Chapter 15

A FAIRER AND MORE CONSISTENT TREATMENT OF ENTITY DISTRIBUTIONS

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A case for reform

The current system for taxing companies has multiple deficiencies

15.1 As identified in *A Strong Foundation* and in the Overview, the current tax law contains many instances where the tax treatment of income from a particular transaction depends on the nature of the entity undertaking the transaction. The treatment is different both between the various entities and at the individual investor (for example, at the shareholder) level.

15.2 It does not make sense for exactly the same investment to attract very different tax treatment simply because it is put through a trust rather than a company. Such a result violates the tax principle that taxpayers in similar positions should be treated similarly.

15.3 The principle of investment neutrality, identified in *A Strong Foundation*, also requires that business tax arrangements should avoid taxing types of entity differently.

15.4 The company imputation system is a practical way of achieving taxation of distributed entity income at the individual investor's marginal tax rate. However, the existing company imputation system is overly complex and also produces unequal treatment for low income shareholders. In addition, the section 46 inter-corporate dividend rebate, which ensures that there is no double tax paid on inter-company distributions, creates distortions.

15.5 The problems with the current arrangements are discussed below as well as in the Overview.

The existing imputation system is complex

15.6 There is considerable complexity in the present system caused by dividends being either franked or unfranked depending on whether they are paid out of taxable income or not. Virtually all company profits are subject to taxation in the hands of either the company or its shareholders. But only the company's taxable income is subject to company tax (with distributions of these taxed profits being franked). Tax-preferred profits are taxed in the hands of individual resident shareholders as unfranked dividends when distributed.

15.7 This distinction adds complexity both at the shareholder level and at the company level.

15.8 At the company level, a company is required to frank its dividends to the maximum extent that its franking account surplus permits (that is, the required franking amount), taking account of certain anticipated entries to the

franking account. In determining the required franking amount, a company needs to consider a number of factors, such as:

- any obligation to pay committed future dividends, so as to ensure it has reserved credits for these dividends;
- anticipation of possible future franking credits (for example, for tax payable);
- whether the anticipation may result in overfranking which can result in deficit deferral tax and franking additional tax;
- estimated debit determinations where tax is in dispute with the Australian Taxation Office (ATO); and
- whether the dividend may be underfranked which can result in a permanent wastage of a franking account surplus.

15.9 In addition to this complexity, the ability to pay either franked or unfranked dividends provides the potential for companies to stream franked and unfranked dividends to shareholders in a way which maximises the benefits to shareholders but at a higher cost to revenue than is intended in the legislation. Dividend streaming occurs where unfranked dividends are streamed to shareholders that have no need for franking credits so as to preserve the credits for those who benefit most from the credits.

15.10 Both the required franking rules as well as anti-avoidance provisions currently attempt to eliminate the potential capacity to stream franked and unfranked dividends.

15.11 At the shareholder level, dividends received may be franked at varying rates, or completely unfranked. Shareholders may need to apply different gross-up rates to their dividends in order to include the amount of tax paid at the company level in their assessable income.

Low marginal rate shareholders are disadvantaged

15.12 Under current imputation arrangements, excess imputation credits that cannot be used in the income year are lost. There is no refund even though tax has already been paid on the income in the company. This disadvantages low income shareholders, including self-funded retirees, whose marginal tax rates are lower than the company tax rate. They may face the company tax rate on dividend income rather than their own marginal tax rates.

The section 46 rebate creates unintended loopholes

15.13 Companies are currently able to achieve unintended tax benefits from the present section 46 rebate on inter-corporate dividends. Group companies — as well as related companies with less than 100 per cent

common ownership — are able to create taxation benefits by manipulating transactions between companies in the group.

15.14 The current inter-corporate dividend rebate:

- indefinitely preserves tax preferences distributed between entities, even where the entities are totally unrelated;
- enables companies to create artificial tax benefits associated with loss deductions and capital gains tax (for example, companies are able to create artificial losses through the company chain); and
- requires a wide range of specific and complex anti-avoidance provisions to deal with the various loopholes created by it or exacerbated by it (see the Overview for a further discussion of these provisions).

A strategy for reform

Apply a redesigned imputation system to entities

15.15 Achieving consistency of treatment of income earned in different business entities under a redesigned imputation system would provide simplicity, fairness in treatment and improve the integrity of the business tax system.

15.16 In *A New Tax System*, the Government proposed extending redesigned company tax arrangements to trusts, limited partnerships, co-operatives and life insurers. Part of the proposed arrangements is a redesigned imputation system. Two features of the proposed redesigned imputation system are:

- full franking of all distributions; and
- making excess imputation credits refundable.

15.17 Full franking of distributed profits would improve the integrity of the business tax system and provide the basis for greater simplicity. Providing refunds of excess imputation credits would improve the fairness of the system.

15.18 The Review noted in *A Strong Foundation* that the full imputation system set out in the Government's reform strategy, with full refundability and extended to other entities such as trusts, would go a long way towards achieving distribution-related integration.

15.19 *A Strong Foundation* put forward the principle of integration of ownership interests in determining tax liability. That is, for business tax — as distinguished from commercial or legal purposes — entities should be

considered as extensions of their ultimate owners. However, it was concluded in *A Strong Foundation* that practical considerations, such as valuation requirements and complicated capital structures, place significant obstacles in the path of this full integration approach. Entity taxation also ensures an Australian return on profitable inbound investments.

Introducing full franking of all distributions or otherwise improving integrity through the entity chain

15.20 Full franking would improve the integrity of the business tax system by collecting tax on all distributions of profits from entities, rather than allowing some untaxed distributions to be made.

