Dr Don Hamson, Plato Investment Management

Dr Don Hamson is the managing director of Plato Investment Management, which he founded in 2006, and has over 25 years' investment management experience. He has previously worked at State Street Global Advisors, Westpac Investment Management and Queensland Investment Corporation. He has written numerous white papers on after-tax investing and spoken at many conferences and seminars on the subject. Don is the deputy chair of ESG RA and has served on the ASX Corporate Governance Council. He has a PhD in Finance and a Bachelor of Commerce with First Class Honours from UQ, and a University Medal.

TAXING TIMES FOR INVESTORS

Dr Don Hamson

The ALP is proposing a raft of tax changes that will negatively impact after tax outcomes for many Australian investors should they be enacted.

Arguably the most controversial is the removal of cash refunds of franking credits, which we have written extensively on in 2018 (see our articles 'Robbing granny in the name of Paul', 'Which superannuation funds may be affected by the ALP franking credit proposal', 'Which individuals may be impacted by the ALP franking credit proposal', and our submission to the parliamentary inquiry), but they are also proposing to tax discretionary trust income in the hands of individuals at a minimum 30% tax rate, halve the capital gains tax (CGT) discount for individuals and limit negative gearing to new housing only. The franking and trust changes are not grandfathered, whereas the CGT and negative gearing changes are, only applying to new investments from a date yet to be announced. The top marginal tax rate for individuals is also to be raised by 2%. In this paper we consider the impact of these changes.

The biggest increases in tax are the effective 30c in the dollar reduction in the value of fully franked dividends and discretionary trust income for tax-exempt investors (pension phase SMSFs and very low-income individuals) who will not be able to reclaim franking credits and these changes are not grandfathered. The second biggest increase is the effective 13.3c in the dollar hike in CGT for the highest marginal tax rate individual, with CGT rates rising across the board for all taxed individuals. Low marginal tax rate individuals (19c plus Medicare Levy) also receive a not insubstantial 9c in the dollar increase in effective taxes on fully franked income and discretionary trust income.

Will these changes significantly impact returns? This is more difficult to determine. Some believe the franking changes may negatively impact share prices for high yielding stocks like the banks, and income securities. We did see a small sell-off in the price on income securities around the time of the ALP announcement, but prices have since strengthened. New issues of income securities have continued, despite the uncertainty. We don't believe there will be significant reductions in the prices of fully franked stocks because franking credits can still be largely used by the majority of Australian investors such as large APRA-regulated superannuation funds, and higher taxed individuals. Pension phase SMSFs would miss out on franking under the current ALP policy, but members could switch assets to APRA-regulated superannuation funds to continue receiving franking benefits.

Increasing the capital gains tax will reduce investment demand by individuals for all appreciating assets, but investors still need to invest in something. Demand for non-new property will be doubly impacted by both the increase in capital gains tax and the stopping of negative gearing, but investment in new property still enables negative gearing. This might lead to a bifurcated property market with investors preferring new properties over old, leaving old property largely left to home-owners. With both current capital gains tax and negative gearing to be grandfathered, this could lead to further bifurcation, with many current investors being reluctant to sell existing properties. So, whilst there may be less demand from investors for properties, particularly existing properties, there also may be

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less selling activity by existing investors. Overall though, we see these changes as a negative for property prices in what is already quite a soft housing market.

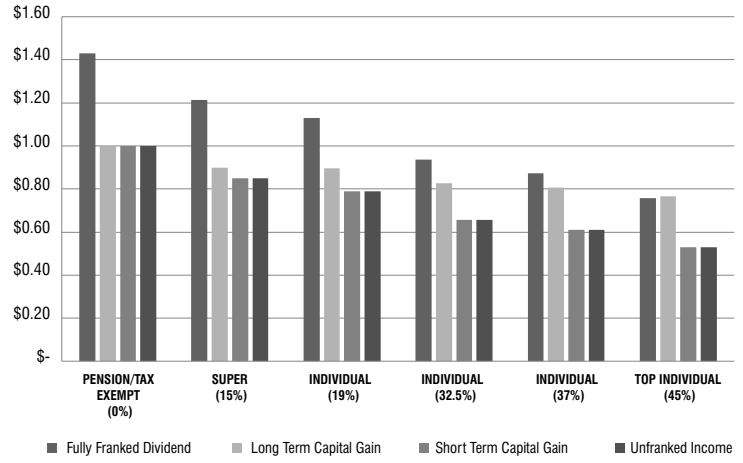
Interestingly, other than the franking issue, the ALP is not looking to increase taxes on superannuation. As such, there will be even more incentive for investors, particularly highest taxed investors, to invest via superannuation, although the ALP is also looking to tighten up non-concessional after-tax contributions cap to $75,000 p.a. with no bring-forward.

