INSTITUTE OF
PUBLIC
ACCOUNTANTS®

18 October 2024

Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By email to: economics.sen@aph.gov.au

Senate Economics References Committee inquiry into Australia's taxation system

The Institute of Public Accountants (IPA) welcomes the opportunity to make a submission in relation to the Senate Economics References Committee inquiry into Australia's taxation system.

The IPA is one of the three professional accounting bodies in Australia, representing over 50,000 members and students in Australia and in over 100 countries. Approximately three-quarters of the IPA's members work in or are advisers to small business and small to medium enterprises.

This submission relates to the following terms of reference:

(a) The social and economic impact of taxing people who earn less than the cost of living.

(f) The actual net company tax rate after franking credits have been refunded.

(g) The cost of recycling franking credits to and from Canberra

Our main points we wish to make are as follows:

- In relation to taxing people who earn less than the cost of living:
    - The taxation of people who earn less than the 'cost of living' must be considered together with the transfer system.
    - The 'poverty line' for different types of households exceeds the tax-free threshold, as does the income eligibility threshold for many transfer payments. Therefore, a large proportion of taxpayers experience churn whereby they pay taxes and receive transfer payments simultaneously.
    - There are inefficiencies and costs associated with complying with the requirements of both the tax and transfer systems, for both taxpayers and government.

- The progressive nature of both the income tax and transfer systems also influence Australians' decisions about their participation in the workforce and their investments and savings.
- The Government should consider means of reducing churn while ensuring Australians are incentivised to participate in the workforce, such as by raising the tax-free threshold.
- A decade ago, the Age Pension constituted almost one-third of transfer payments. With Australia's growing and ageing population, the Government should consider taxation incentives to encourage continued workforce participation as well as to enhance private savings for retirement to reduce reliance on the Age Pension in the decades to come.

- In relation to the imputation system (terms of reference (f) and (g) are considered together):
  - The Parliamentary Budget Office found that the total amount of refunds is generally balanced out by the total amount of additional tax paid by shareholders on higher tax rates.
  - Removing or restricting refundability would likely lead to a number of adverse outcomes for taxpayers as well as disincentivise investment in Australian companies and SMSFs.
  - The Government should review imputation within a broader review of the personal tax system, including bracket creep.
  - Significant changes to the imputation system may potentially increase reliance on the Age Pension if taxpayers cannot rely on franking credits as a post-retirement income stream.

(a) The social and economic impact of taxing people who earn less than the cost of living

The impact of the taxation of individuals who earn less than the 'cost of living' must be analysed together with the impact of the transfer system (through which the government provides payments to individuals). This is because the tax and transfer systems interact and work together.[1] In particular, due to the progressive nature of both systems, broadly speaking those who earn the least (and have the lowest tax burden) are generally the greatest beneficiaries of the transfer system.

The October 2015 Productivity Commission report titled *Tax and Transfer Incidence in Australia* (the PC Report) notes that in 2013-14, transfer expenditure was equivalent to 35 per cent of total tax revenue, although it can be quite volatile.[2] Transfer payments grow as a

---

[1] For example, entitlement to some welfare and transfer payments are subject to taxable income thresholds, and a number of transfer payments are effected through the tax lodgment and refund system by way of offsets to tax liability.

[2] The PC Report, page 9.

proportion of tax revenue when the economy is weak and shrink when the economy is strong.

In 2013-14, the largest transfer payment was the Age Pension, at almost one-third (31.5 per cent) of all transfer payments. Eligibility is subject to an income and asset test. Family Tax Benefits Part A and B accounted for another 15.5 per cent.

Many individuals and families pay taxes, including income tax and GST, and receive transfer payments at the same time. As a common example, a young family with children with one or both parents working would pay income tax on their employment income and GST on their acquisitions of goods and services, while simultaneously directly receiving transfer payments such as Family Tax Benefit (FBT) and childcare subsidies.

The tax-free threshold is currently $18,200. There is currently no official or statutory definition of a 'poverty line' or other 'cost of living' income threshold in Australia. The Melbourne Institute of Applied Economic and Social Research has calculated the 'poverty line' — based on household disposable income — for the March quarter 2024 for various types of households.[3] For example, for a single person household, the poverty line is $612.47 (including housing) per week. For a couple in the workforce with two children, it is $1,150.39. Even if it is assumed that the 'cost of living' metric is as low as the poverty line, it is clear that many individuals and families at or below the poverty line would be subject to income tax on their employment income.

Meanwhile, the eligibility income thresholds for many transfer payments are well above the tax-free threshold and indeed the poverty line. Eligibility for the base rate of FTB Part A, based on the family's adjusted taxable income (ATI), depends on the number and ages of the children, but for example a family with two children at school could potentially obtain the full rate at a family income of $113,205. Tapering of the rate applies to much higher family ATIs, such as $132,325 for two children at school and at the extreme, $215,314 with six children at school.

The Child Care Subsidy upper family income threshold is now $533,280.

For the Age Pension, payments taper until a single person derives $2,500.80 of income per fortnight, or $3,822.40 for a couple. Again, these thresholds far exceed the tax-free threshold.

