Retirement Income Review Response

PLATO INVESTMENT MANAGEMENT – 3 FEBRUARY 2020

We are grateful for the ability to provide comments on the current review of the retirement income system ('the Review'). Plato Investment Management is an investment manager that specialises in managing equities for Australian superannuation investors, with a particular focus on managing retirement focussed income products for Australian retirees. As such we believe we are very well acquainted with many of the issues facing Australian retirees and working Australians approaching retirement. We have provided submissions for previous government inquiries, most recently participating in the House of Representatives Standing Committee Inquiry into the implication of removing refundable franking credits in 2018/19.

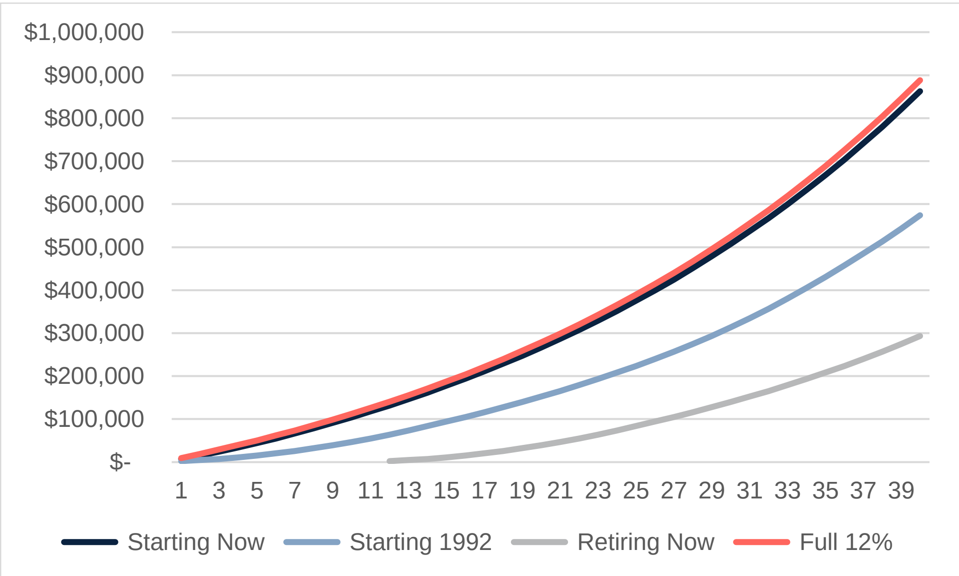
Model

In framing some of our responses, we have developed a simply superannuation model which can be used to understand issues facing our retirement system. The model assumptions are:

1) A worker works for 40 years, contributing superannuation according to the current projected superannuation rates, with 15% contributions tax;
2) The analysis is conducted in real terms (before inflation), enabling comparisons to be made in today's dollars;
3) The worker earns AWOTE of currently $1727.70 a week or $89,840 pa. We do not increase wages other than via modelling in real terms (essentially this means that wages rise with inflation);
4) Investments in super return 4% per annum in real terms after tax, with no allowance for investment risk.

This assumptions within the model can be varied and used to analyse a number of issues. For example, we note the Review discusses the maturity, or rather lack of maturity of the current system which started in 1992 with contributions initially at 3%. In Chart 1 we model the impact of the system's maturity.

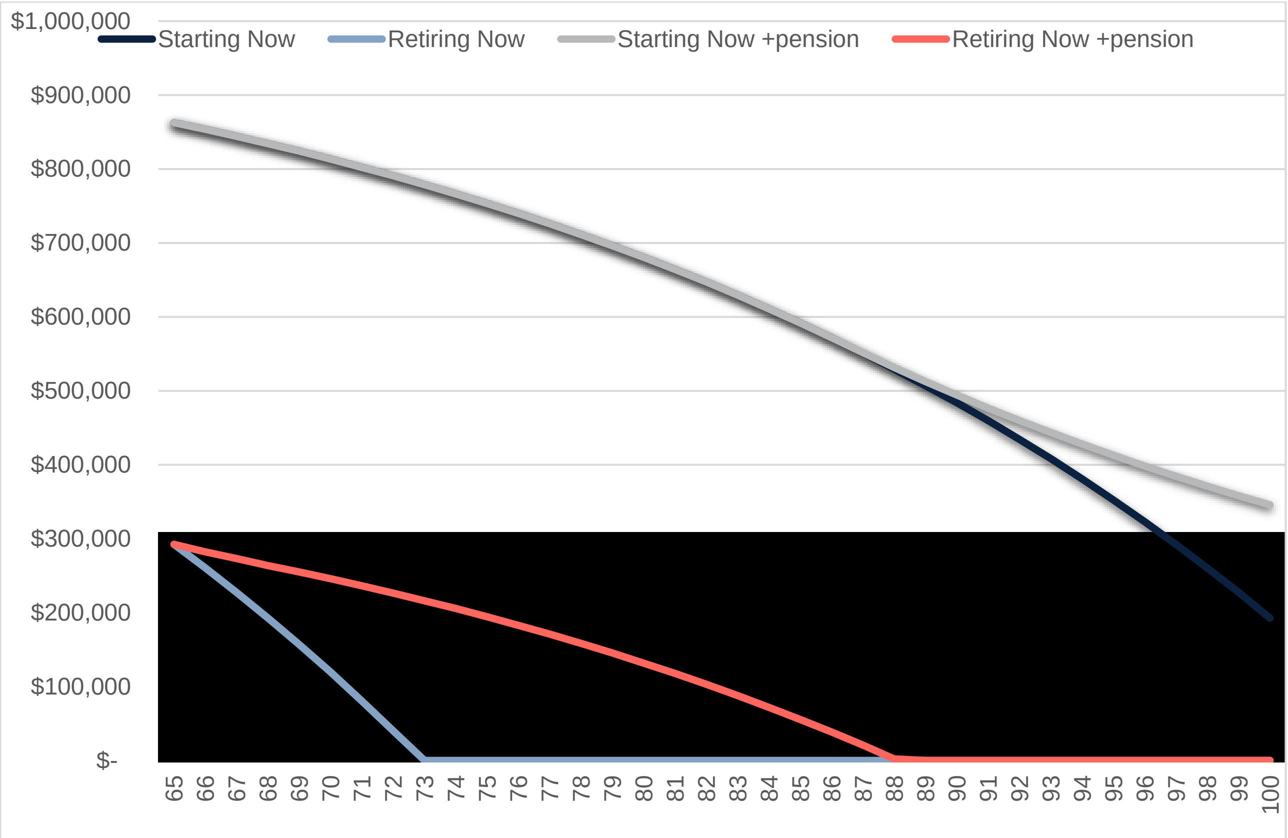
Chart 1. The impact of the superannuation system's maturity.



