Jon Kalkman, AIA Member

The truth about franking credits

We are all familiar with a PAYG taxpayer who has tax deducted from their salary or wages by their employer. In their annual tax return their taxable income is the total of salaries or wages received PLUS the tax already deducted on their behalf and paid to the ATO. The tax payable arising from their annual tax return depends on their marginal income tax rate. Any excess tax already paid by their employer is refunded to the taxpayer as cash. No government has ever suggested that excess tax paid on behalf of a taxpayer as PAYG should not be refunded to the taxpayer.

A similar process applies to dividends from Australian shares. In Australia, companies pay tax on their profits at the rate of 30%. Some or all of the after-tax profits is then distributed to shareholders as dividends. Before 1987 these after-tax profits received as dividends were then taxed again as income for the shareholder. These profits were therefore taxed twice. This was double taxation. Since 1987 the tax paid by the company has been "imputed" as a tax credit available to the shareholder when calculating their income tax.

These tax credits are described as imputation or franking credits. The word franking is associated with a letter that, when it passes through a franking machine, is marked as "postage paid" and is thus "franked". In this case, franking means "tax paid".

For the shareholder, their taxable income is their share of gross profit received, even though part of that income has already been sent to the ATO on their behalf, rather like a withholding tax. A shareholder's taxable income is the actual dividend received PLUS the tax credit attached to those dividends. If the company profit was $100, the company would pay $30 tax to the ATO and distribute $70 in dividends to the shareholder. The shareholder's taxable income is thus $100 even though they only received $70 personally. The $30 tax franking credit held by the ATO is available to the taxpayer to be offset against any tax payable. In any tax year, if the total value of franking credits held by the ATO on behalf of a taxpayer exceeds the income tax payable, then the ATO refunds the balance of the franking credits as cash to the taxpayer.

Clearly a lower rate of company tax, eg. from 30% to 20%, would mean lower franking credits, but the after-tax profit paid as dividend, all else being equal, would increase from 70% to 80%. But the shareholder's taxable income would be unchanged. Using the previous example of $100 in company profits, with a company tax of 20%, only $20 would be paid by the company to the ATO, and $80 would be sent as a dividend to the shareholder. As the shareholder's taxable income remains unchanged at $100 ($80 plus $20), their tax liability also remains unchanged.

In the extreme case there would be no company tax and all company profits would simply be taxed as dividends in the hands of shareholders at their marginal rate. For Australian taxpayers, their taxable income would be unchanged but non-residents, who pay no income tax in Australia, would receive their dividends tax-free.

Lowering the company tax, and the associated imputation credits, is designed to ease the tax burden on foreign shareholders. There may be good reasons why the Australian government would want to do that, but it will make little difference to tax receipts from Australian shareholders.

The tax payable on a shareholder's taxable income depends on their marginal tax rate. At the highest marginal tax rate of 47% they would need to pay $47 tax on this taxable income of $100, but because of the $30 franking credit, this shareholder only needs to pay an additional $17 in tax. Similarly, the taxpayer on the 30% marginal tax rate finds that no more tax is required because the tax credit covers the tax payable. In this case there are also no excess franking credits to be refunded.

Until 2000, franking credits could only be used to offset other tax liabilities up to the limit of those tax liabilities. Any excess credits were simply retained by the ATO and lost to the taxpayer. This was clearly inequitable. Since 2000 any franking credits in excess of tax liabilities are refunded in cash. It is clearly appropriate **and** equitable for the ATO to refund to these taxpayers any excess tax collected on their behalf. All taxpayers whose marginal tax rate is lower than the company tax rate (30%) obviously now benefit from this cash refund of franking credits.

Superannuation is not an investment; it is a tax structure in which to hold investments. Through different tax concessions it is designed to encourage people to save for their own retirement so that they are less dependent on the age pension. There are a number of tax concessions, both for contributions and for retirement benefits along with highly complex rules to prevent people exploiting these tax concessions.

A superannuation fund is a separate taxpayer and in accumulation phase, the fund pays 15% tax on investment income and members' concessional contributions and 10% tax on capital gains. The cash refund of tax credits obviously mean additional income for the fund.

A superannuation fund paying a pension has always been zero taxed on income and capital gains. This provides higher fund balances which allows the fund to provide retirement benefits to its members for as long as possible. As we are all living longer, this is very important. As none of the franking credits is required to pay tax, these tax credits are currently all refunded to the fund as cash. Cash refunds of franking credits from Australian shares provides considerable additional income to all super pension funds, including retail and industry super funds as well as SMSFs.

The purpose and effect of franking credits is to ensure that company profits are only taxed once; in the hands of the shareholder at their marginal tax rate.

It is incorrect to say that the cash refund of excess franking credits is a tax loophole for owning shares, available only to the wealthy. It is not. It is simply the refund to the shareholder of excess tax already paid to the ATO on behalf of the shareholder.

These tax credits are a cash benefit to every Australian taxpayer/shareholder either as individuals or as members of a super fund:

> **Case A:** If a tax payer's only income was dividends from fully franked Australian shares, they can earn $94,500 in dividends and pay minimal additional tax, because the franking credits almost completely pays for the tax liability. The taxable income is $135,000 which is comprised of $94,500 dividend (70%) in addition to $40,500 franking credit (30%). The tax on that taxable income is $40,597. The shareholder's tax liability is only $97 on a dividend income of $94,500 because the tax payable is almost completely covered by the franking credit paid in advance by the company to the ATO on behalf of the shareholder. The tax credit is as good as cash to pay the tax liability.

Case B: Assume the taxpayer is a super pension fund with the same dividend income. The taxable income remains $135,000 but the tax payable is zero. Therefore the fund would receive $94,500 directly as dividends and a tax refund of $40,500 for the excess tax already paid on its behalf. The after-tax income is $135,000 or 42% higher than the dividend alone. This demonstrates the attraction of owning fully franked Australian shares in a super pension fund. It might also explain why many Australian super pension funds have a higher asset allocation to equities than their international peers.

If Labor adopts the policy of denying a cash refund for excess franking credits, then the super fund in Case B (typically a SMSF) is in exactly the same tax position as the taxpayer in Case A. Both taxpayers have a taxable income of $135,000 and both have $94,500 after-tax because both taxpayers have paid $40,500 in tax which is an effective tax rate of 30% on their taxable income. Excess franking credits that currently are refunded as cash would then be confiscated.

This policy will allow some taxpayers with sufficient taxable income to use these tax credits (which are as good as cash) to pay their tax liability but it would deny other taxpayers on low marginal tax rates (including many SMSFs paying pensions) the benefit of this cash credit, thereby increasing their effective tax rate. That would be extremely unfair.

Taxpayers on low marginal tax rates, such as retirees, with any fully franked shares will see a reduction in income with this policy. This policy has all the hallmarks of a cynical tax increase on retirees who derive passive income from Australian shares but it does so in a way that the average voter may not comprehend. Middle class retirees are clearly the target of this policy. We should expect their considerable anger at yet another change to the rules affecting their retirement savings.

SMSFs holding fully franked Australian shares and paying a pension would also see a sharp drop in the income earned by the fund depending on their asset allocation. This proposal does not effect on the tax paid by members on their retirement benefits from their super fund because, after age 60, all retirement benefits (pensions and lump sums) are tax-exempt.

However, this proposal will severely limit a super fund's capacity to fund future retirement benefits. In the context of increased life expectancy that is a huge concern. As super balances become more rapidly depleted, it will place an additional burden on the age pension system which is already under great strain. Besides being electorally extremely unpopular it is exceedingly short-sighted from a public finance point of view.

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