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How Labor's tax policy will deliver 'perverse' outcomes

Labor's plan to deny franking credits to some self-funded retirees mean a couple with $1 million will end up with a smaller income than a couple with $500,000.

by **Joanna Mather**

Financial planners have detailed a range of "perverse" outcomes likely under Labor's plan to deny franking credits to some self-funded retirees.

Take the example of a husband and wife with $1 million who end up receiving a smaller income in retirement than a couple who saved $500,000.

This is because the first couple – we've called them the Joneses in our example – are ineligible for the age pension and, if Labor is elected, their status as non-pensioners will mean they are no longer entitled to franking credit refunds either.

As a result, their income will be $50,000 in 2019. This compares with $56,000 for the Smiths, who saved half the amount the Joneses did but are able to get the part-pension and the full benefit of franking credits.

Compare the pair

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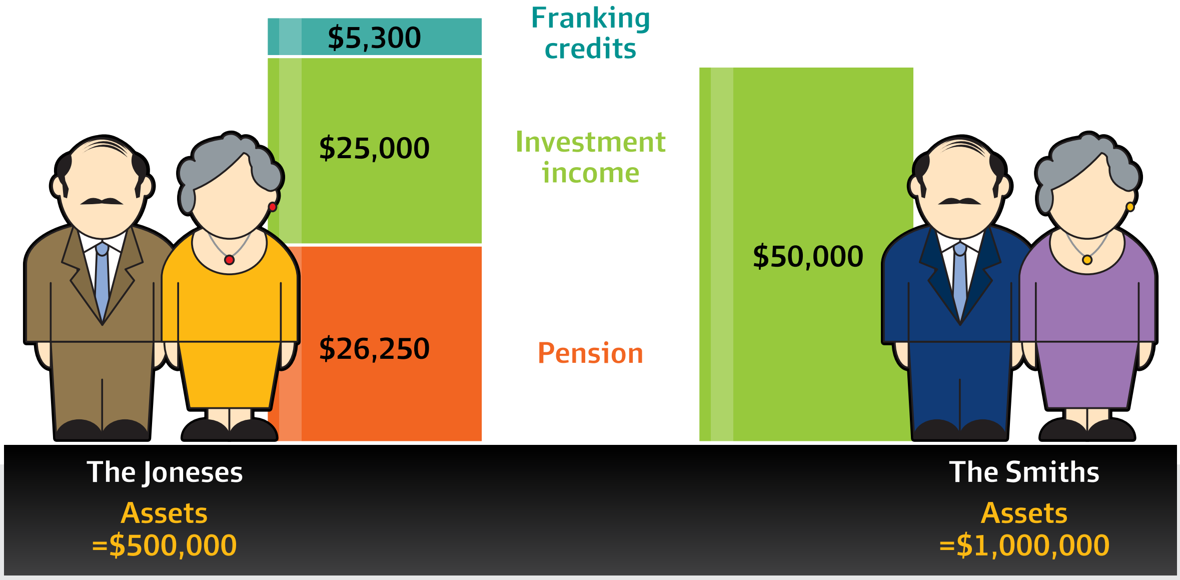
Our couples, the Joneses and Smiths, are aged over 65. The Joneses have **$500,000** in assets in addition to their family home; the Smiths **$1 million**.

Assume both invest half of their assets in a balanced portfolio earning 5%, and the other half are in fully franked Australian shares which also earn 5% in dividends. Each couple's total income is their pension + investment income + franking credits.

Labor has announced it will deny franking credit refunds. The "pensioner guarantee" provides a permanent exclusion to all recipients of a full or part age pension. For SMSFs, the exclusion applies only if they were in receipt of pension payments on March 28, 2018, after which there are no exclusions.

$56,600 TOTAL INCOME **$50,000**



Source: Australian Investors Association, Atlas Wealth | Interactive: Les Hewitt

By way of further comparison, the full age pension for a couple is $38,000 a year.

Jon Kalkman, a former vice-president of the Australian Investors Association, most of whose members are self-funded retirees, said seniors of modest means would suffer if Labor's changes came to pass, not the rich.

"This policy treats some retirees very unfairly it creates perverse incentives for some to give up their self-reliance in retirement and allow the taxpayer to take responsibility for their income, healthcare and age care," he said.

"They are offended at the misrepresentation with the sneering suggestion that all self-funded retirees are multimillionaires who are using a tax rort at the expense of hard-working Australians."

Earlier this month Opposition Leader Bill Shorten announced a Labor government would make all franking credits non-refundable.

After copping criticism, he softened the policy with a "pensioner guarantee".

This guarantee means everybody receiving a government age pension or entitlement will still get refunds.

Self-managed super funds with at least one member in receipt of a pension on or before March 28, 2018, were also quarantined.

Going forward, no SMSFs will be eligible to receive refunds. The policy will increase federal government revenue by $10.7 billion in its first two years.

If the Smiths in the above example had their money in an SMSF and started receiving a part-pension after March 28, they would be ineligible for refunds.

On the other hand, if the Joneses and Smiths had their money in a pooled super fund, they would be neither better nor worse off.

To be clear, all shareholders will still be able to use their franking credits to reduce taxable income. But for retirees, who largely do not pay tax, these credits are useless. Which is why the loss of refunds will be material for many. The SMSF Association estimates about 1 million people will be affected.

Work less, save less

Brisbane-based financial adviser Jason Delisser gives another example: a retired couple with $300,000 of Australian shares receiving a 4 per cent dividend (franked at 100 per cent for illustrative purposes).

The couple would have total income of $52,716 a year, thanks to multiple income streams from the age pension, dividends and franking credits.

Now, take a couple who have $900,000 invested in the same manner.

They would receive annual income of $36,000 – 32 per cent less.

Mr Delisser is worried the situation will reach a "tipping point" where pre-retirement advice constitutes working less, accumulating fewer assets and skewing investments to the tax-sheltered family home.

He said Labor's franking credit policy would narrow the gap between the income one could expect as a self-funded retiree and the value of the age pension.

"Let's say you're heading to age-pension age and you have two alternatives," he said.

"Option A is to accumulate $800,000 and option B is to accumulate $500,000 and spend the remaining $300,000 on whatever you please.

"Option B is going to provide increased government income through the age pension of approximately $23,000 a year, which is effectively a government-paid, risk-free return of 7.8 per cent on the $300,000 you have expensed.

"The latter is pretty compelling from an income perspective."

James Ridley, a financial planner with Atlas Wealth Management, said Labor's franking policy was as "destructive" as the Coalition's changes to the age-pension assets test.

"I don't think the ALP has provided a rational and logical justification for confiscating franking credits," he said. "If the proposed changes proceed, we will see a greater dependence on the age pension due to retirees having to draw down capital to maintain income levels.

"A lot of retirees will have to consider ways they can reduce their assets, whether it be through upgrading or renovating their homes or gifting, within limits, to other family members."