



**APRIL 2015**

## Welcome to the April 2015 Update

Taxation seems to be the topic of discussion lately. It has been the subject of comments from various journalists, some based on leaks and government comments, and some from various other industry participants, all putting in their two cents worth. Jon Kalkman's article re Imputation Credits, and the SMSFOA submission are pertinent.

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### Imputation Credits are not tax concessions

**Jon Kalkman**

According to the Murray Financial System Inquiry, dividend imputation creates a bias in the system because income from other investments including bank deposits and fixed interest investments do not have the same concession.

The reason for that incongruity is simple. If banks paid tax on bank interest before the interest was paid, the depositor would need to take that tax already paid into account before they prepared their own tax return. Unless the tax already paid was a tax credit to the depositor, the interest on the bank deposit would effectively be paid taxed twice; once by the bank and again by the depositor.

### Upcoming Events



**AIA Annual Investors Conference**

**Geelong Discussion Group**

5<sup>th</sup> May 2015 7.00pm

**Perth Information Meeting**

Wembley Downs, WA

5<sup>th</sup> May 2015 7.30pm

**Frankston South Discussion Group**

6<sup>th</sup> May 2015 1.00pm

**For NSW Members -**

**One Day Course:**

**How to beat the fund manager, -  
Strategies for individual Investors**

12th June 2015

[Details](#)

### Imputation Credits are not tax concessions (Cont'd)

This is precisely the situation that applied to dividends from Australian shares before 1987. Dividends are always paid out of after-tax profits. Until 1987, companies paid tax on their profits at the company tax rate, which was then as high as 39% and dividends were then taxed again in the hands of the shareholder at their marginal tax rate which was as high as 60%. With these punitive rates of tax there was little incentive for companies to pay dividends. Many companies preferred to reinvest the after-tax profit into the business and many shareholders preferred to take their investment returns as capital gains which were then lightly taxed. That situation still applies in the US and may explain the greater volatility of the US stock market.

Since 1987 the dividend imputation system has been straight forward. If a company makes \$100 in profits and the company tax rate is 30%, then \$30 is sent to the ATO and \$70 is sent to shareholders as a dividend. Under the imputation system, the dividend carries a tax credit to the shareholder for the tax already paid. These tax credits are sometimes called franking credits because after a letter goes through a franking machine it comes with postage paid and is said to be “franked”. These tax credits are described as imputation or franking credits and these terms are used interchangeably. In this case franking means “tax paid”.

A PAYG taxpayer has tax withheld from their wages by their employer but their taxable income includes both their take-home pay and the tax already paid by their employer. Similarly, a shareholder's taxable income includes the dividend received as well as the associated franking credit because this tax has already been paid to the ATO on their behalf. In this case the taxable income is \$100. Importantly, the franking credit (\$30) is a tax credit that can be applied to their tax liability from their dividends and any other income.

Clearly if the company tax was lower, the franking credit would be lower but the dividend, all else being equal, would be higher and the shareholder's taxable income would be unchanged. Using the previous example of \$100 in company profits, if the company tax was 20%, only \$20 would be sent to the ATO and \$80 would be sent to the shareholder. As the shareholder's taxable income remains unchanged at \$100 (\$80 plus \$20), so their tax liability remains unchanged.

In the extreme case there would be no company tax and all company profits would be taxed in the hands of shareholders at their marginal rate. For Australian shareholders, their taxable income is still unchanged but non-residents, who pay no personal income tax in Australia, would receive their dividends tax-free. Lowering the company tax (and the associated imputation credits) is designed to ease the tax burden on foreign shareholders. Why would an Australian government want to do that?

Until 2000, imputation credits could be used to offset other tax liabilities only up to the limit of those tax liabilities. Any excess credits were simply lost to the taxpayer. Since 2000 any imputation tax credits in excess of tax liabilities are refunded in cash. Taxpayers whose marginal tax rate is lower than the company tax rate obviously benefit from this tax refund. Taxpayers whose marginal tax rate is higher than the company tax rate clearly need to make up the difference.