For someone entering the system now the black line the expected growth in superannuation over a working life. The expected superannuation balance after 40 years is approximately $862k. Were the worker subject to the full 12% contribution rate for all their working life this would increase slightly to $888k. However, for a worker who entered the workforce in 1992, they would only expect to retire with $574k, due to the much lower contributions in the early. Worse still, someone retiring today who only started saving for retirement in 1992, the expected balance is not quite $300k.

To further consider the impact on retirement income, we then model the drawdown stage using the same assumptions together with current aged pension rules (Assets test $547500 for an individual) assuming the individual owns a home and has no other assets other than superannuation and spends the ASFA comfortable allowance of $43,601pa. Chart 2 compares retirement balances for the Starting Now and Retiring Now examples from Chart 1, with and without the aged pension. Note that in the with pension examples, once superannuation runs out the individual will be completely reliant on the aged pension ($933 per fortnight). The aged pension significantly extends the period of time that one is able to consume the ASFA comfortable amount.

Chart 2. Declining retirement balances with and without the pension.



12. What evidence is available to assess whether retirees have an adequate level of income?

We believe any discussion around current retirement balances and income levels should take into account the information from Charts 1 and 2. Chart 2 highlights that the income levels of current retirees will be very reliant on the aged pension, and will likely be fully based on aged pension entitlements from around age 88. Retirees with smaller investment balances will be even more reliant on the aged pension (refer the gender gap example in Chart 5 below).

Our results are heavily reliant on the level of assets a person retires with and the expected rate of return on those investments. Relatively small changes in return assumptions, can have relatively significant impacts on outcomes, and create great angst for retirees. The recent policy debate around the refunding of franking credits highlighted this. We wrote two papers that highlighted the impact of such changes and their discriminatory nature ("Which individuals may be impacted by the ALP franking credit proposal" 2018 and "Which superannuation funds may be affected by the ALP franking credit proposal" 2018). We note that the loss of franking credits can severely impact a retiree's income, making reliance on the aged pension much more likely. We strongly argue that retention of franking credit refunds is important. This is particularly the case for existing retirees, or individuals about to retire, given the immaturity of our system as shown in Charts 1 and 2, and the current record low level of interest rate.

The analysis is also very reliant on the level of drawdown. We assume the ASFA comfortable standard for an individual as the drawdown. Our results would change significantly if one assumed a 70% of pre-retirement after tax income was the drawdown. Under the 70% metric, the retiring now case in Chart 2 would run out of investments 7 years earlier at age 81.

Another critical assumption that we make in our base case is that the base worker works and saves for 40 years before retiring. The assumption of 40 years of continuous work may be generous.

We have only shown analysis for individuals. Our modelling suggests that outcomes for couples are generally better than for individuals, again based on the ASFA comfortable spending level.

13. What should the Panel consider when assessing the equity of the retirement income system?

We find it difficult to grapple with the concept of equity and fairness. We think the following quote highlights the difficulty of assessing "equity".

"Part of the problem in trying to define the concept of social equity is that it reflects ideas of "fairness" and "justness" which have a normative component in that they are based on moral values or considerations. What one person thinks is fair may differ markedly from what another thinks is fair. Those working in different disciplines may also have different conceptions of the term. Philosophers such as John Rawls have explored how an equitable society may be brought about through notions of distributive justice and legal theorists have looked at equitable decision-making in terms of procedural fairness.

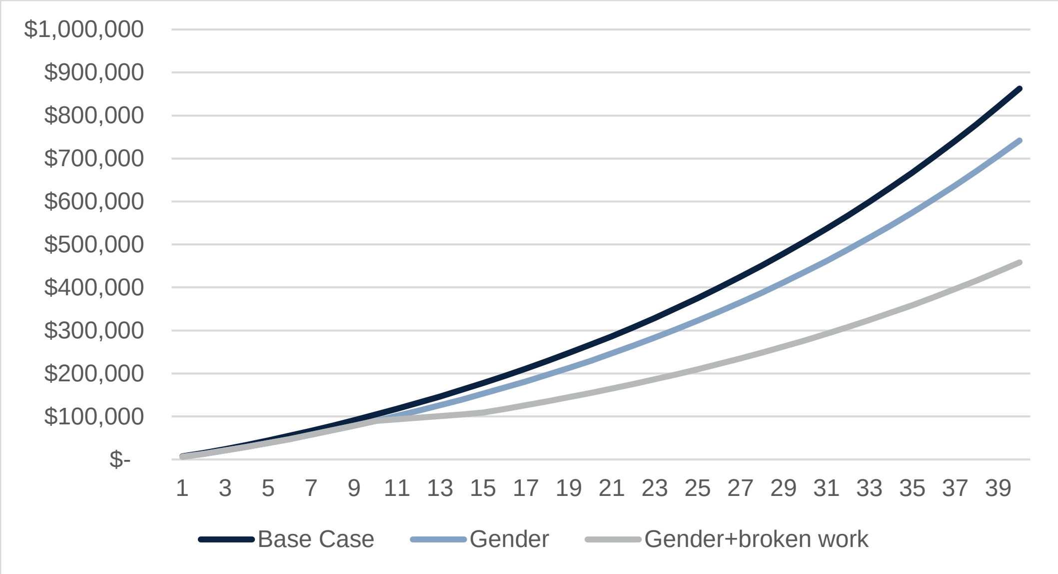
https://socialequity.unimelb.edu.au/stories/what-is-social-equity

The gender gap in superannuation highlights our struggle with the concept of equity. Clearly most people would consider that the fact that women have much lower superannuation balances than men, implies the system is not fair. However, from a procedural basis, the superannuation system doesn't discriminant against women. We will consider the gender gap in the following question.

