IMPUTATION IMPLICATIONS

FRANKING — MYTH AND REALITY

by DAVID WILLIAMS

Six months after the introduction of a refined system of dividend imputation, uncertainty still exists about its precise effects on various types of shareholders. This article looks at some of those effects.

This paper assumes that the Taxation Laws Amendment Act (No. 3) 1987 is granted royal assent but is otherwise based on the law as at November 1, 1987.

Prior to July 1, 1987 under the Income Tax Assessment Act 1936 the then system of taxation of companies and the taxation of dividends by companies to their shareholders involved a significant element of double taxation. The company was taxed upon its profits in the year in which they were earned and, when distributed as dividends, the after-tax profits have been taxed in full in the hands of the shareholders without any regard to the tax paid on the profits out of which the dividend had been declared.

The intercompany rebate system provided under section 46 of the Act only served to defer this double taxation in the case of a shareholder which was a company. In the case of a company shareholder that deferral was only until that company made a distribution (directly or indirectly down a corporate chain) to shareholders who were not companies.

In the case of a non-resident shareholder, dividend withholding tax was imposed at a rate of 30 per cent (reducing to 15 per cent in the case of a resident of a country with which Australia had a comprehensive double tax treaty). Dividend withholding tax was (and still is) a final tax.

The desire to avoid the imposition of double taxation led to a number of results.

In the case of a closely held company, which is referred to for taxation purposes as a "private company", the controllers of the company usually sought to retain after-tax profits in the company rather than distribute them to shareholders who would pay further tax on the dividends. This led to the introduction of Division 7 of Part III of the Act which has forced private companies to distribute significant parts of their after tax income (100 per cent in the case of private company dividends, 90 per cent in the case of other property income and 20 per cent in the case of business income) to shareholders to be taxed in their hands usually at their marginal rate (in more recent years 60 per cent or higher) or suffer undistributed profits tax at a rate of 50 per cent.

In turn, this led to elaborate schemes also developed to enable companies to satisfy the sufficient distribution requirements of Division 7 without adversely affecting their actual financial position.

Schemes were also developed to enable companies to satisfy the sufficient distribution requirements of Division 7 without adversely affecting the financial position of the relevant company.

The distinction under the Act between private companies and public

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companies has now substantially disappeared (although it still remains for the operation of s.108 and s.109).

An alternative approach which gained some popularity both in relation to the closely controlled company and the public company, has been the use of trusts to avoid the imposition of double taxation. This has produced particularly favourable results for "shareholders" who qualify as exempt entities. In turn this led to amendments being enacted which deem certain "spin-off" investment unit trusts to be treated as companies for taxation purposes (Division 6B of Part III of the Act) and which deem certain public trading trusts to be treated as companies for taxation purposes (Division 6C of Part III of the Act).

In addition, elaborate schemes were developed to ensure that a company could make a tax-free distribution, effectively in cash, to a shareholder. Anti-avoidance provisions, particularly section 177E and section 46A and 46B, were introduced to bolster the definition of "dividend" contained in section 6(1) of the Act. Suffice it to say any distribution which is made by a company to its shareholders is likely to be caught by the Act.

Introduction of the company imputation system

It was proposed as part of the ALP program for the reform of the taxation system in Australia that an imputation system be introduced in relation to dividends paid by companies. According to the Treasurer's statement of September 19 1985, this proposal was expressly designed to "remove the current problem whereby company income is taxed twice — first at the company level and then in the hands of shareholders when distributed as dividends."

In the Draft White Paper, the proposal was for a partial imputation system only. The system that has been implemented is a full imputation system.

Under a full imputation system each shareholder receives a credit for the *whole* of the tax paid by the company declaring the dividend in respect of the dividend that the shareholder actually receives.

Under a partial imputation system, the shareholder receives a credit in respect of part only of the tax paid by the company. This means that for shareholders on higher marginal rates, the dividends are not received tax-free.