15.21 As discussed in the Overview, full franking would enable the removal of a wide range of complex anti-avoidance provisions currently seeking to address a lack of integrity through the company chain. It would support the consistent treatment of distributions of profit by way of share buy-backs, particularly through the entity chain. It would also support measures aimed at addressing loss cascading down the entity chain outside consolidated groups and artificial benefits from dealings between related entities, again outside consolidated groups.

15.22 Nevertheless, achieving full franking via the deferred company tax proposed in *A New Tax System* has some disadvantages. The question is whether the integrity benefits can be achieved in other ways without the disadvantages of the deferred company tax approach.

Refunding excess imputation credits

15.23 As noted in the Overview, the taxing of trusts like companies could result in cash flow disadvantages for some taxpayers — even though the availability of refunds means that over the year the taxpayers are liable for the same amount of tax. Investors in collective investment vehicles who have much of their saving in that form may be affected in this way.

15.24 A low marginal rate taxpayer, for example, may receive regular distributions from a cash management trust. The distributions may be the taxpayer's main source of income. Currently the only tax collected during the year of receipt may be a once only instalment of provisional tax late in the year of income. That instalment would be at the taxpayer's marginal rate. Under entity taxation, the beneficiary would receive the distributions from the cash management trust net of tax at a rate of 36 per cent at the entity level. The beneficiary would not be compensated for the excess tax until assessment after the year of income. Although overall the beneficiary will not pay any extra tax, there is a negative timing impact on the cash flow of the beneficiary.

15.25 It is important that an efficient, rapid refund mechanism be devised that addresses this potential cash flow problem for taxpayers who are affected.

15.26 An alternative way of addressing this — at least for investors in collective investment vehicles — would be to subject these vehicles to flow-through taxation. That alternative is discussed in Chapter 16.

Key policy issues

What are the options for achieving integrity through the entity chain while recognising the impact on foreign investors?

15.27 Three options are discussed for achieving integrity through the entity chain:

- impose a deferred company tax;
- apply a resident dividend withholding tax similar to that in place in New Zealand; and
- tax unfranked inter-entity distributions.

Option 1: Impose a deferred company tax

15.28 Under a full franking system, taxable income would, as now for companies, be subject to company tax. In contrast to current arrangements, however, distributions of tax-preferred profits would also be taxed (at the company tax rate) at the entity level. This deferred company tax would subject distributed tax-preferred income to tax at the entity level so that all distributions of profit would then be fully franked. As under each of the three options, company tax paid would then be creditable under the imputation system to resident individual shareholders, trust beneficiaries, members of co-operatives, life insurance policyholders or partners in a limited partnership.

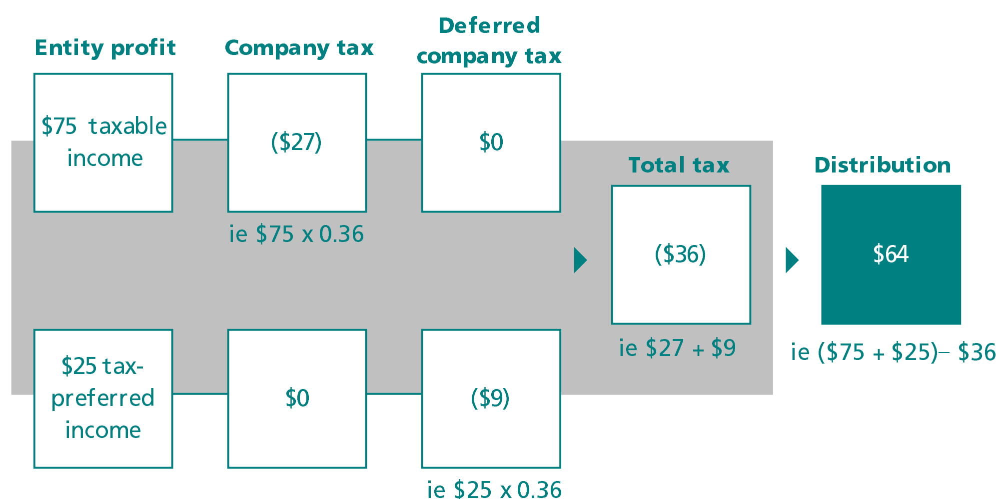
15.29 Deferred company tax would not only apply to distributions paid to individuals and superannuation funds. It would also apply to distributions of tax-preferred income from one entity to another (other than in the case of consolidated groups, if consolidation is included in the reforms adopted by the Government) — with arrangements to ensure that double taxation did not occur through the entity chain. This is common to each of the three options.

15.30 Figure 15.1 shows the operation of the full franking arrangements with a deferred company tax. At the current 36 per cent company tax rate, $100 of entity profit would give rise to a potential franked dividend of $64 and

$36 of company tax (regardless of the mix of taxable and tax-preferred income in the $100).

15.31 In the example, the entity earns $75 of taxable income, on which $27 of company tax is payable. The entity also earns $25 of tax-preferred income (from the effect of tax incentives), which is not taxed at the entity level at the time of derivation. Upon distributing its profits, the entity is liable to pay $9 in deferred company tax, in order to fully frank a cash distribution of $64.

Figure 15.1: How deferred company tax would work at the entity level



Option 2: Apply a resident dividend withholding tax

15.32 Another way of providing full franking would be to levy a resident dividend withholding tax (RDWT) at the company tax rate on distributions of tax-preferred income to Australian resident investors.

15.33 Under the RDWT option, a withholding tax would be levied on unfranked distributions paid from a resident entity to resident investors, including other resident entities (other than in the case of consolidated groups).

15.34 Unfranked distributions paid to foreign investors would be subject to the existing non-resident dividend withholding tax (generally levied at the rate of 15 per cent). The existing exemptions from non-resident dividend withholding tax (such as for tax exempt foreign pension funds) could be retained.