After-tax value of returns

In Figure 1, we show the current after-tax value of one dollar of pre-tax return for four types of investment returns – fully franked dividends (30% corporate tax rate), long-term capital gains, short-term capital gains and unfranked income in the hands of various taxpayers. Note for individuals we also add the 2% Medicare Levy to the relevant marginal tax rate. Fully franked dividends are currently the most valuable form of return for all Australian investors bar those investors on the very highest 45% tax rate, where the 50% CGT discount makes a long-term capital gain the most valuable. Figure 1 clearly shows the value of franking credits, but can be misleading, as the franked dividend is paid out of after-tax corporate profits, where 30% tax has already been paid, whereas other forms of returns have had no tax paid. For instance, no tax is paid on unfranked income such as interest income or rental income. If we add back the value of the corporate tax paid, in exactly the same way that franking credits are included in one's taxable income we get quite a different result, which is shown in Figure 2.

Figure 2 highlights that the current franking system puts taxes on corporate profits, and unfranked income held directly or via trusts on an equal footing. It also highlights the lower effective tax rate on capital gains.

Figure 1. The current after-tax value of one dollar of pre-tax income



Source: Plato

Post ALP changes

We re-draw Figures 1 and 2 post the ALP tax changes in Figures 3 and 4. We increase the top marginal tax rate by 2% and reduce the CGT discount by 50% for individuals, and factor in the impact of eliminating refundable franking credits. Note, we only show the CGT impact for new investments (refer our later discussion) and for superannuation taxed at 15%, we assume the superannuation fund has sufficient tax payable (tax on contributions and tax on other income) to offset or use up all the franking credits.

The impact of franking changes creates two classes of tax-exempt investors – those who still receive franking credit refunds such as charities and Centrelink pensioners, and those that can't. In this case, a dollar of fully franked dividend is only worth $1 for pension phase SMSF, not $1.43, a substantial difference. Similarly, for someone on the 19% marginal tax rate, a fully franked dividend is only worth $1, versus the $1.13 in Figure 1. For investors on higher tax rates, the value of fully franked dividends remains the same (other than for the highest marginal tax rate individual due to the 2c tax rate increase).

In Figure 4 you can clearly see the loss in value of fully franked income versus other forms of income for tax exempt investors who can't claim franking credit refunds. To further highlight the changes, Figure 5 plots the differences between the current situation, shown in Figure 2, with the ALP proposal, shown in Figure 4.

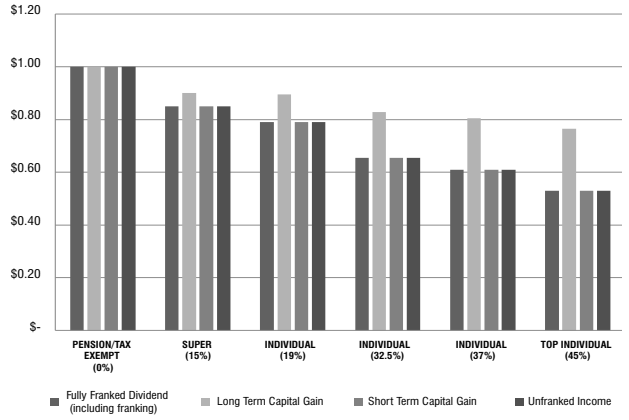
Figure 5 also clearly highlights the impact of not refunding franking to low tax investors (0% and 19%) tax rates, as well as the increase in the capital gains tax rate. The 30% loss in value on fully-franked dividends for tax exempt investors who can't utilise franking is by far the largest tax change, dwarfing the increases in taxes for the highest marginal taxed individual.

