In recent weeks the Henry Review of Taxation has been floating the idea of abolishing the imputation credit system on dividends paid by Australian shares. As a self-funded retiree with a Self managed Superannuation Fund I have developed an investment strategy where my annual income depends in large part on the dividends from Australian shares and associated imputation credits.

This investment strategy was adopted because it meant that with sufficient income, I would never be forced to sell shares when the market was depressed and therefore I could afford to ride out the market volatility in exchange for a higher long-term return provided by shares and a growing income stream flowing from dividends. It also meant that I would never be dependent on the taxpayer for income support.

Dividends from Australian shares are paid from the after-tax portion of company profits. Dividends paid to shareholders then have tax (imputation) credits for the company tax already paid. The imputation credit represents the tax already paid on behalf of the shareholder. This credit can then be used to pay tax on income from any source. Since 2000 any imputation credit not used this way is refunded.

As a superannuation fund paying a pension does not pay income tax, these tax credits are then fully refunded by the ATO.

The company tax rate is presently 30%. With full imputation, the dividend is thus 70% of the before-tax portion of company profits. Using these proportions, every 70 cents of dividend brings with it 30 cents of tax credit. This refund represents additional income to the pension fund.

For example, if a super fund held 100,000 Telstra shares paying 28 cents per share in dividends, the fund would receive $28,000 in dividend from this holding. The imputation credit would mean the ATO would refund another $12,000 of tax already paid. This is the ratio of 70 : 30 set out above. So the income from these shares is actually 40 cents per share rather than the 28 cents per share quoted. Taken together the grossed up return it is worth 142.85% of the dividend alone. Clearly you can see how valuable imputation credits are to a super pension fund invested in shares.

Imputation credits mean the difference between my super fund generating enough annual income to meet living expenses and having insufficient income. If the income is inadequate, some capital needs to be liquidated to meet the mandatory pension withdrawal to pay living expenses and that leaves less capital for the following year. The process of capital liquidation thus accelerates to the point where all capital is exhausted and the retiree is no long self-funded but becomes reliant on the taxpayer for income support.

The last 15 months have seen some of the worst share market volatility for generations. Many super funds will be holding up to 50% less capital than they were at the end of 2007. That may not be a long-term problem as the sharemarket recovers, provided that these super funds continue to generate sufficient income to pay mandatory pension withdrawals.

The proposal to abolish imputation credits represents a significant cut in the income to a super fund. In my case, a reduction in income means that some shares may need to be sold to cover my cashflow requirements and I would then be forced into the situation I have tried desperately to avoid – I would be forced to sell assets in a depressed market and crystallise enormous capital losses.

Under this proposal, my super fund would have an effective tax rate of 30%. At present, the fact that earnings inside a pension fund are tax free is one of the great incentives for people to save for their own retirement through superannuation. Encouraging self reliance has always been government policy.

The suggestion that company tax would be dropped to 20% in exchange for abolishing imputation credits is of no benefit because it still means a cut in income to a super fund and the fund would still pay an effective tax rate of 20%.

All capital and income held by companies is ultimately owned by and taxed in the hands of shareholders. If there were no foreign resident shareholders we would not need company tax at all, because all profits would be taxed in the hands of Australian shareholders. So company tax is really a withholding tax that ensures foreign residents/shareholders pay tax in Australia on profits made by Australian companies.

Imputation credits simply represent the tax withheld by Australian companies on behalf of their Australian shareholders in the same way that employers withhold tax for PAYG wage earners. As such, imputation credits are important to ALL Australian taxpayers who own shares in Australian companies either directly or indirectly through managed funds or superannuation funds because imputation credits represents tax already paid and can be used to offset tax payable on other income.

Without imputation credits we will return to a situation that existed before 1987 where company profits are taxed twice, once in the hands of the company and then again in the hands of the shareholder. This would simply encourage more investment into unproductive areas of the economy such as housing.

Why the government would want to alienate all Australian taxpayers who are shareholders in Australian companies is simply unfathomable. Abolishing imputation credits will prove enormously unpopular and is likely to determine the way many shareholders vote at the next and subsequent elections.

The government should certainly reduce the company tax rate if it is necessary to lower the tax burden on foreign residents but in fairness to Australian taxpayers, the imputation credit system must be maintained.

Jon Kalkman
[removed for privacy reasons]