14. What factors and information should the Panel consider when examining whether the retirement income system is delivering fair outcomes in retirement? What evidence is available to assess whether the current settings of the retirement system support fair outcomes in retirement for individuals with different characteristics and/or in different circumstances (e.g. women, renters, etc)

We will use our superannuation model to explain the gender gap. We start with the gender pay gap issue whereby women earn 14% less than men (https://www.wgea.gov.au/data/fact-sheets/australias-gender-pay-gap-statistics). If women earn 14% less than men, they will also generally save 14% less towards their superannuation, and our simple model confirms this represents a 14% lower ending superannuation balance. If we further allow for women having career breaks and returning to work on a part time basis, we believe we can fully explain why there is a significant gender gap. Chart 2 shows that allowing for a 14% gender pay gap, a career break of 5 years after 10 years of full-time work, followed by part time work (50%) thereafter can explain a gender superannuation gap of almost 50%.

Chart 3. Explaining the superannuation gender gap.



Solving the gender superannuation gap is easier said than done. Solving the gender pay gap would be a good start but would only reduce the gap by around 12% if women continue to have significant career breaks.

Perhaps a novel part solution to the superannuation gender gap for many women would be for the system to allow for joint superannuation accounts. Allowing for shared superannuation accounts would solve the problem for couples, but not for single women. We note that other features of the retirement system do take into account the status of individuals/couples (e.g. the aged pension), so this change would simply formalise how the aged pension system works for couples. Of course, changing the system would initially involve considerable administration costs, however, there are likely to be reduced ongoing costs associated with the consolidation of superannuation accounts.

Chart 3 only plots wealth to retirement, so to see the impact on retirement income, we extend our model to plot the impact on retirement incomes using the methodology from Chart 2. Chart 4 compares the retirement incomes of our base case with the gender gap case. As can be seen, we would expect both males and females entering the workforce today to be able to draw on the ASFA comfortable income level through retirement.

Chart 4 suggests that workers entering the workforce should be well catered for by our retirement system. However, for workers retiring now, who have only been covered by the system since 1992, the outcomes aren't as good. In Chart 5, we replicate Chart 4 for individuals retiring now, who have only been in the system since 1992. Chart 5 highlights that under our base case, a male will likely run out of superannuation by around age 88, with access to the aged pension significantly supplementing consumption. However, taking into account the gender gap we model (47%), the outcome for females retiring now is much less positive, with a female being entirely dependent on the aged pension from around age 75.

Chart 4 Retirement balances for base case and the gender gap case.

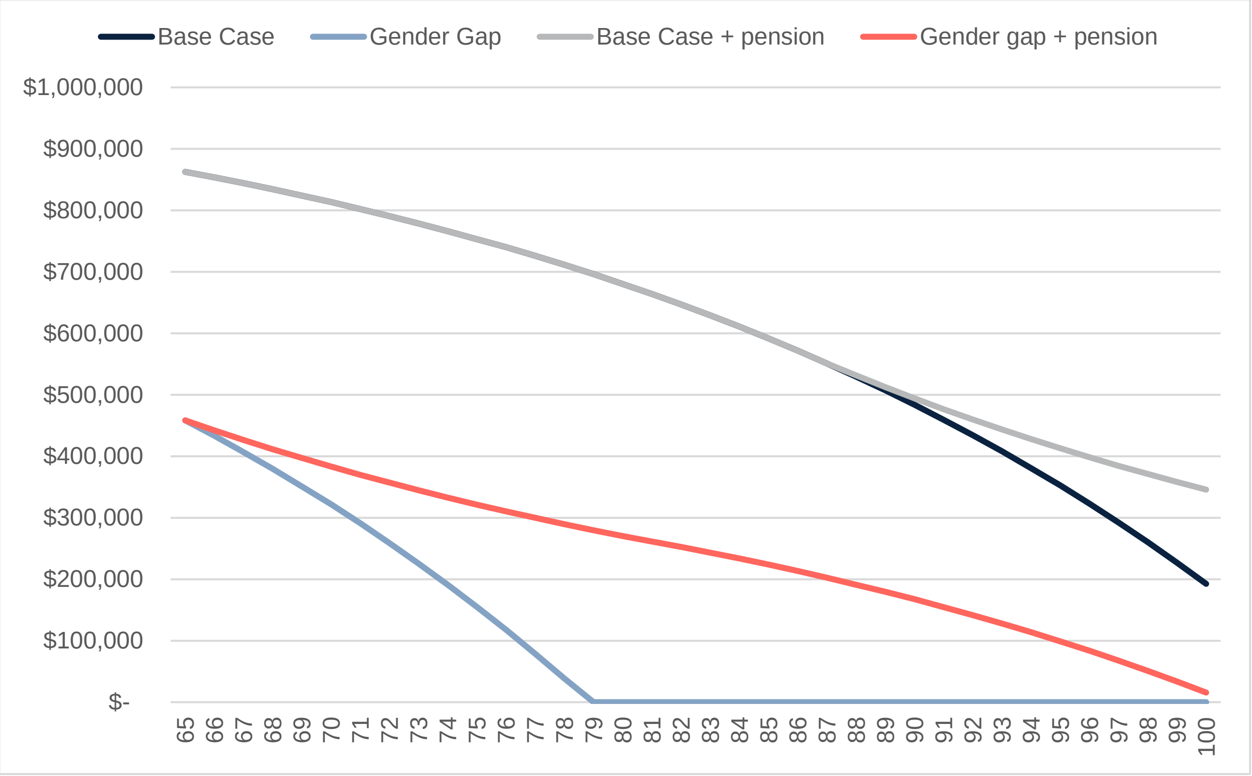
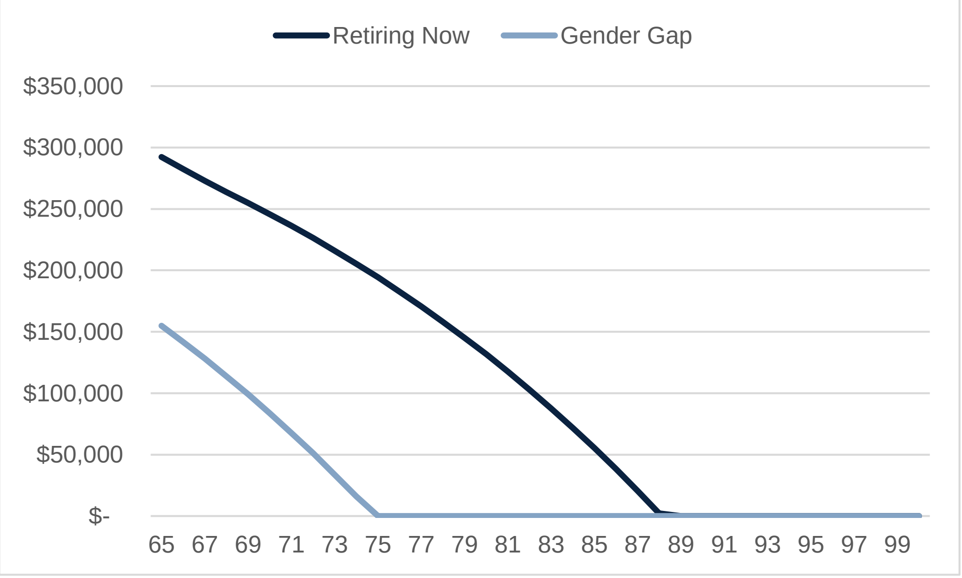