Figure 15.2: The effect of refunding RDWT when distributions flow through to non-resident investors

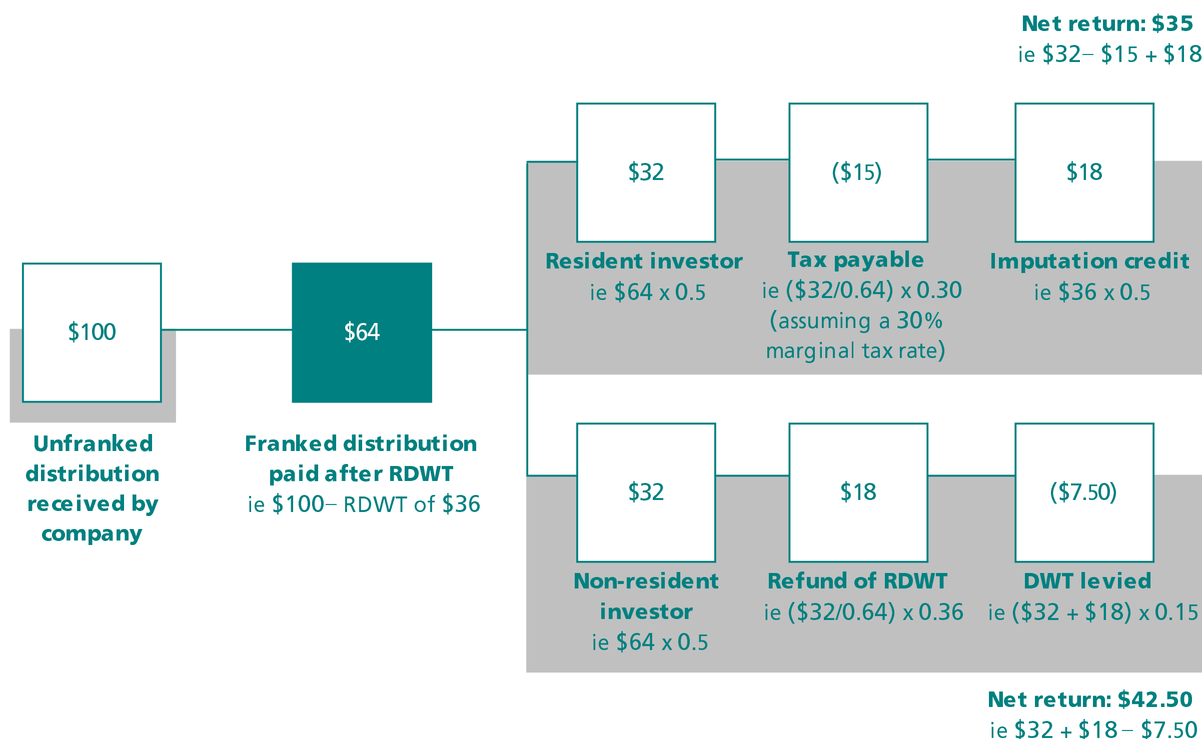
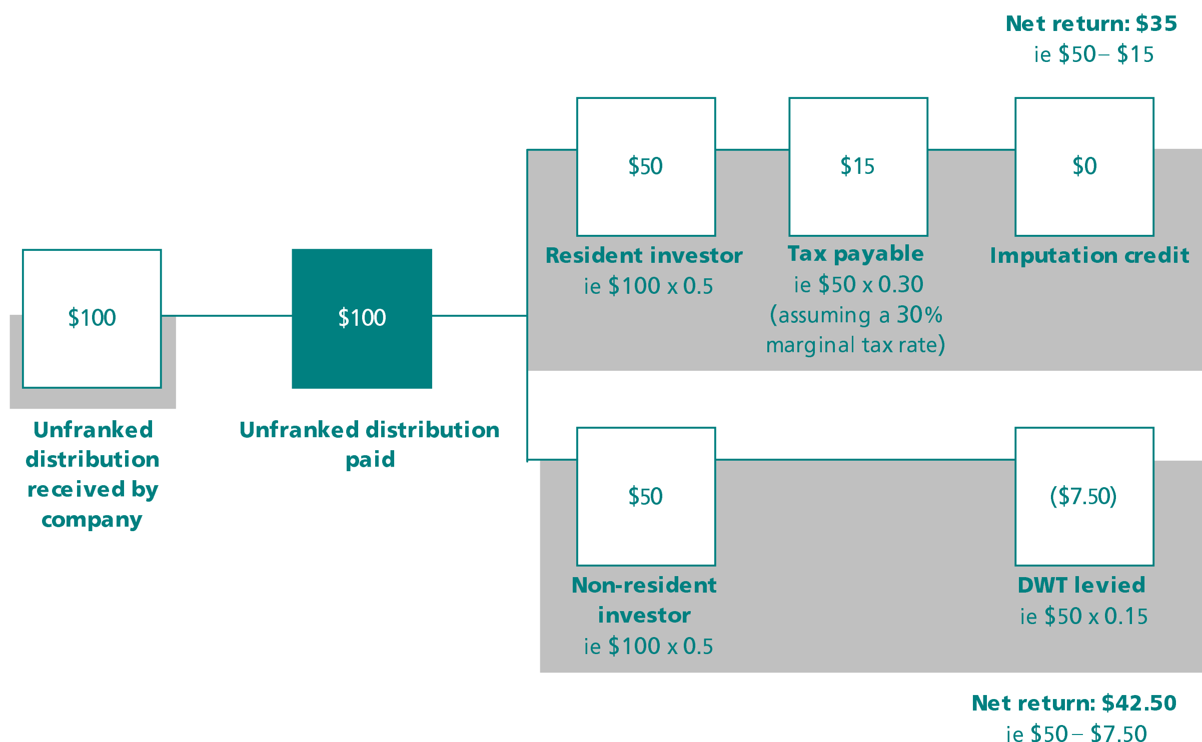