The imputation system actually introduced to apply from July 1, 1987, involved in one respect a radical departure from the initial proposal.

The main difference centred on the removal of the compensatory tax system which was to apply when dividends were paid to shareholders. Instead, there was implemented a system whereby profits will be allocated to a Franking Account (FA) once those profits have borne the full 49 per cent tax rate (or the prevailing tax rate) and dividends paid out of the FA will be entitled to receive the benefit of imputation credit rebate and be received effectively tax-free in the hands of shareholders.

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Hence, in terms of the company, no additional complications will be added to the existing reporting and paying requirements of companies other than to maintain the Franking Account and to notify the shareholders of certain additional details of the franked nature of the dividend declared. This alteration from the originally proposed system is likely to have significant benefits in respect of cash flow and for companies which pay no tax or low tax and which have a high dividend policy.

Effect on shareholders

The essence of this imputation system for resident individuals (referred to in the Act as "natural persons") is as follows:

- Franked dividends will be included in assessable income together with the amount of the franking credit attaching to the dividend.
- An imputation credit rebate equal to the amount of the franking credit will be available to the taxpayer against income tax payable in that year.
- The rebate will not be able to be used against any other tax liability, e.g. medicare levy, provisional tax payable, tax assessed for an earlier or later year.
- Unfranked dividends will continue to be taxed as before, i.e. the amount of the dividend received will be included in the assessable income of the taxpayer.
- When a dividend is partially franked, there will effectively be a split treatment with the portion that is franked treated as a franked dividend and the portion unfranked treated as an unfranked dividend.

The obligation of a shareholder, who is a natural person who is resident at the time the dividend is paid, to include an additional amount in his assessable income arises from s.160AQT.

The amount to be included is an amount equal to:

$$\frac{FA \times CR}{(1 - CR)}$$

where CR is the general company tax rate in the year in which the dividend is paid (currently 49 per cent) and FA is the franked amount of the dividend.

Currently this results in an additional amount to be included equal to 49/51 × the franked amount of the dividend. This is an amount to be included *in addition* to the actual dividend received.

Pursuant to s.160AQU, the individual shareholder will be entitled to a *rebate* of tax in that shareholder's tax assessment of an amount equal to the amount included in the assessable income of that shareholder pursuant to s.160AQT, i.e. the gross up amount.

Where a dividend is received that is not fully franked, the amount in excess of the franked amount of the dividend will be included in the assessable income of the shareholder under s.44(1), but there will be no gross up amount included in respect of the unfranked amount of the dividend. Effectively, the individual shareholder will be subject to tax as has been the case in the past.

The operation of the imputation credit rebate provision will not apply if the person concerned is not a resident at the time of payment of the dividend. Prima facie, in such a case the dividend withholding tax provisions will apply and the franked part of the dividend will be excluded from dividend withholding tax. The operation of s.160AQT and other provisions in Part IIIAA envisage changes of residence during the course of a year. In the case of individuals, there is little likelihood of more than one

TABLE 1

WITHOUT IMPUTATION — 49% TAX RATE

	$	$
Taxable income of company		200.00
Less tax at 49%		98.00
Net profit after tax		102.00
If distributed to shareholder		102.00
Less taxed on $102 at 50.25%		51.26
Net to shareholder		50.74

WITH IMPUTATION

Taxable income of company		200.00
Less tax at 49%		98.00
Net profit after tax		102.00
If $102 distributed to shareholder the shareholder is taxed on actual distribution	102.00	
Plus s.160AQT add back	98.00	
Shareholder taxed on	200	
Tax at 50.25% equals		100.50
Less s.160AQU rebate		98.00
Net tax payable by shareholder		2.50
Distribution actually received		102.00
Less additional tax paid		2.50
Net to shareholder		99.50