Chart 5. Retirement balances for individuals retiring now supported by the aged pension.



We will leave the concept of fairness for others to determine.

19. What factors should be considered in assessing how the current settings of the retirement income system (e.g. tax concessions, superannuation contribution caps, and Age pension means testing) affect its fiscal sustainability? Which elements of the system have the greatest impact on its long-term sustainability?

Many commentators have questioned the sustainability of current tax concessions, although we note that recent changes to limit contributions and the dollar amount in pension phase super have significantly reduced these concessions at the high end. Nevertheless, Figure 4 of the Review highlights that overall tax concessions are still likely to be somewhat larger for the top 10% of income percentiles.

Figure 4 implies there may be some merit in also limiting the total amount in superannuation, not just the amount in pension phase superannuation. However, we believe Figure 4 only shows part of the overall tax situation. A recent Treasury Working Paper "Recent personal income tax progressivity trends in Australia" 2019 (https://treasury.gov.au/sites/default/files/2019-09/p2019-t396438.pdf) looks at the total level of income tax paid by the top 10% of individuals. The top 10% of tax-payers paid 45% of all personal income tax in 2015-16 in spite of the high tax concessions for superannuation enjoyed by this top 10%. Since the 1994-95 tax year, when superannuation contributions were much lower, this percentage has risen 9% from 36%. The paper concludes "*Successive Australian governments have collectively reduced marginal personal tax rates and increased personal tax thresholds, and, in doing so, have redistributed personal income tax incidence away from lower income earners and towards higher income earners. There has been a consequential increase in personal income tax concentration onto a narrower proportion of high income earners within the Australian population.*" Were superannuation tax concessions to be reduced for the top 10%, the proportion of tax paid by those 10% would increase even further.

In terms of sustainability, we also note that our Chart 2 implies that we would expect workers entering the workforce today would expect to rely much less on the aged pension compared to workers already retired or retiring today. We would thus expect the percentage of aged pension recipients in Figure 5 to substantially fall over the next 40 years, which should improve the sustainability of the retirement system.

About Plato Investment Management Limited

Plato Investment Management Limited (Plato) (ABN 77 120 730 136) is an equity investment management firm specialising in providing retirement income for pension phase investors and SMSF investors.

Plato was founded in Sydney by Dr Don Hamson and currently manages over $5.7 billion in FUM (31 December 2019). Plato is majority owned and operated by its investment staff and supported by its minority equity partner, Pinnacle Investment Management Limited, a leading multi-affiliate investment management firm. For more information please visit www.plato.com.au

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Which superannuation funds may be affected by the ALP Franking Credit Proposal?

Dr Don Hamson – September 2018

The ALP proposal to limit refunding of franking credits will clearly impact pension phase self-managed superannuation funds (SMSFs). We believe it has the potential to impact many other superannuation funds. In this paper we build a model of the key variables which determine whether a superannuation fund is likely to lose refunds of net franking credits under the ALP proposal. Our model is consistent with and helps explain an article in The Australian[1] which reported that $309m in franking credit refunds were paid to over 2000 APRA regulated superannuation funds, including 50 (out of a total of 240) large APRA funds, in 2015-16, impacting 2.6m member accounts.

The ALP proposal

On March 13 the ALP announced a proposal to abolish the net refunding of franking credits to Australian investors other than for charities and endowments which would be exempted from the proposal. The initial proposal was expected to impact 1.17m individuals and superannuation funds and generate $59B in government savings over 10 years.

On March 26 2018, the ALP revised their proposal in the light of significant public criticism of the initial proposal. Direct investments by pensioners (part and full on aged, disability and other Centrelink pensions) were excluded from the no franking credit refund regime. This exclusion means that 306,000 individuals on pensions will continue to receive franking credits on investments in Australian shares and partly offsets the criticism that this proposal impacts many battlers. SMSFs are also exempt from the no refund rule if they had at least one pensioner or allowance recipient member before March 28 2018, but we understand this exemption only applies to SMSFs, and not to other superannuation funds.

Which super funds are affected?

The proposal looks to abolish the net refunding of franking credits, but franking credits themselves are not abolished. Australian investors can continue to use franking credits to offset income tax payable and for a superannuation fund, contributions tax payable.

Whilst the ALP believes the main superannuation funds impacted by this proposal will be pension phase SMSFs, ATO taxation data (as quoted in The Australian)

[1] "*Labor's $3.75B retiree savings grab revealed*" The Australian, April 18 2018.

and analysis of APRA statistics show that many APRA regulated funds will likely also be impacted. This implies the impact of this proposal may be far broader than initially predicted (1.17m individuals).