Figure 15.3: The current tax treatment when distributions flow through to non-resident investors



15.35 Where distributions that are paid between resident entities are subject to RDWT and are subsequently passed to foreign investors, the RDWT would be refunded and non-resident dividend withholding tax (DWT) applied to the cash dividend plus refund. This refund would relieve foreign investors from the RDWT and the application of DWT would produce the same outcome as now for non-residents. That equivalence is illustrated by Figures 15.2 and 15.3. The operation of the RDWT within the entity would be equivalent to that of deferred company tax illustrated in Figure 15.1 — except that with RDWT entities would have to keep track of franked and unfranked distributions they received so that refunds could be provided for any dividends paid to non-residents that had previously been subject to RDWT.

Option 3: Tax unfranked inter-entity distributions

15.36 The third option is directed at removing the problems associated with the section 46 inter-corporate dividend rebate, without requiring full franking of all distributions. It would involve taxing distributions of tax-preferred income in the hands of resident recipients — that is, equivalent to the current treatment of taxing unfranked dividends paid to individuals or private companies. In the case of entity shareholders, this would mean that they would be taxed on unfranked distributions, compared with having the benefit of the section 46 rebate, which allows the distribution to flow through untaxed. This would not apply to intra-group distributions in a consolidated group.

15.37 Distributions to non-residents would continue to be subject to dividend withholding tax. The existing exemptions from non-resident dividend withholding tax (such as for tax exempt foreign pension funds) could be retained. In a similar way to the RDWT option, tax on unfranked dividends paid by other entities could be refunded to foreign investors.

Discussion of the options

Deferred company tax

15.38 The implications of imposing a deferred company tax on distributions of tax-preferred income to non-resident and resident owners are as follows:

- There would be a simple consistent application of deferred company tax. All dividends would be fully franked. This would allow the removal of current anti-dividend streaming rules as well as the required franking rules.

- Distributions of tax-preferred income to non-residents would attract the company tax rate rather than dividend withholding tax (DWT) which generally applies at 15 per cent.
- This would require the company tax/DWT switch outlined in Chapter 30 — that is, the company tax underlying dividends paid to non-residents could be converted to DWT to increase the creditability of Australian tax in the home country of portfolio investors.
  - This would mean that most non-resident portfolio investors would be better off, on the basis that the company tax/DWT switch is accepted by foreign taxing authorities.
  - The effect of deferred company tax would, however, put greater weight on achieving a move towards a 30 per cent company tax rate — to help ensure that foreign investors receiving a significant amount of unfranked dividends are not worse off.
  - Beyond the company tax/DWT switch, consequential changes to international tax arrangements would still be necessary because of the taxing of trusts like companies.
- No tax treaty renegotiations are formally required.
  - Countries operating foreign tax credits systems should allow credit for deferred company tax to non-portfolio foreign investors.
  - The company tax/DWT switch should also not be regarded as a disguised company tax.
- Consequential changes to international tax arrangements would also be necessary because of the taxing of trusts like companies.
- The reported after-tax profits of entities would be reduced for those companies required to pay deferred company tax, even though the mechanism of payment has the equivalent effect of a withholding tax. Markets and shareholders would need to appreciate the impact of the change on those listed companies deriving significant tax-preferred income. The reduction in reported after-tax profits might change the behaviour of companies in relation to dividend payments.
- The potential 'double tax', which can arise from the distribution of untaxed profits due to temporary tax preferences, would be more apparent as it would occur at the entity level rather than at the shareholder level as currently. Options for dealing with this potential double tax are discussed later in the chapter.

- A number of different options for payment arrangements are possible depending on whether or not deferred company tax is to be collected by instalments.

Resident dividend withholding tax (RDWT)

15.39 The implications of applying a RDWT at the entity rate on distributions of tax-preferred income to Australian owners but refunding any prior RDWT paid on such distributions to non-residents are as follows:

- Unfranked distributions paid to non-residents would continue to attract tax at the rate of dividend withholding tax — rather than the company tax rate.
  - Consequential changes to international tax arrangements would still be necessary because of the taxing of trusts like companies.
  - But the full range of consequential changes would not be as important.
- After-tax reported profits of distributing entities would not be affected as the tax on unfranked distributions would be more directly identified as a withholding tax. Entities which receive unfranked distributions would have an increased tax liability.
- The incentive for dividend streaming would remain — because refunds would only be provided for RDWT, not company tax, paid on franked dividends distributed to non-residents. Anti-streaming rules would therefore need to be retained.
  - Consequently, it would be necessary to continue to identify unfranked dividends separately and additional complexity would arise from the refunding of prior domestic withholding tax paid on dividends to foreign investors via a chain of domestic entities.
- There would be no need for new RDWT payment arrangements other than including tax withdrawn from distributions to residents, due to the existence of the current DWT payment arrangements.

Taxing unfranked inter-entity distributions

15.40 The implications of taxing unfranked inter-entity distributions but continuing to apply DWT to such distributions to non-residents are as follows:

- Non-residents would not be affected.
  - Changes to international tax arrangements, though, would still be necessary because of taxing trusts like companies.

- Entities which cannot use imputation credits, such as some tax exempt entities and tax loss entities, would not be affected.
- After-tax reported profits of distributing entities would be unaffected under this approach but entities which receive unfranked dividends would have an increased tax liability.
- Dividend streaming of unfranked and franked dividends would remain an issue.
- As a result of replacing a withholding tax mechanism on distributions of tax-preferred income with recipient taxation, the integrity benefits would be reduced compared with the other two options. There would be less integrity with the taxation of distributions of tax-preferred income down the company chain and out of share buy-back arrangements.

