COSTING NOTE - DENYING FRANKING CREDIT REFUNDABILITY

PROPOSAL DESCRIPTION

Franking credits received by individuals, APRA-regulated superannuation funds, and self-managed superannuation funds (SMSFs) would no longer be refundable.

Key Policy Parameters

- The start date is 1 July 2019. Under the proposal, refundability will be denied for franking credits received through franked dividends and distributions paid from 1 July 2019.
- Refundability would not be denied for not-for-profit entities, tax-exempt entities (including the Future Fund), individuals receiving an Australian Government pension, and SMSFs who had a member receiving an Australian Government pension prior to 28 March 2018.
- The estimate is based on an announcement date of December 2018.

FINANCIAL IMPLICATIONS (IMPACT ON UCB, $M)

	2017-18	2018-19	2019-20	2020-21	2021-22	Total over FE
Receipts	0	0	..	4,700	4,900	9,600
Total	**0**	**0**	**..**	**4,700**	**4,900**	**9,600**
Reliability:	There is significant uncertainty regarding the projected growth in franking credits, as well as the range of behavioural responses to this proposal.					
Other information:	**Is there a cash/accrual wedge** — No. **Is the policy mature within the forwards** — No, we anticipate growth rates in franking credit refunds and behavioural responses to mature outside the forward estimates. **Departmental funding** — Not yet considered. **Expiry date of costing** — MYEFO 2018-19.					

.. Not zero but rounded to zero, * Unquantifiable.

COSTING DETAILS

Methodology	For individuals, the cost is estimated using a microsimulation model based on uprated and reweighted 2015-16 individuals tax data supplied by the ATO. For those individuals who receive a refund in the absence of this proposal, a proportion of their franking credits are sold. This proportion is based on the source of each franking credit and the size of the refund. This behavioural response is assumed to grow over time. Some of the sold credits are assumed to be purchased by an entity that can use the credits to offset tax. For self-managed superannuation , the cost is estimated using SMSF tax return data from 2015-16. A proportion of franking credit refunds held by SMSFs is assumed to be sold, as investors shift to other forms of investment. This behavioural response is assumed to be greater for higher wealth SMSFs. In addition, the behavioural response is assumed to grow over time. Some of the sold credits are assumed to be purchased by an entity that can use the credits to offset tax. The impact of the following current Government policies is factored into the baseline of franking credit refunds to individuals and SMSFs: • the decreasing company tax rate under the Enterprise Tax Plan (ETP); • the $1.6 million superannuation transfer balance cap; and • personal tax reductions under the Personal Income Tax Plan (PITP).
Key Assumptions	*Growth in franking credits* For individuals, franking credits received are grown in line with relevant tax revenue

	forecasts from the Budget 2018-19. For SMSFs, franking credit refunds are grown in line with historical growth rates in franking credit refunds to SMSFs over the past 4 years. Beyond the forward estimates, we expect this growth to decline towards a long run growth rate of nominal GDP. However, we assume that this growth rate will not be reached by the end of the medium term. *Behavioural responses - individuals* The main mechanism by which individuals are expected to respond is through rebalancing their portfolios away from franked dividend paying shares. The size of the behavioural response differs depending on the source of the franked dividend and the size of the refund. We assume that there will be relatively little rebalancing of franking credits received from private entities (such as a company of which the individual is director). We assume that those individuals receiving large refunds through their personal portfolio investments are more likely than those with small refunds to shift away from investing in franked dividend paying shares. *Behavioural responses - SMSFs* We assume that SMSF funds with members who also hold a reasonable share of their assets in APRA funds see a shift of those assets into APRA funds. Assets that shift into APRA funds are assumed to continue to draw the benefit of the franking credit since most APRA funds are in a net taxpaying position. Some other SMSFs will rebalance their portfolios away from franked dividend paying shares towards other forms of income to compensate for the fall in after-tax returns on shares in the absence of refundability. These other forms of income could include fixed income, property trusts, managed funds or offshore equities. We assume the behavioural response increases with SMSF wealth to reflect factors such as the quality of financial advice. This response increases over time to reflect investors' shift away from investments previously attracting refunds in favour of alternative investment strategies. *Behavioural responses – APRA funds* We do not explicitly model a behavioural response of APRA funds as their refunds have been historically volatile. We do not expect them to receive a significant amount of refunds overall in the future. However, there could be an increased rate of consolidation, where funds currently receiving refunds would merge with other funds to be able to utilise franking credits against the tax liabilities of the consolidated fund. *Timing* We have assumed that the revenue gain occurs on assessment. For the purposes of the costing, 100% of the tax revenue from a year is expected to be collected in the following year (e.g. if refundability is denied for the 2019-20 year, the revenue from that year is accounted for in 2020-21).
Key Areas of Uncertainty	The costing is sensitive to expectations of future growth in franking credits and refunds, as well as the magnitude of the assumed behavioural response. While these assumptions are informed by consultation across the Treasury and with trusted external stakeholders, they remain heavily judgement-based.

	The cost estimates over the medium term are particularly unreliable for this costing. This is because the costing compounds - so over time, the costing is increasingly sensitive to these assumptions around behaviour and growth.

FINANCIAL IMPLICATIONS OVER THE MEDIUM-TERM (IMPACT ON UCB, $M)

	2017-18	2018-19	2019-20	2020-21	2021-22	Total over medium term (2018-19 to 2028-29)
Receipts	0	0	..	4,700	4,900	45,800
Total	0	0	..	4,700	4,900	45,800