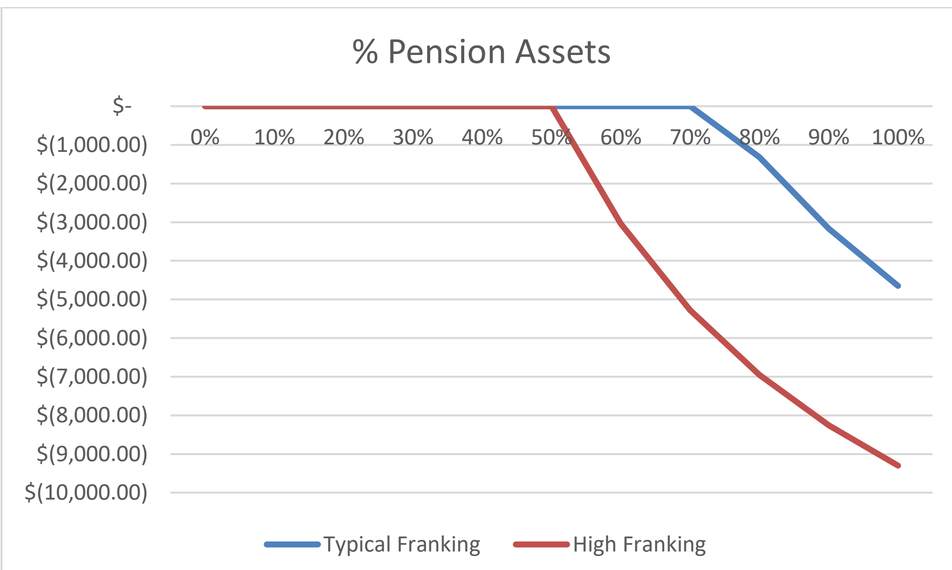
To better understand which superannuation funds may be affected we built a superannuation tax model under which we undertake sensitivity analysis of the key drivers to losing franking credit refunds and their potential magnitude. Franking credits will be lost if total tax payable by a superannuation fund is less than franking credits received. Tax payable by a superannuation fund is a function of tax on investment earnings on the accumulation portion of a fund, as well as contributions tax payable on normal contributions. The percentage of pension phase assets, the level of taxable earnings and the level of contributions will vary from fund to fund and may vary from year to year. For example, taxable investment earnings will be largely determined by the state of investment markets. The level of franking credits can also vary between funds and over time. We base our estimate of the typical impact of imputation assuming an average SMSF exposure to Australian shares based on March 2018 ATO statistics of 31%, and the franking credit yield of the S&P/ASX200 Index which has averaged approximately 1.5% pa over the 10 years to December 2017. Investors with higher allocations to Australian shares, or allocations to higher yielding Australian shares could earn even higher levels of franking credits and would thus stand to lose more if franking credit refunds are denied. In our sensitivity analysis we double the level of franking credits in our high franking scenario.

We then varied the proportion of a superannuation fund devoted to pension and accumulation as well as the levels of franking credits, contributions tax and taxable income[2]. Figure 1 illustrates the outcome of our sensitivity analysis varying the proportion of pension assets and the level of franking credits. Clearly funds with 100% pension assets will lose all their franking credits assuming they are not subject to the pensioner exemption for SMSFs. We estimate that for a typical level of franking credits, funds with 70% or less in pension assets should not expect to lose franking credits. For funds with double the typical level of franking credits this number drops to 50%.

[2] We vary pension proportions in rests of 10% from 0% to 100%. For franking credits we used a normal level of franking credits as discussed above and then we doubled the level of franking credits to reflect a higher exposure to Australian shares and/or a higher franking yield from the Australian portfolios. We use two levels of contributions – none (reflecting for instance pension phase SMSF with greater than $1.6m balances per member) and 7% of the accumulation balance which attract contributions tax of 15%. Similarly we varied the taxable income level which can be caused by for instance realisation of capital gains. Full details of our assumptions are available on request.

If accumulation phase (or 15% taxed) members aren't paying contributions and therefore aren't paying contributions tax, funds are more likely to lose franking credits, whilst funds with higher levels of taxable income would be less likely to lose franking credits. Higher levels of taxable income are usually associated with strong markets and/or the realization of capital gains.

Figure 1. Sensitivity analysis of the impact of non-refund of franking credits for superannuation funds expressed as $ annual cost on $1m pension balance.



Source: Plato

We also note that the number of funds impacted will likely vary from year to year in response to the level of investment returns. When investment returns are very low or negative, tax on investment earnings will also be low, increasing the chance that the value of franking credits received by a fund exceeds tax payable. Accordingly, when investment returns are low, a higher percentage of superannuation funds may miss out on some or all of their franking credits, exacerbating the low investment returns.

Summary and Discussion

In this paper we have developed a model to predict the likely superannuation funds which may lose franking credits should the ALP's proposal to limit the refunding of net franking credits be implemented in its current form. This model suggests that it is not just pension phase SMSFs which will be impacted by the ALP proposal. We find that the loss of franking credits is likely to positively related to:

1) The percentage of assets in pension, with maximum loss at 100% pension assets, but losses starting to occur from 50% to 70% pension assets; and
2) The level of franking credits generated by the underlying assets (the more franking credits generated the more likely you are to lose some);

and negatively related to:

3) The level of taxable income generated from the underlying assets (with losses in franking credits more likely in periods of weak investment markets/weak taxable income meaning investors may likely receive a double hit to returns); and
4) The level of contributions/contributions tax payable by accumulation members (the less contributions tax payable the more likely a fund loses franking credits).

Our model explains why The Australian reported that 50 large APRA regulated superannuation funds (out of 240) received net refunds of franking credits in the 2015/16 tax year. Our model finds that any relatively mature superannuation fund, where maturity is defined by the percentage of member balances in pension mode, may be in a net franking credit refund position.

Whilst many SMSF members have been vocal critics of this proposal, we believe members of other superannuation funds probably don't even know they receive franking credit refunds (they are not reported on investment summaries) and probably won't know whether they might miss out on franking credits should this proposal be enacted. We suggest these members or their advisors should ask – would my superannuation fund lose net franking credit refunds?

Finally, we believe that as the superannuation industry matures as a whole, as more and more members of superannuation funds migrate to pension status, the loss of franking credit refunds will impact a growing number of superannuants, be they members of government, industry, retail or SMSFs. As such we believe this proposal may represent a ticking time bomb for the whole superannuation industry.

Which superannuation funds may be affected by the ALP Franking Credit Proposal?