15.41 A comparison of the three options is set out in Table 15.1.

How might the potential for double taxation of distributed tax-preferred income be addressed?

15.42 Under each of the above three options, as well as under the existing law, temporary tax preferences may, in some limited circumstances, result in 'double taxation'.

15.43 Temporary tax preferences, such as the accelerated depreciation provisions, initially allow for taxable income to be lower than economic income. If the untaxed profits are distributed, they take the form of an unfranked dividend, taxable either in the company (with credits to the shareholder) or in the shareholder's hands. However, in later years, if the tax preference is not repeated, taxable income will exceed economic income. In these circumstances, double taxation may occur (at least temporarily) as there may be insufficient after-tax income in the later years to enable the extra franking credits to be passed to shareholders.

15.44 'Permanent' tax preferences, where liability to company tax on income is permanently reduced, such as an exemption, do not give rise to double tax.

Table 15.1: Comparison of the options for achieving integrity through the entity chain

Feature	Deferred company tax	RDWT	Taxing inter-entity distributions
Full franking of all distributions	Yes	Yes	No
Simplification of franking account	Yes — remove required franking rules	No	No
Remove potential for unfranked dividend streaming	Yes	No — but could simplify existing rules	No — but could simplify existing rules
Tax impact on non-resident investors:			
▪ Franked distributions	No change	No change	No change
▪ Unfranked distributions	Taxed at company tax rate compared with DWT rate Therefore requires company tax/DWT switch	No change if no DWT switch Position improved if DWT switch applied	No change if no DWT switch Position improved if DWT switch applied
Inter-country considerations	DWT switch Foreign tax credits for deferred company tax	None unless DWT switch adopted	None unless DWT switch adopted
Impact on after-tax profits	Yes — reduces profit	No impact (except for entities in receipt of unfranked distributions)	No impact (except for entities in receipt of unfranked distributions)
Impact on 'double tax' on distributed temporary preferences	Still applies but at entity level	Still applies at shareholder level	Still applies at shareholder level
Impact on tax-preferred income distributed to tax exempt entities	Taxed	Taxed	Untaxed
Impact on integrity of distributions through domestic entity chain	Greatly improves integrity	Greatly improves integrity	Improves integrity

15.45 Table 15.2 provides an illustration of the effect of temporary tax preferences under the current system as well as under the three options for full franking and taxing inter-entity distributions. The illustration is based upon the following assumptions:

- an entity earns income of $150 in Year 1 and Year 2;
- the accounting depreciation in each year is $50;
- the tax depreciation is $100 in Year 1 and zero in Year 2;
- the entity has no franking account surplus at the start of Year 1; and
- the entity fully distributes all after-tax profits each year.

Table 15.2: Illustration of the tax impact of temporary tax preferences

	Current $		Deferred company tax $		RDWT $		Taxing inter-entity distributions $	
	Year		Year		Year		Year	
	1	2	1	2	1	2	1	2
Income	150	150	150	150	150	150	150	150
Accounting depreciation	-50	-50	-50	-50	-50	-50	-50	-50
Accounting profit	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Tax adjustments:								
Accounting depreciation	50	50	50	50	50	50	50	50
Tax depreciation	-100	0	-100	0	-100	0	-100	0
Taxable income	**50**	**150**	**50**	**150**	**50**	**150**	**50**	**150**
Entity level								
Accounting profit	100	100	100	100	100	100	100	100
Company tax (based on taxable income)	-18	-54	-18	-54	-18	-54	-18	-54
Deferred company tax	n/a	n/a	-18	0	n/a	n/a	n/a	n/a
Reported profit (distribution)	**82**	**46**	**64**	**46**	**82**	**46**	**82**	**46**
RDWT					-18			
Individual investor								
Distribution received	**82**	**46**	**64**	**46**	**64**	**46**	**82**	**46**
Gross-up	18	26	36	26	36	26	18	26
Taxable income	**100**	**72**	**100**	**72**	**100**	**72**	**100**	**72**
Personal tax (at 47%)	-47	-34	-47	-34	-47	-34	-47	-34
Imputation credit	18	26	36	26	36	26	18	26
Tax payable	**-29**	**-8**	**-11**	**-8**	**-11**	**-8**	**-29**	**-8**
Summary of overall tax								
Entity level								
Year 1	-18		-36		-18		-18	
Year 2	-54		-54		-54		-54	
Total		**-72**		**-90**		**-72**		**-72**
Effective tax rate at the entity level		**36%**		**45%**		**36%**		**36%**
Individual level (including RDWT)								
Year 1	-29		-11		-29		-29	
Year 2	-8		-8		-8		-8	
Total		**-37**		**-19**		**-37**		**-37**
Effective extra tax		**18.5%**		**9.5%**		**18.5%**		**18.5%**
Total tax (entity plus individual)		**-109**		**-109**		**-109**		**-109**
Effective overall tax rate		**54.5%**		**54.5%**		**54.5%**		**54.5%**

15.46 The illustration shows that the overall tax effect is the same under the current law as well as the three options. Under deferred company tax, however, the (potential) double tax would be the liability of the company, whereas under the other options it would be the liability of the investor.

15.47 In the above illustration, the $72 of tax on the $200 of profit is divided between $18 in Year 1 and $54 in Year 2. Under each of the options the higher company tax liability in Year 2 will result in excess franking credits (of $28). These credits may be used to frank other tax-preferred income, but if the entity does not generate additional tax-preferred income those credits would be unused.