It is clear that many Australian households experience 'churn' — where they pay tax and receive payments at the same time. The PC Report notes that churn is largest for households in the middle of the income distribution.[4] In particular, a 2005 study found that couples with children pay roughly the same amount of tax as they receive in cash and non-cash benefits.[5]

---

[3] Melbourne Institute: Applied Economic & Social Research, *Poverty Lines: Australia — March Quarter 2024*.

[4] PC Report, page 31.

[5] PC Report, page 44.

The PC Report identified two categories of costs from churning[6]:

1. The separate administration of the tax and transfer systems — can a similar outcome be achieved with less churn?
2. Compliance costs on individuals, who are subject to different information and compliance requirements from the two systems.

We urge the Government to consider reforms to reduce churn, particularly for the most affected lower-to-middle income family households — many of which earn less than the cost of living, and yet have to make tax payments while simultaneously receiving substantial transfer payments. The reduction of churn could greatly reduce the economic cost borne by both the taxpayers in interacting with two systems and in respect of multiple transfer payments and the government in respect of the costs of administration. There would also be a societal benefit in reducing the number of systems an individual needs to understand and navigate.

The Government could consider raising the tax-free threshold to something closer to the cost of living or poverty measure, while also appropriately reducing the transfer payments payable to these taxpayers, such that they will not be worse off but much complexity and compliance will be removed.

The tax and transfer systems can affect incentives to undertake paid work — in particular, whether to enter the workforce, whether to work full-time or part-time, how many hours to work and whether to obtain higher paid jobs.[7] For example, in a family with young children, one parent will consider the net financial implications of whether it is worthwhile re-entering the workforce or increasing work hours or accepting a higher paying role in light of a progressive income tax system, and potentially reducing the family's entitlement to the Child Care Subsidy and FTB.

The PC Report explains that, for any given individual, an increase in tax, or a decrease in transfer payments, may:

- increases the incentive to undertake paid work because it reduces the amount of income that would otherwise be available to spend; or
- decreases the incentive to undertake paid work because it makes unpaid activities relatively more attractive (the substitution effect).

Most empirical work indicates that the substitution effect dominates.[8]

We urge the Government to explore the extent to which the income effect and the substitution effect applies in the current day, particularly for those individuals and families earning less than the cost-of-living threshold which are much more likely to be receiving transfer payments that may exceeds the taxes they pay. This would assist the Government in forming policies about the tax and transfer systems which encourage and reward

---

[6] PC Report, page 48.

[7] PC Report, page 13.

[8] PC Report, page 14.

workforce participation while ensuring that more households can sustain the rising cost of living.

The tax and transfer systems also influence whether to save and invest, when to save and invest, how much to save and invest, how long to save and invest for, and asset classes in which to invest.[9] The PC Report also noted that incentives to save and invest are particularly affected by policies related to retirement income such as eligibility for the Age Pension and the taxation regime for superannuation.

Australia has an ageing population. The Government anticipates that over the next 40 years, the number of Australians aged 65 and over will more than double and the number aged 85 and over will more than triple.[10] This also means that there will be proportionally fewer individuals of working age contributing to the revenue. In order to sustain the Budget in the coming decades — as aforementioned, the Age Pension constituted around one-third of transfer payments a decade ago — it is imperative that the Government considers whether there may be greater incentive, possibly in the form of concessional taxation, for capable older Australians to remain in the workforce, and to continue to save through superannuation or other privately held investments for their retirement, rather than relying on the Age Pension and reducing their workforce participation to meet the eligibility income thresholds.

We also note that a pensioner's home is not included in the assets test for the Age Pension (although it will affect the assets threshold). In considering the impact of the tax system Age Pensioners with low taxable incomes, the Government should also consider how their family home is treated for the purposes of these thresholds. An Age Pensioner holding onto a large family home which has experienced huge capital growth over many decades, which could be sold, would be in a much better position to be able to privately fund some of their retirement needs compared to a lifelong renter, and may have much less need to stay longer in the paid workforce earning taxable employment income.

We encourage the Government to commence a holistic review of the tax and transfer systems — including capital gains and GST — to ensure that individuals and households can afford the cost of living, are encouraged and rewarded for participating in the workforce, that the welfare safety net is sufficient to support those who need it and that the projected levels of tax intake and transfer payments — in light of Australia's growing and ageing population — will be sustainable for the Budget in the coming decades.

(f) The actual net company tax rate after franking credits have been refunded.

(g) The cost of recycling franking credits to and from Canberra.

Inevitably there are substantial costs incurred in the operation of the imputation system, including the compliance costs borne by companies and shareholders and for the ATO, the costs of administration and compliance activity.

---

[9] PC Report, page 14.

[10] Australian Government, *Intergenerational Report 2023 at a glance*.

The Government may also consider whether the refundability of franking credits reduces the effective tax paid on the underlying profits to less than the company tax rate of either 25% or 30%.

