Taxation Laws Amendment (Company Distributions) Bill 1987

Date Introduced: 2 April 1987
House: House of Representatives
Presented by: Hon. Paul Keating, M.P., Treasurer

Digest of Bill

Purpose

To end the 'double taxation of dividends' by allowing a rebate of tax on franked dividends paid by resident companies in the shareholders' hands where sufficient franking credits exist; to remove the liability for withholding tax for non-residents in respect of franked dividends; and to strengthen the provisions relating to when equity investments will be considered as loans.

Background

The Bill will introduce the imputation system of company tax which was one of the measures announced by the Government in the September 1985 Statement on the Reform of the Australian Taxation System. While the Bill introduces the essential elements of imputation, certain measures will be implemented by a separate Bill to be introduced at a later date. Examples of changes not covered by this Bill include the abolition of Division 7, which deals with private companies, and the treatment of bonus shares.

As the law currently stands, company earnings are effectively taxed twice. First, they are taxed in the hands of the company as company income at the company tax rate. Secondly, when dividends are distributed they are taken as assessable income in the hands of the person who receives them and are subsequently taxed at that person's marginal rate. This system, referred to as the classical or separate system of company tax, has been justified on the grounds that companies are separate legal identities and, as well as gaining the advantages this contains such as limited liability, the separate identity should also pay tax.

Various factors implicit in the system of 'double taxation' made it inequitable and, as up to 78.9 cents in every dollar distributed as dividends could be paid as tax, investment in shares and the use of companies lost favour. For example, the growth in the use of family trusts can be attributed to 'double taxation of dividends'.
The classical system of company taxation was criticised because of problems of equity and efficiency by both the Asprey\(^1\) and Campbell\(^2\) Committees. The Asprey Committee recommended a system of partial imputation with the aim of full imputation. The Campbell Committee favoured a system of full integration where all profits would be taxed in the hands of the shareholder at their marginal rate. Imputation systems were examined but were considered less favourable as neutrality between debt and equity and between retaining and distributing profits would not be fully achieved, and that a degree of inequality for low income investors would remain. Regarding imputation the Report stated, 'Thus from the Committee's point of view, financial decisions are biased away from those that would lead to the most efficient functioning of the financial system.'\(^3\)

One of the changes expected as a result of the introduction of the imputation system is an increase in the attractiveness of equity investments compared to loans. This should arise as the return to equity investors will increase with the abolition of 'double tax' on company profits while the return from loans will not be effected.

The system proposed in this Bill is known as imputation as the tax paid by a company will be imputed or allocated to the shareholders. The proposed system will apply from the 1987-88 tax year.

As originally announced the imputation system was to contain a compensatory tax which meant that when a resident company distributed dividends it would be liable to compensatory tax at the rate of $49 for every $51 distributed to shareholders. This tax was to be offset against company tax liability, if any, and where the company tax liability was not sufficient the compensatory tax would still be payable. The payment of compensatory tax would have been a step towards the more timely collection of company tax. However, on 10 December 1986 following representations from interested bodies as to cash flow problems the tax may cause and the inequities of collecting tax from companies that would not otherwise have to pay tax at all or until some future time, the compensatory tax proposal was dropped. The nett cost of the changes is estimated at $300 million in a full year.

Outline

The basis of the imputation system is the franking of dividends for resident companies. Franking is the allocation of franking credits (which generally arise on the payment of company tax) to dividends. Companies are to keep an account of franking credits and franking debits (generally where a franked dividend is paid) and the surplus in this account can be used to frank dividends. The full dividend will be included in the recipients income and a rebate will be allowed to the degree that the dividend was franked. Thus if a dividend is fully franked there will be a rebate equal to the company tax paid if the recipients marginal tax rate is below the company rate the tax credit may be offset against other tax liabilities. The amount of franking will largely depend on the surplus in the franking account though rules will apply to ensure full franking when the surplus will allow this. In addition, the rules will require consistency in the franking of various dividends.
Main Provisions

The imputation scheme will be introduced by a new Part IIIAA, titled Franking of Dividends, which will be inserted into the *Income Tax Assessment Act 1936* (the Principal Act) by clause 14.

The calculation of franking credits is dealt with in proposed Subdivision B of proposed Division 2. Resident companies will accrue a franking credit for the payment of company tax with the amount of credit being the adjusted amount paid (proposed section 160APM), the issue of a company tax assessment (proposed section 160APN), the receipt of a franked dividend from another company (proposed section 160APP), the receipt of an increased company tax assessment (proposed section 160APR) or the reduction of a foreign tax credit (proposed section 160APT).