Clearly foreign investors would prefer a lower company tax rate as they gain no benefit from the imputation system. To the extent that Australia depends on foreign investment, company tax rate may need to be lowered, but under current arrangements, any change in the company tax will have no impact on Australian shareholders. This is because the purpose and effect of the dividend imputation system is to ensure that Australian shareholders pay tax on their dividends at their marginal rate and no more. *It is not a tax concession to shareholders.*

The refund of unused imputation credits and the tax-free status of super pension funds together explain the popularity of Australian shares inside SMSFs. Because the marginal tax rate of a super fund paying a pension is zero, the imputation credits are refunded in cash to the

fund on completion of the fund's tax return. Using the example above, if the fund receives a \$30 tax refund in addition to a \$70 paid in dividend, the tax refund is more than 40% greater than the dividend by itself. Retail and industry super funds paying pensions also receive a refund for their imputation credits but the lack of transparency around their operations means that most members of these funds are unaware of the benefits that Australian shares bring to their retirement savings. That notwithstanding, fund managers most certainly are aware of, and are keen to retain, these tax benefits.

In the context of the Murray Inquiry there have been a number of suggestions made, each would have far reaching consequences:

- The abolition of imputation credits would simply mean a reversion to the double taxation of dividends that applied before 1987, once at the company level and again in the hands of the shareholder.
- Removing imputation credits would adversely affect every Australian shareholder, including those who hold shares directly as well as those who hold superannuation accounts with retail or industry super funds that invest in Australian shares.
- Removing imputation credits would decimate those shares which have become popular because they pay high fully-franked dividends. The impact on superannuation funds is incalculable and because the superannuation system is now so large, the impact on the share market would be profound.
- Allowing dividends to be considered as tax-paid by virtue of the imputation credit but without a cash refund for taxpayers on low marginal tax rates would discriminate between taxpayer as some would benefit from these tax credits and others not at all. This would not be politically popular.

*Jon Kalkman is a director of AIA*

### More sound and fury – signifying nothing!

#### Call for caution on tax reform

The SMSF Owners Alliance (SMSFOA) has called for cool, calm thinking on tax reform, particularly in regard to fairness in superannuation. Duncan Fairweather, Executive Director of the SMSFOA says that a "perspective on fairness is taxes paid (and benefits received) relative to a person's lifetime income." The discussion paper also states that "the tax concessions in super have to be judged taking into account Australia's full retirement income support arrangements, including the means-tested Age Pension." The SMSFOA fully

supports such sentiments and has consistently modelled the impact and fairness of super by including its interaction with the Age Pension and taking into account lifetime taxes paid ([link](#)).

#### Press Release by the SMSF Owners Alliance 1 April 2015

There are no surprises in today's report from ASFA that wealthier people have higher superannuation account balances – mostly held in self-managed funds – and benefit from larger retirement income streams. But the report does not give a balanced picture and doesn't help advance an objective tax debate. What's lacking in ASFA's report, and in much commentary on this issue, is how much more tax these people pay in the first place. As the Treasurer has pointed out this week, 2% of taxpayers pay 26% of income tax. The top 20% of taxpayers pay 65% of income tax.

Fairness can't be judged by looking at superannuation tax benefits in isolation from income and other taxes paid.



A better perspective would be gained by taking into account all taxes paid over a lifetime and all tax concessions received. Hopefully a more objective picture will be gained through the current Tax White paper process.

A focus on the tax benefits derived from large superannuation account balances is looking at the issue through a very narrow prism.

These balances were legitimately accumulated in accordance with old rules. It is no longer possible, under current contribution caps, for people to amass very large amounts in superannuation.

ASFA estimates that a retired couple with their own home and in good health need \$58,000 a year for a

comfortable retirement. People will make their own judgement about whether a retirement income of 75% of average weekly earnings is sufficient for them.

ASFA's report doesn't point out that someone starting now will need to amass nearly \$5 million in superannuation to fund such a pension in the future.

A better benchmark, which does not involve making subjective judgements about what is good enough for people in retirement, is what is known as a Reasonable Replacement Rate – generally around two thirds of pre-retirement income – which is a well-accepted international concept referred to by Ken Henry in his landmark tax reform paper in 2010.