The key question for Government is whether all of these costs are outweighed by the benefits of effectively taxing distributed company profits at the shareholder's marginal rate.

The Parliamentary Budget Office (PBO)'s recently published Budget Explainer[11] (Explainer) noted that one aspect (we may consider this an advantage) of a dividend imputation system is that no special tax arrangements are needed to tax dividend income. Dividends are simply included with other income and the combined income from all sources is taxed. Tax systems in other countries often involve separate arrangements for difference sources of income.[12] This would vastly increase the complexity and costs of administration and compliance.

The Explainer identifies that prior to 1 July 2000, the inability to obtain refunds of excess franking credits led to several effects including[13]:

- incentives to invest in assets other than shares, because the overall after-tax return would be lower for shares;
- incentives for small businesses to remain unincorporated, such that the profit for a sole owner was taxed at the owner's marginal rate, however low that was; and
- incentives skewed towards investing through large superannuation funds — which have a greater capacity to absorb franking credits — rather than SMSFs.

Should the refundability of franking credits be removed or the imputation system restricted, these effects are likely to arise again.

The proportion of franking credits refunded is[14]:

- for individuals — 15%
- for large superannuation funds — 2%
- for SMSFs — 62%
- for charities and the Future Fund — 100%.

From 2024-25, the marginal tax rate of 16% applies to individuals with taxable incomes between $18,201 and $45,000. From $45,001, the marginal rate is 30%. For every $1 of a franked dividend, only those in the two lowest tax brackets would receive a refund. The PBO observed that the average marginal tax rate for shareholders happens to be close to 30%. This means that the total amount of refunds is generally balanced out by the total amount of additional tax paid by shareholders on higher tax rates.[15] Therefore changing the current system may not significantly increase revenue while increasing complexity and costs.

---

[11] *Dividend imputation and franking credits*, 13 June 2024.

[12] Explainer, page 6.

[13] Explainer, page 6.

[14] Explainer, page 27.

[15] Explainer, page 13.

In terms of SMSFs, the PBO noted that if there was no refundability[16]:

- members of SMSFs could continue to receive franking credits by rolling their superannuation into a large fund — removing refundability may generate little additional tax revenue;
- SMSFs may diversify investments away from Australian shares, with a resulting fall in share prices, and towards other assets such as foreign shares, fixed interest or rental properties — removing refundability would only result in a relatively small amount of additional tax revenue.

The House of Representatives Standing Committee on Economics 2019 report into the implications of removing refundable franking credits (the Committee Report) noted that removing refundability may increase dependence on the Age Pension, which would defeat the purpose of decreasing government expenditure. For older Australians, stakeholders commonly expressed concerns about increased stress arising from the threat of reduced income and increased complexity from the need to alter financial arrangements, including an inability to return to the workforce.

In our submission to the inquiry, we had argued that the removal of refundability would be 'grossly unfair' because it affects SMSFs but not APRA-regulated funds. Similarly, CPA Australia explained that it would create a two-class system, whereby the 'haves' are large superannuation funds and high-income earners who will be able to use their franking credits, and the 'have-nots' would be SMSFs and low income investors including pensioners.[17]

It has also been noted that the removal of refundability would drive down share prices and may drive more investment offshore.[18]

There may be some revenue concerns with the refundability of franking credits — in particular, it provides a greater incentive for shareholders of closely-held companies to delay distributions until the individual shareholders are subject to a relatively low tax rate (e.g. in retirement) to receive a refund. However, the *Re:think* tax discussion paper notes that a similar incentive also exists under classical systems.[19]

Should the Government review the imputation system, in particular the refundability of franking credits, we do not recommend a total abolishment of refundability for the reasons and likely outcomes listed above. Further, efforts to limit refundability — such as by capping the refundable amount — would inevitably increase complexity and compliance costs for both government and taxpayers. If the Government is particularly concerned about excessive tax leakage using the imputation system, it could review the effectiveness of existing integrity rules.

The Government should consider the imputation system in the context of a broader review of the personal income taxation system, in order to address bracket creep and other tax

---

[16] Explainer, page 11.

[17] The Committee Report, page 24.

[18] The Committee Report, page 25.

[19] Australian Government, *Re:think — Tax discussion paper*, March 2015, page 86.

incentives to defer the receipt of franking credits. The Government should also consider the impact on investment and savings decisions. In particular, removing or restricting refundability may deter individuals from investing in Australian shares as a means of privately saving for retirement if they consider that their post-retirement income would be vastly reduced. The dividends, franking credits and capital gains from these investments may reduce the potential burden on the Age Pension.

If you have any queries or require further information, please don't hesitate to contact Tony Greco, Senior Tax Adviser Institute Public Accountants, either at tony.greco@publicaccountants.org.au or mobile: 0419 369 038

Yours sincerely

Tony Greco,

Senior Tax Advisor

Institute of Public Accountants

COPYRIGHT

© Institute of Public Accountants (ABN 81 004 130 643) 2008. All rights reserved. Save and except for third party content,
all content in these materials is owned or licensed by the Institute of Public Accountants (ABN 81 004 130 643).