15.48 In the absence of a temporary tax preference, the total tax paid on $200 of distributed company profits to a top marginal rate taxpayer would be $94 (47 per cent of $200). The effect of the tax preference, under each of the options illustrated, is that $109 in tax is paid. This consists of $81 of tax liability at the shareholder level (47 per cent of $172 of grossed-up distributions) and the $28 in unused imputation credits. This difference results from the fact that, in the second year, the company pays a greater amount of tax ($54, rather than $36), and therefore the amount left for distribution is reduced (to $46, rather than $64). This lower amount of distribution can only be franked to 36 per cent (amounting to a franking credit of $26), which leaves $28 in unused franking credits.

15.49 Under the deferred company tax option, the $18 in deferred company tax reduces the reported profits of the entity. In contrast, under the RDWT option, the $18 is collected by the entity on behalf of the shareholder, with no effect on reported profits; whereas, under both the current treatment and the inter-entity tax option, the $18 is collected at the shareholder level.

15.50 The proposed treatment of trusts and co-operatives like companies would result in the potential double tax issue extending to those entities.

15.51 The circumstances where double tax could arise may not be common. It would require businesses to have used the temporary benefit of the tax preference to distribute amounts in excess of their after-tax taxable income. Entities have some ability to control their distributions to prevent the double tax arising.

15.52 Despite the ability of entities to prevent this double taxation from arising, it would be expected that under all options there will be incentives in certain circumstances (as there are under the existing system) to reduce profit distributions, all the more so under the deferred company tax option.

15.53 Four general options for addressing the potential for double taxation are described below. The complexity in adopting such options needs to be weighed against the fact that double tax cases would not be common and would often be in the control of the entity concerned.

Option 1: Refund franking account surpluses on liquidation

15.54 One option to address the double tax issue would be to refund an entity's franking account surplus that existed upon liquidation. The refund should be limited to the extent to which the surplus relates to temporary tax preferences.

15.55 This option would ensure that there was no double taxation of company profits over the life of the entity, though it would not address the double tax at the time the double tax effect first occurred. It also may be difficult to ascertain the surplus relating to temporary tax preferences. Without some 'grandfathering' of existing franking account surpluses, this option could involve a prohibitively high revenue cost.

Option 2: Allow the double tax to be creditable against future company tax liability

15.56 In the same way that the current franking deficit tax may be used to offset future liability to company tax, one option is to allow payments of double tax to offset future company tax liability. This option could be adopted for each of the three options for dealing with integrity through the entity chain. Under the option to impose tax on unfranked inter-entity distributions, however, the double tax arises at the shareholder level (as under the current system) — and with RDWT the shareholders are formally liable for the tax. It would be unusual to allow a credit to the entity for tax paid by the shareholder or for tax that is the liability of the shareholder (although it may be possible to devise arrangements that provide additional franking credits to shareholders as timing differences are 'reversed'). Therefore, the discussion below focuses on deferred company tax arrangements where the double tax is paid by the entity (and is the liability of the entity).

15.57 This option would address the issue of potential double tax arising with temporary tax preferences when the entity has previously distributed unfranked profits. In principle, operation of this option should be restricted to deferred company tax levied with respect to the temporary tax preference. In addition, the setting off of the deferred company tax should be restricted to company tax levied on income for which the temporary tax preference is granted. Accounting records could assist in providing a basis for this 'ring-fencing'.

15.58 Without ring-fencing to temporary tax preferences, the carry forward would allow the reinstatement of all tax preferences, including permanent preferences. This would produce the undesirable result of companies building up large amounts of carry forward deferred company tax. This was the experience in the UK with the Advance Corporation Tax.

The deferred company tax paid in one period would offset ordinary company tax in the next period but when that income is distributed, an even larger payment of deferred company tax would be required.

15.59 The only way this build-up could be avoided is if entities distribute less and less of the tax-preferred income. This would provide a disincentive for companies to distribute in excess of what can be fully franked.

15.60 A further problem with a build-up of a creditable tax is that if the creditable tax payment is recorded as an asset of the entity (as it was in the UK), there is uncertainty about the circumstances when the 'asset' may need to be written off. Large intermittent write-offs following a period of build-up of credits would be destabilising for financial assessments of an entity.

15.61 In addition, the build-up of this 'asset', which cannot be used, would create pressure for trading in these carry-forward amounts. This is a similar problem to trading in franking credits.

Option 3: Allow prepayment of tax on temporary tax preferences

15.62 A further option is to allow entities to prepay their tax on temporary tax preferences where they have distributed untaxed profits arising from those preferences. The expected payment of the tax may already be recorded in their financial statements as a provision for tax. The prepayment would ensure that sufficient credits were available in the franking account. However, it would be necessary to ensure that the prepayment was not used to protect distributions of untaxed profits arising from permanent tax preferences.

Option 4: Adjust the cost base of the 'funding' asset upon distribution from unrealised gains

15.63 In the case where a distribution is made 'out of' unrealised gains of an entity, double tax may occur at the time when the asset is realised and the entity pays tax on the profits. An option to address this case would be to increase the cost base of the asset by the amount to which a distribution is 'funded' by that unrealised amount. An issue would be whether different rules would need to apply to pre-CGT and post-CGT assets.

Who would have excess imputation credits refunded?

15.64 Taxable resident recipients of fully franked distributions would be assessed on the distribution, grossed-up by the attached imputation credits — with the credits then creditable against tax payable. Both resident

individual taxpayers and complying superannuation funds would be eligible for refunds of excess imputation credits where they exceed total tax payable.

