PDF/Whitepaper.pdf>

³³ Actual nominal GDP is from ABS; forecasts are from the Budget.

- Scaled up by actual and forecast growth in total superannuation assets, this revenue impact becomes \$3.0bn.³⁴

Either method produces a figure that is substantially below the official PBO estimate of the revenue increase from the full removal of refunds of \$5.6bn.³⁵ This implies there was a large behavioural response to *allowing* refunds and therefore there is likely to be a large behavioural response to *denying* refunds, potentially larger than forecast by the PBO.

All else being equal:

- if the behavioural response to a change to refunds is small, then the revenue raised by the change will be substantial, but the impact on those affected would also be substantial; while
- if the behavioural response is substantial, then the revenue raised will be small, and the impact on those affected will also be small (although the transitional economic cost of making a substantial behavioural response could be large).

Benefits of imputation/franking system

Changes to franking credit refunds could affect the benefits of the imputation system which include reducing the incentives for corporate tax avoidance; reducing or removing the debt/equity bias in corporate finance; and increasing capital discipline on businesses.³⁶ As noted in the introduction, the imputation system, including refunds, also helps ensure that Australian investors face the same effective marginal tax rate on different types of investment.

Franking credit refunds and the company tax rate

Under the current system, the company tax rate has little or no effect on Australian investors to the extent they are able to use franking credits. Any changes to franking credit refunds will mean the company tax rate will have a real impact on some Australian investors. In particular, a domestic investor who is no longer be able to use franking credits will feel the full impact of the company tax rate. This investor will therefore benefit from any company tax rate reduction.³⁷

³⁴ Actual and forecast superannuation assets are from Rice Warner's Superannuation Market Projections Report 2017.

³⁵ Treasury did not conduct an estimate of the policy without the pensioner exemption.

³⁶ See

http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_b2-3.htm and http://taxreview.treasury.gov.au/content/FinalReport.aspx?doc=html/publications/Papers/Final_Report_Part_2/chapter_b2-4.htm and <https://www.afr.com/news/policy/tax/axing-dividend-imputation-may-not-be-worth-the-risks-20160210-gmqgfk>

³⁷ See: <https://cuffelinks.com.au/removal-excess-franking-refunds-hits-pensions-super/>