Dr Don Hamson – September 2018

The author is a member of a self-managed superannuation fund which currently receives franking credits and may be impacted by the proposed changes.

Which individuals may be impacted by the ALP franking credit proposal?

Dr Don Hamson – October 2018

In our previous paper entitled *"Which superannuation funds may be affected by the ALP franking credit proposal"* we found that members of many superannuation funds, not just SMSFs, may be impacted by the ALP proposal to no longer refund franking credits.

In this new paper, we consider which individuals, investing in their own names, may be impacted by the ALP proposal.[1]

The ALP proposal

On 13 March 2018 the ALP announced a proposal to abolish the net refunding of franking credits to Australian investors, other than for charities and endowments which would be exempted from the proposal. The initial proposal was expected to impact 1.17 million individuals and superannuation funds and generate $59 billion in government savings over 10 years.

On 26 March 2018, the ALP revised their proposal in the light of significant public criticism of the initial proposal. Direct investments by pensioners (part and full on aged, disability and other Centrelink pensions) were excluded from the no franking credit refund regime. This exclusion means that 306,000 individuals on pensions will continue to receive franking credits on investments in Australian shares and partly offsets the criticism that this proposal impacts many battlers.

Which individuals will likely be impacted?

The proposal looks to abolish the net refunding of franking credits, but franking credits themselves are not abolished. Australian investors can continue to use franking credits to offset income tax payable, they simply won't be able to receive a net refund of franking credits under the proposal. Individuals currently receive a refund of franking credits if the franking credits they receive on dividends exceed their total tax payable.

Franking credit refunds will depend upon the circumstances of each individual, such as other income earned, PAYG tax, deductions etc. Given it would be impossible for us to model each

[1] Many articles have showcased individual examples of people who may lose franking credits, but to our knowledge no-one has broadly documented who might be affected.

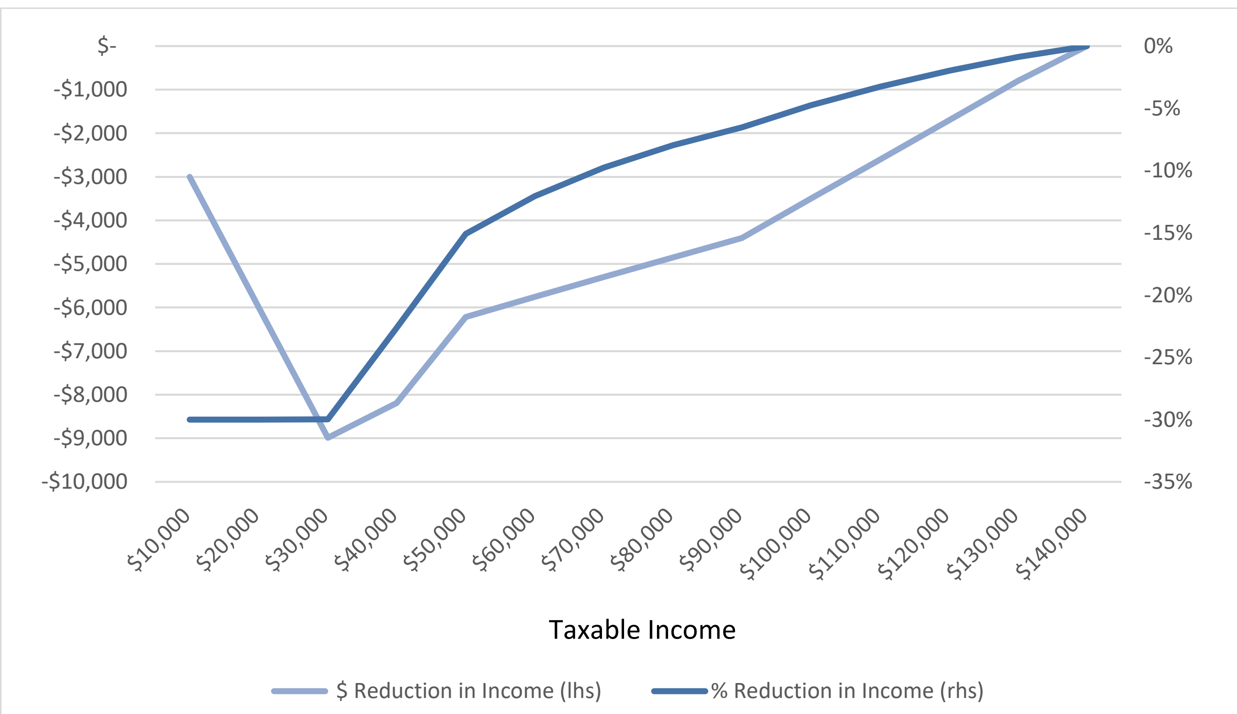
type of recipient of a franking credit refund, so we primarily focus here on those who arguably are most impacted – fully self-funded retirees living off the income of their investments.

Self-funded retiree individuals

Fully self-funded retirees receive no pension entitlements, and therefore will lose the ability to receive a net refund of franking credits under the ALP proposal.

In Figure 1 we model the estimated franking credit refunds for a single fully self-funded retiree whose only income is fully franked dividends, taking into account Australia's marginal tax rates, the Medicare Levy, and tax offsets including the Seniors and pensioners tax offset where applicable. We also assume the individual has no income tax deductions.

Figure 1. Estimated impact of losing franking credit refunds on net income for self-funded retirees receiving fully franked income only.



Source: Plato

Dr Don Hamson – October 2018

A single self-funded retiree should currently receive $9000 in franking credit refunds at a taxable income level of $30,000 ($21,000 in fully franked dividends and $9,000 in franking credits). At this level, a retiree subject to the Seniors and pensioners tax offset would pay no income tax, and thus should currently get a full refund of all franking credits.

Should the ALP policy come into play, this retiree would lose those franking credit refunds, a loss representing 30% of a retiree's after-tax income. Above $32,915, which is the point this tax year when the Seniors and pensioners tax offset phases out, retirees start to become liable to pay income tax, so the dollar and percentage level of franking credit refunds will start to decline.