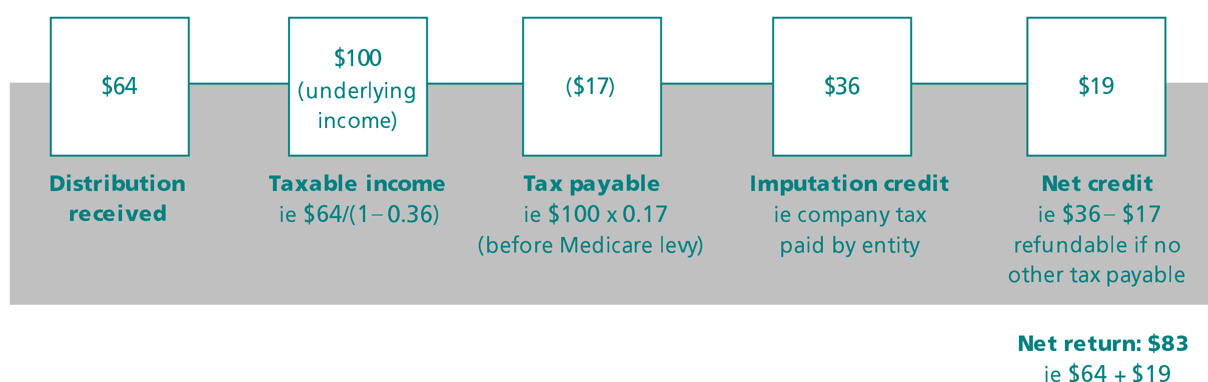
15.65 Under current imputation arrangements, excess credits that cannot be used in the income year are lost. There is no refund or carry-over even though tax has already been paid on the income in the company.

15.66 The benefits to investors of the proposed redesigned system can be illustrated by the following example. Assume a distribution of $64 from an entity to an individual taxpayer facing a marginal tax rate of 17 per cent:

- The $64 distribution would be included in the individual's assessable income grossed up by the $36 tax paid by the entity — so that $100 is included in assessable income.
- Personal tax would then be payable on that $100 ($17) and a credit of $36 would be allowed for the tax already paid by the entity.
- The net effect of the $36 imputation credit would be to produce an excess credit of $19.
- That credit could be offset against tax on other income of the taxpayer. The net tax on the $100 of original profits would then be $17, corresponding to the marginal tax rate of the taxpayer.
- If the taxpayer does not have sufficient income to use all of the excess credits, any remaining excess would be refunded to the taxpayer, ensuring the net tax corresponds to the marginal tax rate of the taxpayer.

15.67 This is illustrated in Figure 15.4.

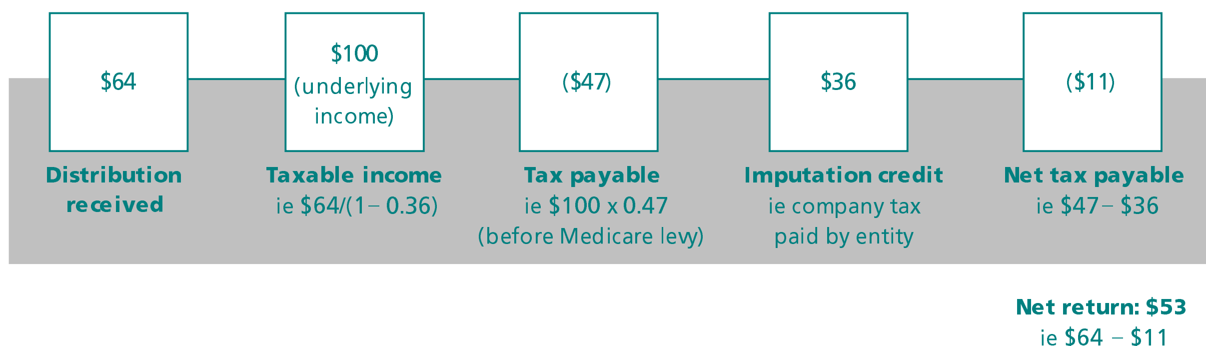
Figure 15.4: 17 per cent marginal rate taxpayer



15.68 A similar result would arise for a complying superannuation fund taxed at a 15 per cent rate. The excess credit in such a case would be $21 (that is, the imputation credit of $36 less the tax on the income of $100 at the superannuation fund rate of 15 per cent).

15.69 In the case of a 47 per cent marginal rate taxpayer (see Figure 15.5) an additional $11 'top up' tax would be payable by the individual taxpayer on the distribution, bringing the overall tax paid on the $100 to $47, corresponding to the taxpayer's marginal tax rate. This is the same overall outcome that would result under the current company tax system.

Figure 15.5: 47 per cent marginal rate taxpayer



Net return: $53
ie $64 – $11

15.70 The refund of excess imputation credits would not produce exactly the same outcome as if the individual invested directly. Where tax-preferred income is associated with an investment, an individual investing directly in the activities producing that income will pay less tax than if investing via an entity. This is because the full franking options would prevent the tax free distribution of tax-preferred income by an entity. However, the direct investor (as with a partner in a partnership) would not be separated from the investment by the entity 'veil' — and the structural CGT issues that go with that. This difference between the direct investor and the entity investor occurs under current company tax arrangements.

15.71 Distributions to partnerships, including the associated credits, would flow through to individual partners in the same way as currently.

How might refundable credits be provided to registered charities?

15.72 The introduction of a redesigned imputation system would mean that trust distributions to charitable funds and organisations would be made from after-tax income. *A New Tax System* proposed a registration process for such organisations (the process for registration is being developed separately from the Review of Business Taxation and organisations listed on the register could be tax exempt or qualify for gift deductibility). *A New Tax System* proposed that those registered could be allowed to claim refunds of excess imputation credits for tax paid at the trust level on 'donations' to them by way of trust distributions. That would maintain the current net tax position of such donations.

15.73 Refunds should not be allowed for imputation credits attached to distributions made to non-resident charities. That would cut across the basic design feature of the imputation system — to provide credits and refunds to resident individual taxpayers to achieve taxation at their marginal rates.

15.74 The options for the timing of refunds to charities could be the same as the options for the general refund of imputation credits.

