Labor's Plan to Restore 'Equity' in our Tax System a Bit Rich… Literally and Figuratively.

6 April 2018

Many journalists and other commentators believe that Labor's proposal to prohibit 'self-funded' retirees from accessing certain imputation credits would help restore equity in our tax system, and would contribute to closing a public revenue gap. Ian McAuley points out that Labor's proposals fail on both counts.

A couple, each earning $100,000 a year in paid employment, would pay about $50,000 in income tax. A moderately wealthy retired couple enjoying an account-based pension in a self-managed superannuation fund, however, could have the same $200,000 income without paying any tax.

It doesn't require any fancy accounting to enjoy that break. Assuming a five per cent return on investment, someone with $1.6 million in an account-based pension fund – usually a self-managed superannuation fund – will get an annual $80,000 tax-free income from the fund, and another $300,000 or so invested outside superannuation can provide just enough income to stay below the $18,200 tax-free threshold. That comes to $98,200 tax-free.

It's a rort.

Labor has conveyed the impression that in restricting people's access to imputation credits it can close this rort, but in reality the rort would remain wide open.

To explain imputation credits, In Australia the corporate tax rate for large companies is 30 per cent. Under imputation, when the shareholder receives a dividend, he or she also receives a credit for the 30 per cent company tax that's been paid. If a company distributes $100 of its profit as a dividend it withholds $30 for taxation and makes a cash payment to the investor of $70, who also receives a tax credit of $30. At the end of the year, when the investor lodges his or her tax return, the Tax Office repays the $30, to be offset against other tax liabilities or to be paid in cash as a refund.

At present if someone receives no income other than tax-free income from a self-managed superannuation fund they get the full value of imputation credits as a refund from the tax office. Labor proposes that taxpayers not be allowed to claim imputation credits in excess of tax liabilities, which means that people in such a situation would be denied a refund of their imputation credits.

Those pushing Labor's proposal represent such as payment as a refund of a tax that the retiree has never paid. That sounds fair, but it's quite a fallacious way to put it. Withheld imputation credits are no different from the tax withheld by an employer in a PAYG system, which most of us are familiar with. Instead of the taxpayers' employer having withheld their tax, the company in which they hold shares has withheld their tax.

Labor has already had to acknowledge that many pensioners with small parcels of shares would be caught in its trap, and it is designing some complex work-arounds. It has yet to acknowledge that there are also people in their late 80s and 90s who missed out on the superannuation breaks, and are living entirely off investment income without any of the breaks enjoyed by superannuants.

As an example, an aged person drawing a $30,000 dividend income from $600,000 in invested assets outside superannuation would be ineligible for any government pension. Her $30,000 income would include about $9,000 in imputation credits. Under Labor's proposals she would be able to apply her imputation credits only to the $2,000 tax on a $30,000 income, and would lose the other $7,000. Labor doesn't seem to have thought through its proposals.

More basically Labor's proposal would entrench and worsen the unfairness of the present system. That's because it doesn't close the rort of tax-free superannuation, and it seems to be aimed at a group of moderately well-off superannuants while leaving the very rich untouched.

Labor's proposals have three shortcomings.

For a start it targets self-managed funds, but not funds operated by financial institutions – the "retail" funds operated by banks and the industry funds operated by employer and union groups. The industry funds are certainly less exploitative than the retail funds, but for people with superannuation balances above about $300,000 they are still more expensive than a simple self-managed fund. Someone in Labor seems to have assumed that anyone with a self-managed fund is a wealthy plutocrat, rather than someone trying to stay free of the parasitic funds management industry.

In response to Labor's proposals some retirees would close their self-managed funds, and transfer their retirement savings into high-fee-low-return institutions paying allocated pensions – to the pleasure of the finance sector. At a time when the bad behaviour of the finance sector is in full display, it's difficult to understand why Labor is specifically targeting investors who have broken free of it.