WITH IMPUTATION — PARTIALLY FRANKED DIVIDEND

It is assumed that the dividend is franked to 60%		
Taxable income of company		200.00
Less tax at 49%		98.00
Net profit after tax		102.00
Of the $102 to be distributed the franked amount will be	61.20	
and the unfranked amount will be	40.80	
If $102 distributed to shareholder the shareholder is taxed on actual distribution		
franked amount of the dividend	61.20	
unfranked amount of the dividend	40.80	
total of actual distribution	102.00	
Plus s.160AQT add back on $61.20	58.80	
Shareholder taxed on	160.80	
Tax at 50.25% equals		80.80
Less s.160AQU rebate		58.80
Net tax payable by shareholder		22.00
Distribution received		102.00
Less additional tax paid		22.00
Net to shareholder		80.00

WITH IMPUTATION — WHOLLY UNFRANKED DIVIDEND

Taxable income of company		200.00
Less tax at 49%		98.00
Net profit after tax		102.00
If distributed to shareholder		102.00
Plus s.160AQT add back on $Nil		0.00
Shareholder taxed on		102.00
Less taxed on $102 at 50.25%		51.26
Net to shareholder		50.74

TABLE 2

WITHOUT IMPUTATION — 40% TAX RATE

	$	$
Taxable income of company		200.00
Less tax at 49%		98.00
Net profit after tax		102.00
If distributed to shareholder		102.00
Less taxed on $102 at 41.25%		42.08
Net to shareholder		59.92

WITH IMPUTATION

Taxable income of company		200.00
Less tax at 49%		98.00
Net profit after tax		102.00
If $102 distributed to shareholder the shareholder is taxed on actual distribution	102.00	
Plus s.160AQT add back	98.00	
Shareholder taxed on	200.00	
Tax at 41.25% equals		82.50
Less s.160AQU rebate		98.00
Net rebate able to be used by shareholder		15.50
Distribution actually received		102.00
Plus additional rebate available		15.50
Net benefit to shareholder		117.50

WITH IMPUTATION — PARTIALLY FRANKED DIVIDEND

It is assumed that the dividend is franked to 60%		
Taxable income of company		200.00
Less tax at 49%		98.00
Net profit after tax		102.00
Of the $102 to be distributed the franked amount will be	61.20	
and the unfranked amount will be	40.80	
If $102 distributed to shareholder the shareholder is taxed on actual distribution		
franked amount of the dividend	61.20	
unfranked amount of the dividend	40.80	
total of actual distribution	102.00	
Plus s.160AQT add back on $61.20	58.80	
Shareholder taxed on	160.80	
Tax at 41.25% equals		66.33
Less s.160AQU rebate		58.80
Net tax payable by shareholder		7.53
Distribution received		102.00
Less additional tax paid		7.53
Net to shareholder		94.47

WITH IMPUTATION — WHOLLY UNFRANKED DIVIDEND

Taxable income of company		200.00
Less tax at 49%		98.00
Net profit after tax		102.00
If distributed to shareholder		102.00
Plus s.160AQT add back on $Nil		0.00
Shareholder taxed on		102.00
Less tax on $102 at 41.25%		42.08
Net to shareholder		59.92

change of resident status in any one year of income.

Where a person, who is a resident at the time a final dividend is declared, emigrates and becomes a non-resident of Australia prior to the dividend physically being paid, on the basis of the existing law the shareholder concerned will not be entitled to the benefit of the operation of the imputation credit rebate provisions.

The operation of the imputation credit rebate provisions will not apply where the dividend is exempt income of the shareholder (this will rarely be the case with an individual).

Where a resident individual derives assessable income as a partner in a partnership or as a beneficiary in a trust estate and part of that assessable income is attributable to dividends derived by the partnership or trust estate (as the case may be), then special provisions apply to enable the operation of the imputation system to the resident individual: see s.160AQX and s.160AQZ.

The mythology attaching to the imputation system is that the shareholder is only "excused" to the extent that the company has already paid tax on the profits "allocated" to the dividend distribution. In reality the operation of the franking account and the franking of dividends is much more complicated than the foregoing myth acknowledges.

