



December 2018

December is upon us and summer has arrived with the typical heat and flooding rains that signal the start to the festive period around Christmas and New Year. To all our clients, we wish you a safe and happy Christmas and a prosperous 2019.

The final 3 months of the year has seen a return to high levels of volatility across all assets classes after a steadily rising first 9 months of 2018. Most equity markets have given up all the gains of 2018 and in the case of Australia, we have given up 2 years of price appreciation. By design, diversification into more stable asset classes such as Fixed Interest has enabled most portfolios to keep much of the gains of the last 2 years.

Markets react poorly to uncertainty. In recent months we have seen more than usual in the form of Chinese/US trade wars, a faltering Brexit Plan, an unstable Australian Government, oil prices down 22%, uncertainty around local and U.S interest rates and the retreat in domestic housing prices.

On the economic front however, news has been broadly positive. The Reserve Bank lifted its growth forecast for 2018 to 3.5% from 3.25%. The Federal Budget edges closer to surplus, with a lower-than-expected budget deficit of \$2.35 billion in the year to October, the best in a decade. Unemployment held steady at 5% in October, while petrol prices dropped 22% in November to a national average of \$1.37 a litre, the biggest fall in a decade. Growth rates in the U.S. are outpacing the growth in Australia and U.S. unemployment is now at a 50 year low of only 3.7%.

Our preference is to look through the noise and focus on the fundamentals, which are largely positive.

Over the holiday period, the office will close on the 21st December and re-open on the 7th January 2019.

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FRANKING DIVIDENDS FACING THE ... CHOP...



Index ▲ 1.56 ▼ 0.12

Here we go again. Superannuation could be about to undergo more change with the federal opposition announcing it will end cash refunds of franking credits on share dividends if it wins the next election. The change would have a significant impact on people paying little or no tax, especially self-funded retirees in pension phase. Seniors groups are up in arms, but many Australians have been left wondering 'franking what?'.

Dividends paid by Australian companies are not just a source of income for investors; they also offer potential tax benefits in the form of franking credits, also known as imputation credits.

What is dividend imputation?

Dividend imputation was introduced by the Hawke/Keating Government in July 1987 to end the double taxation of company profits. Before then, companies paid tax on their earnings and shareholders were taxed on the dividends paid out of profits at their marginal rate.

Under the current system, if the company has already paid tax on the income the Australian Taxation Office (ATO) gives shareholders a tax credit.

Dividends on shares with imputation credits are called franked dividends and may be fully or partly franked, depending on the amount of tax the company has paid and in what country. There are no credits for tax paid on overseas earnings.

The system was made more generous in July 2000 when the Howard/Costello Government allowed excess franking credits to be paid as a cash refund. The Labor Party proposal effectively restores the original tax treatment of dividends.

How does it work?

If the proposal is adopted, it will have no impact on investors on a marginal tax rate above the 30 per cent company tax rate. But investors who pay less than 30 per cent tax stand to lose some of their share income.

Say an Australian company 'OzInvest' makes pre-tax earnings of \$1 a share. It pays tax at the company rate of 30 per cent, or 30c a share, and returns the remaining 70c to shareholders as a fully franked dividend. The level of benefit you receive depends on your marginal tax rate.

High marginal tax rate

Sarah pays tax at the top marginal rate of 47 per cent including the Medicare levy. She has 100 shares in OzInvest and receives \$70 in dividends plus a \$30 imputation credit.

Sarah's taxable income on the dividend is \$100 (after adding the \$30 imputation credit to her \$70 dividend), so she's liable for tax of \$47. However, this is offset by the \$30 imputation credit leaving her with only \$17 tax to pay.

Low marginal tax rate

Alice also receives taxable income of \$100 from OzInvest, but she pays tax at the lowest marginal rate of 21 per cent (including Medicare levy). As the

imputation credit of \$30 is more than her tax payable of \$21, she currently receives a tax refund of \$9 cash. Under the new proposal, she would lose \$9 a share.

Paying no tax

Many retirees or people who earn below the annual tax-free threshold of \$18,200 pay no tax at all on their fully franked shares. Because franking credits are fully refundable, they can claim a full refund from the ATO.

David has a self-managed super fund in pension phase which pays no tax and he has no other income. He receives a \$70 dividend from OzInvest and claims a cash rebate of the full \$30 franking credit. Under the new proposal, he would lose this \$30 a share.

Still at proposal stage

Of course, the proposal is just that. With a federal election not due until next year, the earliest it could come into effect would be July 2019 and only if passed by both houses of parliament. Already there are hints of compromise, with Labor leader Bill Shorten saying full and part-pensioners and people on government allowances will be exempt from the change.

It's too early to be alarmed or to change investment strategy based on what may or may not happen in future. But it is important to understand how the proposed changes could potentially affect you and what alternative investment strategies may be beneficial.

If you would like to discuss your retirement income strategy, please give us a call.