Franking debits will arise where the required franking amount is at least 10% of the value of the dividend and this amount is not reached (the debit being the degree to which the dividend is under franked—proposed section 160APX), where company tax is applied to reduce a tax liability (proposed section 160APY), an amended assessment reducing company tax is issued (proposed section 160APZ), the allowance of a foreign tax credit (proposed section 160AQA), the payment of a franked dividend (proposed section 160AQB) or the issue of an estimated debit determination (proposed section 160AQC).

A franking surplus may be carried over from one year to the next (proposed section 160APL).

Proposed Division 3 deals with estimated debits. Where a company has taken ‘liability reduction action’ (i.e., generally action to reduce company tax payable—proposed section 160APA) or paid an instalment of company tax, that company may seek a declaration by the Commissioner as to the amount of estimated debit that is not to exceed the amount reduced or paid (proposed section 160AQD).

Proposed Division 4 contains the formulas for calculating the required franking amount which, where more than one formula applies, will be the greatest amount calculated (proposed sub-section 160AQE(1)). The provisional required franking amount will be calculated by reference to the current dividend, the amount of any committed future dividends and the amount of any franking surplus reduced by the franking amount of earlier dividends. As a result, where the franking surplus is sufficient full franking will be required (proposed sub-section 160AQE(2)). Where a committed future dividend is paid and was committed at the time of payment of an earlier dividend in the same franking year and the earlier dividend was franked above the required franking amount, the latter dividend is to be franked to the same extent as the earlier dividend (proposed sub-section 160AQE(3)). Similarly, dividends paid on the same day but under different resolutions are to be franked to the same degree (proposed sub-section 160AQE(4)). Companies with a franking deficit at the end of a franking year will be liable to franking deficit tax calculated in accordance with the formula $FD \times (CR/1-CR)$ where $FD$ is the amount of franking deficit and $CR$ is the general company tax rate (proposed section 160AQJ).
Where franking deficit tax and company tax are payable the amount of company tax payable will be reduced by the lesser of the franking deficit tax or the company tax less any allowable foreign tax credits (proposed section 160AQK).

Franked dividends paid to shareholders who are natural persons, trustees or in a partnership are to be included in assessable income with the amount included calculated in accordance with the formula FA x (CR/1-CR) where FA is the franked amount of the dividend and CR is the general company tax rate. This liability will be in addition to any other existing liability (proposed section 160AQT). Where such a sum is included in assessable income and the taxpayer is not a partnership or a trustee other than a superannuation or approved deposit fund trustee, the taxpayer will be entitled to a rebate equal to the amount included (proposed section 160AQU). As a result, the marginal rate of tax will be calculated on income including franked dividends. Proposed section 160AQY will provide for rebates for certain trustees while proposed section 160AQZ will extend the rebate to partners.

Where trust or partnership income is included in the assessable income of a company and a franking credit arises in relation to that income, a deduction will be allowed. The amount of the deduction will be the 'potential rebate amount', that will be calculated in accordance with the formula contained in proposed section 160APA, to a maximum equal to the relevant income (proposed section 160AR). Similar deductions will be allowed for non-resident beneficiaries (proposed section 160ARA), certain trustees (proposed sections 160ARB and 160 ARC) and non-resident partners (proposed section 160ARD).

Proposed Division 8 deals with returns and assessments and contains provisions relating to returns, amendments and assessment of franking tax.

The general provisions relating to objections, review and appeals will apply (proposed section 160ART).

Additional penalty tax is dealt with in proposed Division 11. Where, at the end of a franking year, the franking deficit is greater than 10% of the franking credits that arose during the year and dividends were franked at more than the required amount, penalty tax at the rate of 30% of the franking deficit tax payable will be payable (proposed section 160ARX). In addition, penalties will apply for incorrect dividend statements (proposed section 160ARY), failure to furnish a return (proposed section 160ARZ) and making false or misleading statements (proposed section 160AS).

The denial of the rebate for short term equity that is equivalent to debt will be extended to the payment of all dividends that may reasonably be regarded as equivalent to the payment of interest on a loan. This amendment will apply to dividends paid after 1 p.m. Australian eastern summer time on 10 December 1986 (clause 7 which will insert a new section 47D into the Principal Act).

Section 128B of the Principal Act will be amended by clause 11 to remove the withholding tax liability of non-residents in respect of franked dividends.
References
1. Taxation Review Committee, 1975, Chapter 16.
3. Ibid. p.216.

For further information, if required, contact the Economics and Commerce Group.

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This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.

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