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FINANCIAL REVIEW

Investors to lose $5b in tax credits

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The proposed drop in the corporate tax rate will wipe out $5 billion of tax credits sitting on listed companies' balance sheets that belong to investors.

Owed to investors

Franking credit balance, FY2013 ($m)

Company	Credit balance
BHP Billiton	10,528
Woodside	2,545
Woolworths	1,943
CBA	742
Westpac	585
Telstra	283
ANZ	265
Westfarmers	243
NAB	71

SOURCE: WARAKIRRI

Fund managers and super funds are demanding listed companies find ways to pay special dividends so their investors will not lose franking credits when the corporate tax rate drops from 30 per cent to 28.5 per cent in July 2015.

The Abbott government has proposed the cut to compensate large companies for its 1.5 per cent levy to pay for the paid parental leave scheme. Because that levy is outside the franking credits regime, it will reduce the amount of franking credits that allow investors to pay less income tax when they get dividends. Major fund managers are angry the change will be backdated and shave $5 billion off the $73 billion of franking credits held by companies but not yet paid to investors.

"Investors own these assets and billions of dollars of value will potentially vanish if the companies do not pay them out," said Andrew Nolan, head of investor solutions for Warakirri Asset Management, a consultant on after-tax investing of the nation's biggest asset managers, including Australian Super.

The franking credit regime allows investors to receive a tax break on the income they receive from dividends. The credit is given to reflect taxes already paid by the company.

It is uncertain if the government's planned corporate tax cut and the paid parental leave levy will get the support of the new Senate after July 1, this year. The Greens say they will not support a tax cut for big business but would support a tax cut for small business. This would mean large businesses would face a 31.5 per cent company tax rate.

Labor has not yet said if it will support the tax cut and the Palmer United Party wants a different system so companies pay tax annually, not quarterly.

COMPANIES SIT ON BILLIONS

Australia's largest companies, including Commonwealth Bank of Australia, BHP Billiton and Telstra are amongst those sitting on billions of dollars of franking credits that can only be transferred to investors when they are paid dividends.

David Fleming, a director of Renaissance Asset Management said it is stepping-up talks with companies about opportunities for fully franked special dividends, off-market buybacks and takeover consideration being paid with fully franked income.

Matthew Ryland, director of Greencape Capital, has about $5 billion under management in large cap stocks, said: "Retained franking credits are an interest-free loan to the government that we want to minimise at all costs. I would like to think corporate boards around Australia are paying attention because failure to do so would mean loss of value for their shareholders. While there is value we want to get it out to shareholders."

Some companies, including Korvest, a listed metal manufacturer, have announced special dividend payments, dividend reinvestment plans, or cash options for its investors.

But others, including those with the largest franking credit balances, are waiting to see what the government announces, or the boardroom decides, before making a decision.

BHP Billiton, which has $10.5 billion of franking credits, and which has a payout ratio of about 50 per cent, said it would maintain a "progressive base dividend as well as returning excess capital to shareholders".

Woodside Petroleum with about $2.5 billion, said it is "aware of the government's stated intention to change the tax rate next year, however it is not yet clear whether there will be any transitional measurements relating to franking".

HOCKEY QUIET

A spokesman for the Federal Treasurer Joe Hockey declined to comment on specific measures. "The best thing we can do for returns to shareholders is to grow the economy, which will boost the profitability of all businesses. Our company tax cut will support investment and job creation across all sectors of our economy, while our paid parental leave scheme will boost productivity and participation."

Chief executives and corporate treasurers are expected to quizzed about plans for franking credits at annual meetings before the proposed reduction of company tax. But some warn companies could push back by claiming they could use their capital, might be forced to increase borrowing or cannot justify the payouts to overseas' investors that do not benefit.

Plans to cut company tax to 28.5 per cent at the beginning of the next tax year means the value of retained franking credits will fall by about 7 per cent, say Warakirri analysts.

If all earnings and franking credits are not distributed to shareholders, retained earnings and franking credits remain on the company balance sheet and can be paid to shareholders in future years.

“From the start of 2015/16 financial year, retained franking credits will be devalued by 7 per cent,” said Mr Nolan.

That is because if the company rate falls to 28.5 per cent, any retained earnings paid as fully franked dividends will be franked at the lower rate.

WORTHLESS

Alternatively, the change in franking will mean 7 per cent of retained franking credits are likely to be rendered worthless as companies will be unable to distribute them to shareholders.

Ten top listed companies, covering banking, mining and retail, hold about $17 billion of franking credits for more than 5.5 million investors.

“Paid parental leave is not a tax and should not be used as an excuse to diminish the availability of franking credits,” according to Ian Currie, chairman of the Australian Shareholders' Association.

“Parental leave does not mean they should not pay out as much as they can,” Mr Currie said.