Second, it's easy for people to change their investment strategies to avoid the losing any income. Savvy holders of self-managed funds – and most are reasonably savvy – would soon shift their investments away from shares in Australian companies paying dividends carrying imputation credits ('franked' dividends).

Some investors would shift to fixed interest, which will become more attractive as interest rates inevitably rise. That's not a wise strategy. Fixed-interest investment is a way of going broke slowly, but it would appeal to risk-averse investors. And in time they would become dependent on the age pension, much earlier than would have been the case had they kept their investments in equities.

Some would shift from long-term investment in dividend-paying firms to speculation in shares with prospects of high capital gains – adding another driver of instability to stock markets.

Some would invest in real estate, directly or indirectly through real-estate trusts, setting off another boom and keeping housing unaffordable.

A simple strategy for those with only a few holdings in listed investment companies or index funds is to sell their shares just before they go "ex-dividend", and to buy them back the following day, thus enjoying the full market value of the dividend and imputation credits, less the small brokerage associated with online trading. That would be another driver of financial market instability, to the benefit of brokers.

And third, the people least affected or entirely unaffected would be the very well-off, with amounts well in excess of $1.6 million in their funds. The Coalition's decision to limit tax-free superannuation to an asset cap of $1.6 million and to require any excess amount to be put into an account paying 15 per cent tax was one of its few meaningful reforms. People with $5 or $10 million in superannuation assets would shift their dividend-paying investments into these funds, using imputation credits to offset the 15 per cent tax they are paying on high balances. But those credits would not be available to lesser mortals with less than $1.6 million in their accounts.

In a short time the government's revenue stream would dry up, we would still have the injustice of self-funded retirees paying no tax, and dividend imputation, a useful reform introduced by the Hawke-Keating Government, would be compromised.

Imputation was designed to avoid double-taxation of company profits – a reform that effectively gives Australian investors one of the lowest rates of corporate taxation in the developed world (but don't expect Mathias Cormann or Scott Morrison to acknowledge that). It was also designed to encourage Australians to invest in equities, so that the benefits of corporate prosperity could be spread, and to support the use of our savings to finance equity in Australian companies.

If Labor really wants to address inequities in our retirement income system there are two simple solutions.

One, which is probably the most just, is to consider all of one's income from a superannuation account in the pension phase as normal taxable income, to be added to other income for tax assessment. That would obviate the need for people to continue to hold self-managed superannuation once they retire: all their savings would be in the same taxable pool. Combined with modestly lower personal tax rates, that would go a long way to restoring taxation progressiveness and contributing to public revenue.

The other, a little less elegant in terms of taxation principles, is to restore a flat rate of tax on earnings from funds in the pension phase. A 15 per cent tax (which is imposed in the accumulation phase) would provide about the same taxation revenue as Labor hopes to get from abolishing imputation credits, and would not encourage diversion of investments away from equities. Public revenue would be more secure, and of course there is no reason why the rate should not be higher – perhaps 32.5 per cent to align with the middle-income bracket.

Both of these solutions would apply to all high-wealth retirees, and would not fall disproportionately on those with superannuation balances in the $0.3 million to $1.6 million range.

Most people with such assets, particularly at the upper end of the range, are reasonably well-off, and it would be churlish for them to object to losing their tax-free benefits. But Labor's proposals seem to be targeted only at this very group, and not at the very rich. Understandably, even those who believe they should be taxed, are angry. In public policy fairness counts.

There may be some in Labor who believe that anyone over 65, or anyone with more than two bob in assets, is a rusted-on Coalition supporter, but the reality is that this group includes many retired professionals who have given a lifetime of support to progressive parties. They are probably not annoyed enough to switch to the Coalition, but they are unlikely to be responsive to calls for donations or for help in marginal seat campaigns.

Whoever in Labor's backrooms thought up this idea should be put out to pasture. Labor needs a face-saving way to drop it and to address real tax reform – reforms that will see all wealthy retirees paying their fair share of tax..