THE TAX INSTITUTE

TaxVine

MEMBER FEEDBACK

Regarding Senior Tax Counsel's report 'The effects of Labor's proposal to deny excess imputation credits'

Editor's note: Bob Deutsch's article on the Labor party's proposal to deny excess imputation credits can be found in TaxVine 46 (30 November 2018).

Member 402 writes:

Hi Bob,

Thank you for entertaining the request to revisit some of the issues that you have raised in your article 'The effects of Labor's proposal to deny excess imputation credits'.

But more importantly, to address some of the misconceptions of how franking credits work within a retail superannuation fund.

I'm a member of the Institute and have been working in the financial services industry (specifically for organisations operating within the retail investments, superannuation and life insurance sector) for the past 20 years, managing income tax for such organisations and investors/members in their products. Accordingly, I do believe that I have the knowledge and experience to be able to comment or at least provide some insight as to how retail superannuation funds typically handle or deal with franking credits.

With this in mind, I would like to provide specific responses to certain sections (highlighted below) of your article and please note that everything stated below is from the perspective of a retail superannuation fund that operates a Master Trust investment structure.

But let's start with an explanation of this investment structure and how unit pricing works with such a fund and its product offering!

Investment structure

Yes, it is true that within such a fund, income tax is calculated at the whole of fund/entity level. However, fairness and equity amongst members is most certainly key and paramount from the trustee's perspective.

As a consequence, typically a fund is broken down into smaller investment (asset) pools which houses the interests and assets of members that belong in the same cohort. Now the cohorts typically within a fund can be setup a number of ways.

For instance, by asset class (eg equities, fixed interest, cash & etc.) and perhaps further broken down into sub-classes such as domestic vs global. A blend of these asset classes and sub-classes are possible which give rise to investment options such as Capital Stable, Balanced, Moderate, High Yield & etc, which attempt to appeal to all members and their appetite which vary across the risk vs return spectrum.

Of late and as compelled by law, investment option design and orientation based on asset classes have largely been ditched and replaced (under MySuper) with say Life Stage options, which are designed as low-cost options geared towards members who may be less engaged with their superannuation.

Here, investment options typically attempt to house members within say 5 to 10-year cohorts (based on the year or decade that they were born) and assuming that members at the same stage in their lives all share the same risk vs return appetite.

Furthermore, the very same investment options (whether based on asset class or life stages) will be replicated in order to separate members in accumulation from those in pension phase. In other words, there is at least a pair of the same investment option within a fund given the differential tax treatment of investment earnings in accumulation phase versus retirement (pension) phase which effectively doubles the number of cohorts required.

Nevertheless, it should be noted that every member in the same cohort will subscribe to units in the particular investment option that has been devised for that cohort. A member's value or interest in the fund (on a given day) is determined based on the number of units they hold *multiplied* by the price of those units on that day. In other words, based on their interest in an investment option.

Notably, there is nothing that prevents a member from investing in multiple investment options should they wish to diversify their investments within the fund.

Unit pricing

The unit price of an investment option is typically calculated based on the Net Asset Value (NAV) divided by the number of units on issue.

In other words, and on any given day, the Fund first needs to determine the total assets and then subtracts off that, the total liabilities of that investment option in order to arrive at its NAV.

Income tax and franking credits merely feeds into the above equation as a liability and an asset respectively.

Specifically, income tax on investment earnings represents a liability when accrued and not paid away to the ATO. Once paid however, the liability reduces, but the assets of the investment option (i.e. cash) also reduces.

On the other hand, franking credits represents an asset (receivable) when accrued and not yet received from the ATO. Once received, the receivable is extinguished, but the assets of the investment option (ie cash) increases by the same amount.

It should be noted that whilst there is no tax on investment income derived on investment assets within a Pension option, franking credits are still accrued daily within the Pension option's unit price given they are recognised as a refundable tax offset (at this present time).

However, the critical point here is that the pension side excess imputation credit of $1,000,000 can be utilised to offset the shortfall in tax payments that arise on the accumulation side.

A trustee in fulfilling and meeting its statutory/fiduciary duties (including best interest) will ensure that members in the same cohort are treated fairly and those in a different cohort are treated equitably. In practice, this is duty is carried out at the investment option level with tax calculated at this level and then aggregated to provide a whole of fund/entity tax position.

With this in mind and in your example, it is inconceivable that the tax liability of say an accumulation (Super) option with a tax liability of $1m can just be extinguished with the $1m tax asset of another investment option. Once again, that is not possible when you are required to calculate daily, a tax provision on a standalone basis for each investment option as part of releasing a unit price every day.

But more importantly, it would be inconceivable to mix or blend the tax outcomes of different members, after having consciously segregated the fund and methodically arranged members and their assets into discrete and separate cohorts.

While on this topic, I often ponder reading about all this, how and to what extent pension mode members are compensated for the benefit of the excess credit generated on their side of the ledger being used to reduce tax liabilities that would otherwise arise on the accumulation side of the ledger.