ASFA queries whether it is fair for younger generations of taxpayers to be funding the tax concessions of older, high net worth individuals. It seems to ignore the fact that the superannuation system is much fairer in relation to intergenerational transfers than the Age Pension. Superannuation is built during a person's working life while the Age Pension is funded by taxpayers now and in the future.

The superannuation system is intended to provide a means, for the first time in our history, to enable the current generation of Australians to fund their own retirement and not be a burden to their children and grandchildren.

By and large, it is only SMSF owners who are achieving this objective with an average account balance of \$500,000. An average account balance of less than \$30,000 in the large APRA-regulated funds, represented by ASFA, is clearly falling well short.

As ASFA's report notes, the number of SMSF members with \$2-5 million in their accounts is around 35,000 – 3.5% of the one million Australians with self-managed accounts. The number with balances of between \$5 – 10million is 3,000 (0.3% of all members) and the number with more than \$10 million in their accounts is 1,000 (0.1% of all members).

Instead of worrying about a small number of high account balances and retirement incomes, ASFA should be concerned about why most of the members of the managed funds it represents are not going to have enough superannuation to fund ASFA's own notion of a comfortable retirement.

This is due in some part to the high fees charged by APRA funds which concerned David Murray's Financial

System Inquiry and is a key reason why people are deserting the major funds and setting up their own SMSFs.

SMSFOA believes that everybody – individuals and companies – should pay the taxes set by the Government. People who have accumulated savings through hard work, having paid their fair share of tax and more along the way, should not be penalised for their success.

Given the Government's intention to have an open and sensible conversation about tax so that we can have a lower, fairer and simpler tax system, stirring up envy with headline grabbing tall poppy numbers is not a constructive contribution to the debate which should be about how every Australian can be a taller poppy.

We attach an excerpt from SMSFOA's submission in response to the FSI's Interim Report which more broadly canvasses the issue of fairness.

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**The AIA will be making a submission on some aspects of the 'Re:Think' report on behalf of members. If you have a strong view on any item contained within the report, or you would be willing to contribute to the drafting of our submission, then please email the office with your details.**

**[Download 'Re:Think', Tax Discussion Paper](#)**





## An AIA First! Create your own investment plan

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### Good news for SMSFs and bankruptcy comes with a caution

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*A 2015 Supreme Court decision is both good news and a caution for contributions to super in the context of business failure*

A recent court decision demonstrates what can happen when a business borrows from a bank to make large super contributions to an SMSF, and then the business folds.

The Court of Appeal division of the Victorian Supreme Court handed down the decision of [Australasian Annuities Pty Ltd \[2015\] VSCA 9](#) ('AA 2015') this year. In addressing one of the lines of argument, the case suggests that the SMSF was entitled to keep the money. However, the other line of argument involved the application of a well-established rule, which meant that the bank was entitled to its money back.

#### The facts

Australasian Annuities Pty Ltd ('AA') carried on a financial planning business. More specifically, AA acted as trustee of a family trust, and in that capacity acted as a service entity, providing management, administration, accommodation and staffing services to another entity, which held the relevant financial services licence and received financial planning client commissions and the like.

On 7 May 2007 a facility with a limit of \$2.5 million was signed with Macquarie Bank. Security for the loan included a registered first ranking fixed and floating charge over the whole of the assets and undertakings of AA.

Ten days later Macquarie Bank advanced \$2.5 million to AA pursuant to the facility.

The sole director of AA had an SMSF along with his wife and sons. A significant portion of the \$2.5 million was contributed to the SMSF.

The fortunes of AA appear to have waned and on 29 June 2009 receivers and managers were appointed in respect of AA. The receivers and managers were appointed by Macquarie Bank under securities conferred on the bank securing the advance made by Macquarie Bank to AA.

The receivers and managers of AA brought a claim in AA's name against both the SMSF trustee and the financial planner who was the sole director of AA, aiming to recover at least some of the \$2.5 million. As the financial planner had since been declared bankrupt, the claim only proceeded against the SMSF trustee.