We estimate the loss in after tax income is around 23% for someone on a taxable income of $40,000, 15% at $50,000 and 12% at $60,000. Even a single retiree earning up to $130,000 in taxable income from Australian shares would stand to lose a small refund of franking, **effectively paying a higher rate of tax than a standard PAYG wage-earner.**

The loss in franking credits would vary if an individual had other income such as interest received or wages (likely be lower), or tax deductions (likely be higher).

Of course, it is somewhat unrealistic to assume that a retiree only has income from Australian shares, so below we show a real case study of a self-funded retiree who has other investments in addition to fully franked Australian shares.

A Case Study – Mrs H[2]

Mrs H was a fully self-funded retiree, owning a modest home in the outer northern suburbs of a capital city, living off the income from a portfolio of direct shares and some bank deposits. Her assets, other than the home, totaled $650,000, with $50,000 in non-income bearing assets. Of her investments, $500,000 are invested in fully franked dividend paying Australian companies and $100,000 invested in term deposits and cash. Mrs H is ineligible for a part aged pension, since her assets exceed the maximum assets test level (currently $564,000 for a single homeowner).

Mrs H currently has a taxable income of $30,571. The $100,000 in deposits only earns $2,000 in interest, while the share portfolio yielded an average 4% cash dividend providing $20,000[3]. Importantly the dividends were all fully franked, receiving $8,571 in franking credits (these are included in taxable income). With no tax payable due to the Seniors tax offset, Mrs H received

[2] Full name withheld.
[3] Unusually, Mrs H's portfolio was not dominated by high yielding banks and Telstra, hence the relatively low cash yield.

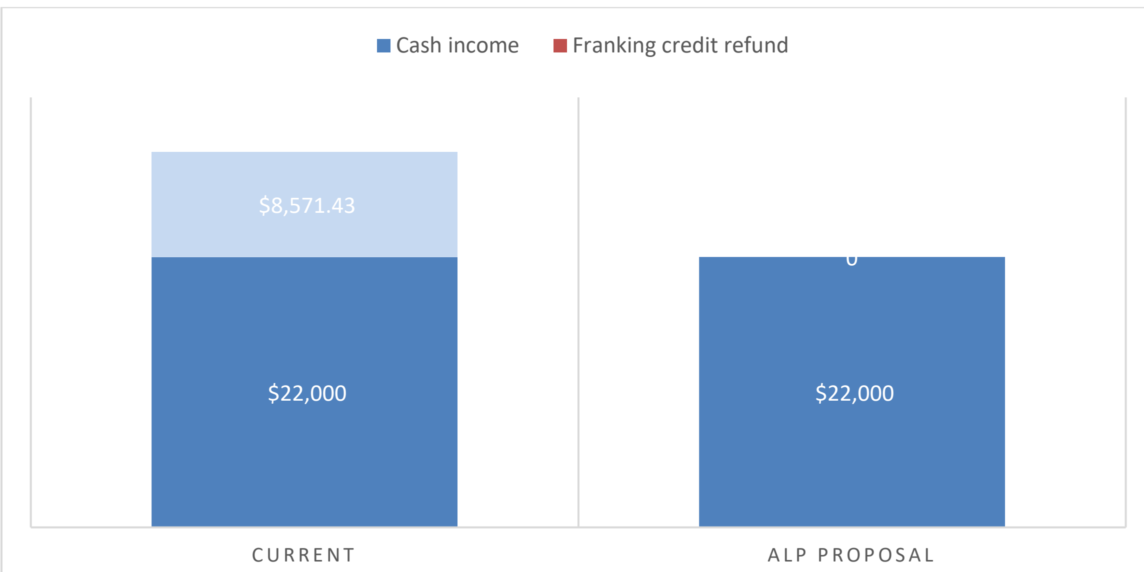
a full refund of her franking credits, considerably boosting her cash income from $22,000 to $30,571.

Since Mrs H is not eligible for any pension entitlements, she would no longer receive those franking credits under the ALP proposal. The loss of $8,751 would reduce Mrs H's income by 28%, reducing her weekly income by $165, from $588 per week to just $423 per week.

This means her income would actually fall below the full aged pension for a single homeowner ($23,889 p.a. or $916.30 per fortnight /$458.15 per week).

Figure 2 highlights the expected fall in annual income if the ALP proposal comes into force.

Figure 2. Estimated income for Mrs H now and should the ALP franked credit proposal be implemented.

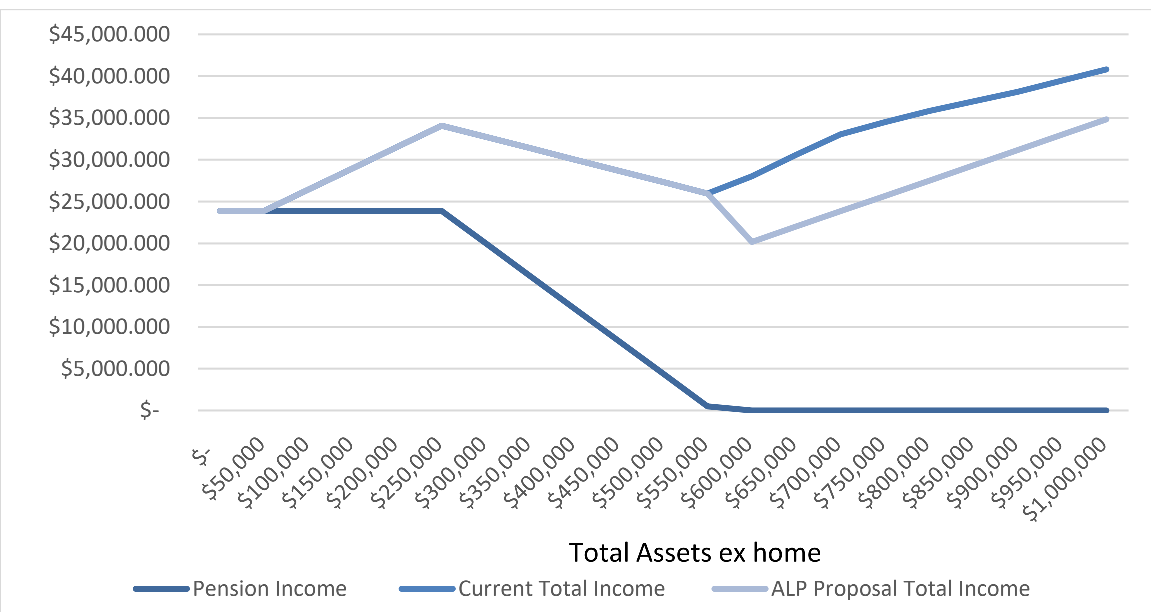


To put Mrs H's position into perspective, we have tried to provide a measure of how her income compares to others. Mrs H's current level of income would place her amongst the poorest 30% of single households according to www.comparyourincome.org/income_inequality_in_australia , and in the bottom 10% should the franking refunds be stopped. According to the *"Poverty in Australia 2018"* (ACOSS and UNSW Sydney) report, Mrs H's level of income post the franking credit loss would place her under the Poverty Line (based on 60% of median income, after housing costs for a lone person using 2015-16 numbers).