Even if there was to be a transfer of the tax benefit from one cohort to another (ie from one investment option to another), it would have to be on a like for like basis only (ie Super to Super or Pension to Pension) due to the differential income tax treatment.

But more importantly, any such transfer or value shift would have to be done on arm's length basis and most certainly that transfer value would not be nil or for no consideration.

I would suggest that the transfer value for franking credits as a tax offset would be dollar for dollar, if a trustee needed to treat all members (i.e. within and across different investment options) fairly and equitably.

So, in practice and on this standalone basis, an investment option that has a tax liability to pay, still needs to pay its tax liability. An investment option that is likely to receive a tax benefit in the form of franking credits as a refundable tax offset will accrue for that tax benefit.

This is the case, even if at the end of the day and come tax return time, the aggregation of all investment options to arrive at the fund's tax position seemingly suggests the franking credits referable to Pension options were used to offset the tax liability relating to the Super options.

Furthermore, if say a member of a Pension option was to leave the fund and redeem their units part way through an income year, the unit price used for their redemption will reflect the franking credit (ie tax asset) accrued up to that point.

In other words, a Pension member is not disadvantaged by their choice to leave before the fund's tax position is finalised for that income year.

Accordingly, I do not believe Pension members are in any way short changed or not compensated for any excess credits. Presently, they do not lose any of their franking credits whether to the Revenue or to any Super members of the Fund.

However, this is "no loss" outcome is only the case where the Fund is still in an overall net tax payable position (after taking into account franking credits as a tax offset).

Quite frankly, this is one of the misconception that I would like to dispel. That is, accumulation members somehow benefit from excess franking credits from pension members.

In practice, it is actually the accumulation members (at the investment option level) who generate a tax liability for the fund as a whole that effectively guarantees that all Pension options (and ultimately Pension members) currently get to retain all their own franking credits as a refundable tax offset.

Notably, the accumulation member does not enjoy any of this tax benefit on the basis they did not derive this in relation to their assets. But have saved those franking credits for the Pension members.

In the event, the tax liability of the accumulation members is insufficient to soak up all of the franking credits as a tax offset (ie fund as a whole is in a net tax refund position) then under Labor's proposal that net tax refund will be lost.

Again, a trustee who needs to ensure that members in the same cohort are treated fairly and those in a different cohort are treated equitably, will need to adopt a methodology that will equitably allocate that net tax refund (loss) across all the applicable investment options.

It is foreseeable that in such a scenario, that loss can only be allocated to investment options that on a standalone basis were in net tax refund position. Notably this would not only be Pension options that have franking credits, but also would include Super options that for instance have excess franking credits as a result of having insufficient investment income (eg as a result of crystallising revenue and capital losses).

In my mind, there is a real concern that, as far as I can tell there is a real lack of much in the way of concrete consumer-friendly information as to who makes the decisions, where are such decisions recorded, on what basis are the decisions made, are the decisions consistent within a fund/across funds, how are any compensating payments treated for tax and regulatory purposes and how is the information communicated, if at all, to affected members.

It is acknowledged that retail funds do need to rethink how they provide or communicate their tax policies and specifically just how they uphold this fairness and equity with franking credits across members and their interest in investment options.

Unfortunately, the present disclosure to members of their interest in the fund (as mentioned earlier) is normally number of units held multiplied by their unit price at the particular point in time. Currently they do not for instance, provide a breakdown of the unit price into its components.

If they did, then franking credits that have accrued (as a refundable tax offset) would be one of those components explaining the appreciation in the unit price of an investment option with investments in Australian Shares.

But more importantly, you will not see any franking credits referable to the Pension options being transferred or shifted elsewhere for anything less than their actual dollar value.

Whether by design or mere inadvertence, Labor's plans will strike with considerable severity at the heart of the SMSF industry but leave large retail/industry funds largely untouched. This cannot be fair or reasonable on any objective measure.

It should be noted that not every retail fund is going to remain untouched. Whilst retail funds do have the capacity to accept many members and to generate taxable income to absorb any or all their franking credits, those smaller or mature funds with a large proportion of members who either do not make concessional contributions and/or are predominantly in pension phase are equally not immune from Labor's proposal.

Notably, members of such funds with this type of member demographics currently are not afforded a Pensioner Guarantee as announced by Labor, which arguably puts them at a competitive disadvantage to SMSFs.

However, one would have to accept that those SMSF members may decide to rollover their super in the SMSF and become a member of these retail funds. But this may well be plausible if say a member of an SMSF did not want to continue to manage and administer their superannuation themselves or upon retirement do wish to purchase a pension from a retail provider instead.

Unfortunately, and ironically, it is this inconsistent treatment of funds and investment structures under Labor's proposal that may ultimately drive outcomes which are not fair or equitable to the member who dared to exercise some level of choice and portability with their super and/or retirement savings.