AA's first case to recover money failed before the Supreme Court in [Australasian Annuities Pty Ltd \[2013\] VSC 543](#). AA 2015 was the result of AA's appeal, which was based on two main arguments.

#### **The argument that the SMSF was a 'volunteer'**

The receivers and managers of AA attempted to claw back money on the basis that the trustee of the SMSF received money 'as a volunteer'. In simplified terms, this was an argument that the money should be returned because the trustee of the SMSF had given nothing in return for the money and therefore should be forced to make restitution by paying back the money.



In a welcome result for SMSFs, the majority held that the trustee of the SMSF did in fact provide valuable consideration in exchange for the contributions, and therefore this aspect of AA's argument failed. In an earlier High Court decision of [Cook v Benson \[2003\] HCA 36](#), the High Court had previously held that superannuation funds provide consideration in exchange for contributions. In that case, the parties had dealt at arm's length. The majority in AA 2015 essentially followed the High Court's reasoning.

The case illuminates that the valuable consideration given by an SMSF trustee in exchange for contributions are the obligations of the SMSF trustee to provide beneficiaries with the rights and benefits under the rules of the fund. These rights and obligations include that an SMSF trustee must:

- administer contributions in accordance with the terms in the deed;
- keep and provide records and accounts to members;
- credit contributions to the appropriate accumulation account;

- effect policies with an insurer;
  - invest money in accordance with the investment strategies of the fund; and
  - give members certain entitlements to death and retirement benefits.
- Had the failed 'volunteer' argument been AA's only argument, it appears AA would have been overall unsuccessful. AA did however have another argument.

#### **The argument based on 'knowing receipt'**

AA also argued that the SMSF was liable to return money because of the principle of 'knowing receipt'. The essence of AA's argument was that the SMSF must return money because the following two elements had been satisfied:

- element 1: the SMSF received property (money) that had been misapplied or transferred pursuant to a breach of fiduciary duty or trust; and
- element 2: the SMSF received that property with knowledge that it had been misapplied or transferred pursuant to a breach of fiduciary duty or trust.

It was not controversial that the sole director of AA was subject to fiduciary obligations. In addressing the first element, the sole director of AA was unanimously held to have breached his fiduciary duties in borrowing money, mainly for the benefit of himself and his wife. The Court found that the financial planner (ie, the then sole director of AA) facilitated the distribution of the money to his SMSF to benefit himself and certain family members as though the money was his to do with as he pleased. The Supreme Court noted that the interests of AA (the company) were not necessarily the same as the interests of the shareholders (who were the financial planner and his wife). Also, AA acted as trustee of a family trust. Although the financial planner and his wife were beneficiaries of the trust, there were many other beneficiaries including various other family members and corporate entities. Naturally, such a wide class of beneficiaries is very common in family trusts. Accordingly, the money that the SMSF received was transferred pursuant to a breach of fiduciary duty.

The second element that AA needed to prove was that the trustee of the SMSF had knowledge that the money was received in breach of fiduciary duties. The trustee of the SMSF had four directors, of which the financial planner was only one. As the financial planner was the most active director, the Court was required to decide whether he was the 'directing mind and will' of the trustee of the SMSF. The majority decided that because the financial planner was the only active or knowledgeable director, was instrumental in the

relevant transactions and directed and oversaw each of the payments to the SMSF, he was the directing mind and will of the SMSF trustee. Accordingly, his knowledge was imputed to the SMSF. The SMSF was therefore held by the majority to have had knowledge (through the mind of the financial planner) that the money was received in breach of fiduciary duty.

The result of the above was that the trustee of the SMSF was liable to pay back money to the receivers and managers of AA.

### Conclusion

AA 2015 reinforces that an SMSF does give real consideration in return for contributions. This is important for defeating certain claims that attempt to claw back amounts that have been contributed.

However, the case should also act as a caution to directors, trustees and their advisers that complex legal structures come with attached obligations that can be the undoing of the parties.

*By David Oon and Bryce Figot, DBA Lawyers*

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