'Far from the end of the world': how to counter Labor's tax change

By John Collett
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Investors were reminded once again this week that legislative risk has the potential to unsettle investors' best laid plans, no less than when markets tank.

Up to about 400,000 wealthier members of self managed super funds are the main target of Labor's plan, if it wins the next election, to stop tax credits from dividends being refundable.

Those without tax liabilities, like most retirees, would need to rejig their portfolios under Labor's tax plan.
Photo: Peter Braig

Since the Howard government made the tax credits refundable in 2001, retirees and others who pay little or no income tax have been enjoying a 30 per cent uplift to the dividends they receive from fully franked dividend payers, such as the big banks and Telstra.

That, along with the low interest rates of more recent times, have driven yield-hungry investors into the big shares.

If Labor's plan to no longer allow refundable tax credits on dividends does come to pass, there would a lot of rejigging of portfolios, particularly among those self-funded retirees who have loaded-up on the big-name shares.

Yield hunger

If they do nothing, they would lose 30 per cent of income they receive from the portion of their portfolio invested in the companies paying fully franked dividends.

About 200,000 of retirees on part age pensions and about 14,000 on the full age pension hold small parcels of shares on which they receive the 30 per cent cash back.

Others with portfolios of blue-chip Australian shares, including even some very low-income non-retirees, will also be be hit.

Anyone with a total income of less than the $18,200 doesn't pay income tax and no income-tax liabilities against which can be offset with tax credits, would also lose under Labor's plan.

Rebalancing your portfolio may be easier than it looks.

Financial planners and accountants, say, however, that if the Labor plan comes to pass, it is far from the end of the world.

At first blush a decent yield does appear difficult to find. Three-year term deposits are paying 3 per cent, at most, with money locked away when interest rates could easily rise from here.

That is about as much as anyone can earn risk-free, as deposits with financial institutions are covered by the federal government's deposit guarantee on the first

$250,000 with each institution. To get a higher yield, some risk with the capital has to be taken.

Seek yield elsewhere

Mark Borg, an AMP financial planner from Adelaide, says if the tax credits form part of your income and you are no longer going to get them, then it becomes a question of where else you can find a similar yield.

"What springs to mind is yield investments such as infrastructure investments that can be listed and unlisted and offer good yields," Borg says.

And they are not as volatile as the share prices of the big banks, he adds.

Jonathan Philpot, wealth management partner at HLB Mann Judd in Sydney, points out that, as a consequence of Labor' plan there could be less demand by yield-hungry investors for blue chip shares.

“Those stocks that have high-income yields but not a lot of growth will not be as attractive if they no longer generate franking credits in the hands of investors,” he says.

Some planners question whether the share prices of the blue chips can rise as quickly if there is less demand from yield-chasing investors.

Laura Menschik, a financial planner and director of WLM Financial, says retirees should be thinking about what to do if the Labor's changes come in.

Laura Menschik of WLM Financial says retirees shouldn't be too fixated on chasing income.

Photo: Tamara Voninski

If Labor is elected, its plan for dividend tax credits would not start until mid-2019, though that may not be much time for those who are looking at gradually selling some of their blue-chip shares to invest elsewhere.

Fixated on income

Menschik has been able to get a higher "total" return, which is capital growth plus income, for her clients than they are able to get from their Australian shares, even though the other investments don't have franking credits.

She says, in her experience, retirees are generally too fixated on the income coming in, rather than the total return.

There needs to be a shift in mentality, she says. "A share investor should take some profits if the share price has risen - fund managers do that," Menschik says.

"What is the overall return that you want, regardless of whether the return is from income, capital growth, franking credits or rental income - what do you need to meet your goals and let's see how we can get it," Menschik says.

And, if a large part of that return comes from capital growth there should be no problem in realising some of gains by selling and using the money to meet expenses, she says.

Menschik points out there are other investments, including managed funds that invest in infrastructure assets, that pay good income, as well as listed property.

Listed property

Many alternative high-yielding investments, like property trusts, though they don't have imputation credits attached to their income streams have cash distribution yields that are similar to the yields of the big companies, even after adding 30 per cent refund of the tax credits.

Winston Sammut, the managing director of Folkestone Maxim Asset Management, a property fund manager, says Australian listed property trusts such as Centuria Metropolitan and Vicinity Centres are each yielding 7.1 per cent, while Centuria Industrial is yielding 7.6 per cent.

Claire Mackay, a planner and chartered accountant at Quantum Financial, says governments constantly tinker with the superannuation and retirement rules.

Just as investors should be diversified in order to better manage investment risk, they also should be diversifying to cover legislative risk, such as changes to tax rules, she says.

Mackay, says it is too early to make changes to portfolios, after all, Labor may not win the next election. "It's about watching the space and being mindful of the possible changes, as there is a long way to go with this," Mackay says.

She says investors need a clearer understanding of Labor's plan and there have been some assurances from Labor that affected pensioners or part age pensioners will be compensated in some way.

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