Table 1 illustrates the operation of the imputation system for a taxpayer with a 49 per cent marginal tax rate.

The clear implication is that if the company is paying an effective 49 per cent tax rate and distributing its after-tax income as fully franked dividends to the shareholders, the shareholders will be significantly better off under the imputation system than without it. It does not automatically follow the share investment immediately becomes attractive as a result of the introduction of the imputation system. There are many other factors, mainly commercial rather than taxation factors, which must be taken into account in formulating an investment decision.

The example in Table 1 assumes that the medicare levy of 1.25 per cent will apply to all taxable income. It should be carefully noted that an individual shareholder including franked dividends in his assessable income is required to pay medicare levy in respect of not just the actual income received, but in addition the gross up amount included in assessable income under s.160AQT. The rebate under s.160AQU is not available to satisfy the medicare levy payable even if all of the income tax payable has been satisfied. Together this means that in respect of dividend income, the medicare levy which is normally 1.25 per cent effectively increases to 2.45 percent i.e. almost double the normal rate. This is one of the less publicised claw-backs arising in the course of the introduction of the imputation system.

The example assumes that the shareholder has "other assessable income" equal to or in excess of $35,000, thereby producing the result that the dividends will be taxed at the effective marginal rate of 49 per cent.

It does not automatically follow the share investment immediately becomes attractive as a result of the introduction of the imputation system.

If this assumption is not correct, i.e. the shareholder has other income less than $35,000 so that the shareholder is being taxed on part or all of the franked dividend income at a rate less than 49 per cent, then there is scope for greater utilisation of the imputation credit rebate. This was seen by the Treasurer as being a significant benefit for shareholders, in that it would encourage "middle-income earners" to acquire shares. In the light of recent market movements this may not be an objective that is realised.

The difference in results between the dividends being taxed at a 49 per cent marginal tax rate and the dividends being taxed at a 40 per cent or lower marginal rate can be significant, depending on the composition and amount of the shareholder's taxable income ignoring the franked amount of any dividends received.

Table 2 illustrates the additional benefit.

If the *only* income of the resident individual is franked dividend income, then, to the extent that an excess imputation credit rebate is available there will be no tax on other income (including unfranked dividends) against which to use such excess imputation credit rebate. Such a situation should not be allowed to develop and will be usually solved by a more diversified investment portfolio.

The ability to use "excess" imputation credit rebate against tax payable on other income does not extend to taxes other than income tax, such as the medicare levy. In addition, any excess imputation credit rebate *cannot* be carried forward, carried back or transferred.

Where an individual incurs losses or deductions, then, in the absence of any other assessable income against which to deduct the losses or deductions, those losses or deductions will be deducted from the grossed-up dividend, i.e. the actual dividend received plus any amount required to be included in assessable income under s.160AQT. This will mean that to that extent, the losses or deductions are effectively wasted, in that the full benefit of those losses or deductions will be lost, or that the full benefit of the imputation credit rebate will not be realised, or both.

The imputation system does not apply in respect of dividends received from companies that are not sufficiently resident at the time the dividend is paid.

Previously, where an individual derived dividend income from a non-resident company (which will not necessarily include a company which is not sufficently resident at the time that the dividend is paid), the dividend was included in the assessable income of the shareholder and credit for the foreign tax paid allowed in terms of s.45 of the Act or s.14 of the Income Tax (International Agreements) Act 1953. Now the credit (if available) is to be allowed under Division 18 of Part III of the Act.

Resident individuals should be attracted towards companies with a dividend and franking policy which sees a maximum of the after-tax profits of the company distributed in the form of franked dividends. This will minimise the increase in the share price due to retention of net profits after tax and hence minimise any capital gains tax complication on disposal of the shares, as well as maximise the cash flow to the shareholder. Problems arising in relation to work capital of the company can be dealt with by the use of dividend re-investment schemes. □