Tax on trust income

Under the ALP proposal, a Labor Government would introduce a standard minimum 30% tax rate from 1 July 2019 for discretionary trust distributions to mature beneficiaries aged over 18. We have attempted to model this for different individual tax rates, and for comparison purposes, show the after-tax values for franked dividend income and other direct unfranked income (for example interest or rental income) earned by individuals in Figure 6. Figure 6 clearly highlights that low tax rate individuals would be better off investing directly rather than via a trust or company structure. The effective tax rate for low tax investors (0% and 19% tax rates) rises to 30% on both franked dividends and trust distributions.

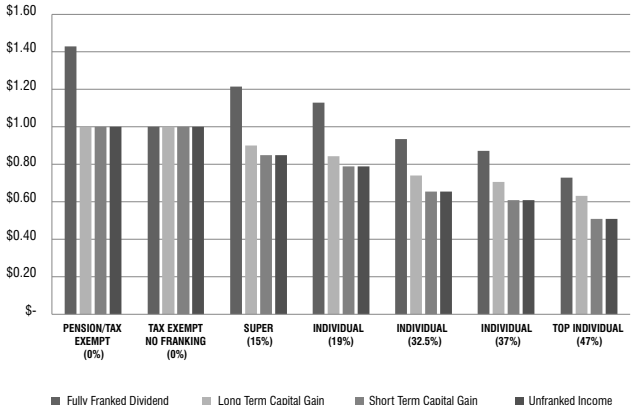
To consider the impact of the change, Figure 7 plots the current tax paid with estimated tax under the ALP proposal, for an individual receiving only taxable discretionary trust income. For simplicity purposes we have excluded the Medicare Levy. Whilst in percentage terms the biggest loss is for incomes up to $18200 per annum, the maximum dollar loss is for someone with a $37,000 taxable income.

Figure 2. The after-tax value of one dollar of taxable income including franking



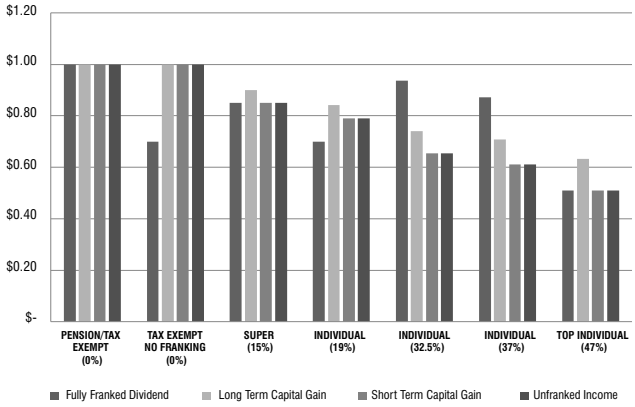
Source: Plato

Figure 3. The after-tax value of one dollar of pre-tax income under the ALP tax proposals



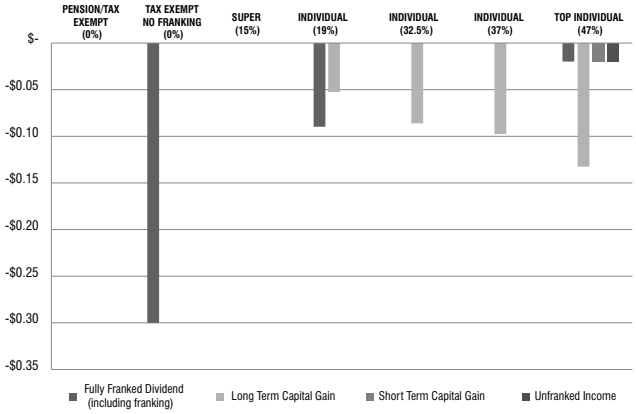
Source: Plato

Figure 4. The after-tax value of one dollar of taxable income including franking under the ALP proposals



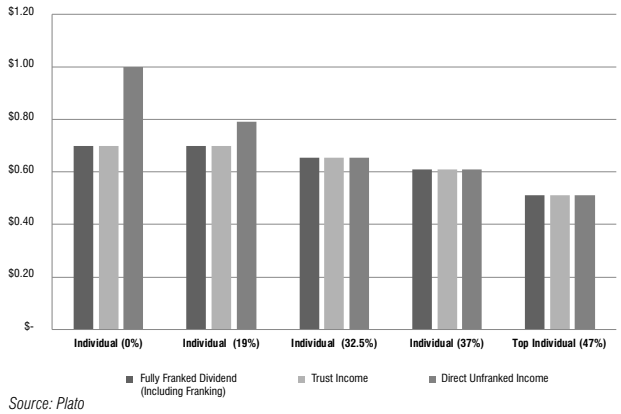
Source: Plato

Figure 5. Estimated differences in the after-tax value of one dollar of taxable income including franking credits under the ALP proposed tax changes versus current position