A generalised model

Of course, not everyone has the same value of assets as Mrs H, so in Figure 3 we vary the level of total assets, again assuming the first $50,000 of assets are non-income bearing (eg. car and home contents) and the same investment asset mix. We plot the total cash income now and should the ALP policy come into play. For reference purposes we have shown the value of the current single aged pension, which declines as assets grow, stopping completely at $564,000 (note the graph numbers are only calculated at rests of $50,000 in assets so that the $564,000 point is not shown). Single home-owning retirees will remain the same if they have below $564,000 in total assets (excluding the home) as pensioners will continue to receive full franking credit refunds. For non-pensioners, the ALP policy has a large impact, with income initially falling by 28% relative to the current situation, as one loses the value of franking credits. The percentage loss in net income declines as assets rise, but we still estimate the loss in net cash income to be around 15% for someone with $1m in assets outside the home.

Figure 3. Estimated variation in incomes for single home-owner retirees investing predominantly in Australian shares should the ALP franked credit proposal be implemented.



Source: Plato

On our estimates, a single home-owning self-funded retiree needs to have more than $750,000 in assets ($700,000 investible assets) under the ALP proposal in order to earn the same income as a part pensioner with $550,000 in assets based on our asset mix.

This would provide a significant incentive for any retiree with between $564,000 in assets (the assets test maximum) and $750,000 in assets to “spend” enough in order to get their assets below the $564,000 assets text maximum so as to receive a part pension and full franking credit refunds.

This spending could for instance be money spent on holidays or invested on the home (which is exempted from the assets test). We have already heard of a number of retirees who are doing just that with others planning to do so.

While we haven’t shown the results here, our modelling suggests a similar situation exists for home-owning couples above their maximum assets test level of $848,000. Again there will be a large incentive for couples with up to $400,000 over the asset’s test maximum to spend that money to get access to both a part pension and franking credits.

Sensitivity to Asset Mix

In the previous section we used Mrs H’s asset mix of 1/6 Cash 5/6 Australian shares. In Table 1, we provide a sensitivity analysis of the asset mix between cash and fully franked Australian shares, varying weights from 100% Australian shares to 100% cash based on an investment of $600,000 for a single home-owner self-funded retiree. Maximum losses (30% of current income) would be felt by investors 100% exposed to fully franked Australian shares, but even a 50% exposure to Australian shares results in an estimated loss of income of 22%.

One of the reasons why franking credits are so important for Australian retirees is that in the current environment, franking credits represent a substantial boost to income relative to income from other asset classes. Mrs H’s interest rate on cash at 2% is half the cash yield of her Australian share portfolio. Grossed up for franking, the yield on the Australian share portfolio is 5.7%, with 1.7% of that in franking credits. The 1.7% franking credit yield is actually higher than the current official overnight cash rate in Australia.

Table 1. Estimated loss in income for single home-owner retiree with $600,000 of investable assets varying asset mix between fully franked Australian shares and cash should the ALP franked credit proposal be implemented.

Cash	Australian Shares	Loss in Income
0%	100%	30.0%
17%	83%	28.0%
33%	67%	25.5%
50%	50%	22.2%
67%	33%	17.6%
83%	17%	10.9%
100%	0%	0.0%

PAYG and other non-retired individuals

Our analysis so far has focused on retirees, assuming all income is investment income. Working individuals may also be impacted by the loss of franking, but we expect this impact to be largely restricted to individuals in the **very** lowest tax paying bracket (earning less than $37,000) where the marginal tax rate is 19%.

We generally would not expect PAYG individuals earning more than $37,000 from their regular wages/salary to be impacted by the loss of franking credit refunds, as their marginal tax rate should be 32.5% plus Medicare levy, meaning they would likely have to pay a small marginal tax on franked dividends.

Non-working, but not retired individual investors would likely have similar but slightly lower losses of franking credits than retirees, as they would not benefit from the Seniors and pensioners tax offset.

Summary and Discussion

We have provided an analysis of how much individuals are likely to lose should they be denied franking credit refunds under the ALP proposal.

Worst impacted individuals are likely to be retirees who just miss out on the aged pension due to having slightly more assets than the maximum assets test level. They could stand to lose up to 30% of their current income levels if they solely invest in fully franked dividend paying companies.

In a case study, we found self-funded retiree Mrs H would stand to lose 28% of her income should she be denied franking credits. Without franking credits the annual income on her $500,000 in Australian shares and $100,000 in cash would fall from $30,571 to just $22,000. The reduced income level would be less than the full single aged pension and would place her under the Poverty Line (60% of median income, after housing costs for a lone person using 2015-16 numbers Source: ACOSS UNSW 2018).

A 28% reduction in income is a substantial reduction, particularly for someone who is retired and would be highly unlikely to be able to re-enter the workforce to make up for the loss of income.

There would, however, be strong incentives for such retirees to spend sufficient money (on for instance holidays or the home) to bring them below the assets test maximum, so as to receive a part pension and full refund of franking credits. **This, of course, defeats the purpose of the ALP policy.**

Our modelling also reveals that the maximum dollar and percentage loss of income will be felt by the least well off self-funded retirees with taxable income levels around $30,000 a year for an individual home-owner. Franking credit refund losses reduce as taxable income rises, mirroring the rising average (and marginal) tax rate of the Australia personal tax system.

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The author is a member of a self-managed superannuation fund which currently receives franking credits and may be impacted by the proposed changes.