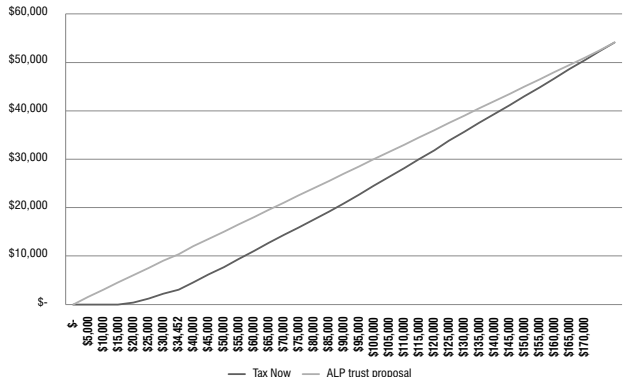
Source: Plato

Figure 6. The estimated after-tax value of franked income, trust distributions and other income for individuals under the ALP proposals



Source: Plato

Figure 7. The impact on ALP trust income proposal – all income from discretionary trust



Source: Plato estimates excluding Medicare Levy

Negative gearing and capital gains tax

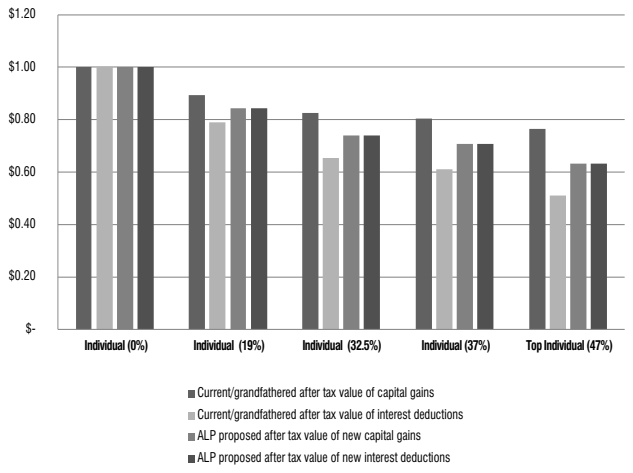
For negative gearing we have taken a slightly different approach. In Figure 8, we look at the effective tax rates on capital gains revenue and interest deductions under the current situation compared to the ALP proposal. Since the negative gearing and capital gains tax arrangements are grandfathered, the current situation will remain for assets already held. It should also be noted that Labor propose to continue to allow negative gearing of new housing, so the deductibility of interest remains the same for new housing as the current situation.

Currently under the negative gearing regime, interest is deductible at the investors marginal tax rate, so for a taxpayer on a 37% tax rate (39% including Medicare Levy) the current after-tax value of income paid is $0.61. I pay $1 of interest and save 39 cents in tax. On the other hand, the current tax rate on long-term capital gains is half the full marginal rate (19.5%) so the after-tax value of any long-term capital gains is essentially $0.805 – I receive $1 and pay 19.5 cents in tax. Under the ALP proposal, interest expenses are not allowed as a tax deduction at the individual's marginal tax rate (e.g. no negative gearing); rather they are carried forward to offset future capital gains. With CGT effectively increasing to 75% of marginal rates, the new effective CGT for this investor is 29.25%, so both revenue and expenses are worth $0.7075 after tax. However, it is actually worse than this, because we haven't taken account of the time value of money in Figure 8. Currently you pay interest each year and can deduct interest charges from negative gearing against income each year.

Under the ALP proposal, whilst you continue to have to pay the negatively geared interest each year, you can only carryforward the interest expense to offset against the capital gain when realised (interest expenses can be deducted in the year they are paid if they can be offset against other investment income from other investments under the ALP proposal). So the interest tax deduction will be in future dollars.

Figure 8 also highlights that there will be significant incentives for investors to hold onto grandfathered assets. **FS**

Figure 8. Changes to the after-tax value of capital gains and interest deductibility (negative gearing).



Source: Plato