When and how might excess imputation credits be refunded?

15.75 *A New Tax System* identified the timing of tax payments by trusts under the proposed pay-as-you-go (PAYG) system and the refund of excess imputation credits for low marginal tax rate beneficiaries as an important design issue for consultation.

15.76 Under existing arrangements, trust beneficiaries pay tax on taxable distributions at their marginal tax rate (including through provisional tax instalments where they apply). Under the new arrangements, tax would be paid first by the entity at the company tax rate through its PAYG instalments system.

15.77 Providing refunds to trust beneficiaries only on assessment would have the advantage of certainty. Eligibility for refundable credits would depend on the individual's total taxable income and total imputation credits received during the year. Until final assessment, eligibility for refundable credits could only be an estimate. As noted earlier, however, the cash flow of some beneficiaries would be adversely affected by the delay in accessing refunds of tax paid at the entity level. In particular, low marginal rate taxpayers would be affected if their income is largely from collective investment vehicles, such as cash management trusts (assuming the alternative tax treatment of such vehicles, discussed in Chapter 16, is not adopted).

15.78 Taxpayers who invest in collective investment vehicles as part of a wider diversified range of investments would be less affected by the taxing of trusts like companies. The franking credits attaching to the trust distributions could reduce the amount of the taxpayer's quarterly PAYG instalments. Such a taxpayer would not have to wait until assessment to receive the benefit of the imputation credits.

15.79 The timing of refunds of excess imputation credits is also an issue for superannuation funds because their 15 per cent tax rate is much lower than the company tax rate.

15.80 There are two possible approaches to the timing of refundable imputation credits:

- provide a refund at the entity level so that distributions to eligible beneficiaries are gross of company tax; or
- allow an option for refundable credits to be claimed through instalments during the course of the income year.

Option 1: Provide a refund at the entity level at the time of distribution

15.81 Under this option the refund could be provided at the entity level rather than the individual investor level. The ideal would be for each distribution to exactly reflect the taxpayer's average rate of tax. However, this is not practical as it would require the distributing entity to know the investor's average tax rate. More practical alternatives may be to:

- treat the distribution as though no tax was paid at the entity level — that is, pay a grossed-up (unfranked) distribution; or
- assume a standard rate of tax — for example, 15 per cent which is the superannuation fund rate.

15.82 An entity would need to know which investors are eligible for this special treatment. The eligible investors could be as follows:

- complying superannuation funds; and
- certain low marginal rate resident individual taxpayers (including those not subject to tax) whose income is largely from investments in collective investment vehicles.

15.83 The responsibility for notifying the entity that a taxpayer is eligible could rest with the investor — that is, the superannuation fund or individual. A superannuation fund would only have to notify the distributing entity once. An individual may be required to notify the entity on becoming eligible and also if the investor later becomes ineligible.

15.84 At the time of distribution, the entity would need to distinguish dividends paid to eligible investors in a similar way as dividends paid to non-resident investors. The entity would pay to the investor the distribution grossed up for company taxation (the gross-up corresponding to the expected refund from the ATO). The investor would be assessed on the grossed up dividend (it would not be franked).

Example 15.1: Unfranked distribution to low marginal rate taxpayer

(Assuming that distributions to eligible investors were treated as though no tax was paid at the entity level.)

A trust derives $100, which is taxed at 36 per cent, so that $64 is available for distribution. The trustee decides to distribute the $64 to a beneficiary who has notified the trust that the person is a low marginal rate taxpayer.

The entity would pay a distribution of $100 to the investor. The distribution would be made up of the $64 after-tax profits plus the $36 gross-up (or expected refund from the ATO). The entity would not need to know the investor's average rate of tax.

The distribution would be fully taxed in the individual's hands as though no tax was paid at the entity level.

Example 15.2: Distribution to superannuation fund franked at 15 per cent

(Assuming that distributions to superannuation funds were treated as though 15 per cent tax was paid at the entity level.)

Using Example 15.1, the entity would pay a distribution of $85 to the superannuation fund. The distribution would be made up of the $64 after-tax profits plus the $21 ($36 – $15) expected refund from the ATO.

15.85 An efficient mechanism for recovering the refunds from the ATO would need to be developed so that entities do not suffer major cash flow problems. Options include making the refund available after the distribution or, perhaps, in conjunction with PAYG instalments, although this may unnecessarily complicate the PAYG system.

15.86 The refund would have no effect on an entity's own tax liability as the entity is simply a conduit for the refund. The refund would not impact on the entity's franking account.

15.87 The advantage of this option is that it overcomes the timing problems for investors associated with the full franking of all distributions. It also reduces the compliance requirements on investors, although investors would have to notify the entity of their eligibility and keep that notification up to date.

15.88 The disadvantages are that complexity would be increased and there would be additional compliance costs for entities in determining distributions paid to eligible investors.

Option 2: Provide a refund to the investor by instalments during the year

15.89 This option would allow refunds to be provided by the ATO through instalments during the year where the taxpayer is not covered by the PAYE system. For example, the taxpayer could be entitled to a refund based on the amount of the previous year's tax refund or other evidence of a likely tax refund.

15.90 This option provides a more timely reflection of the net tax position of the investor than an annual refund. However, it would not have the same degree of certainty as providing refunds on assessment. Difficulties would arise if low income earners received cash refunds during the year on the basis of an estimate and were then required to repay the refunds after the full year tax position was known.

15.91 In order to avoid these difficulties, the availability of refunds by instalments could be subject to specific conditions. For instance, it could be made available only to those individual beneficiaries that had received income almost entirely in the form of specified types of income in the previous year, for example, trust distributions, dividends and pensions. This would target the refund by instalments to those taxpayers who were likely to have stable levels of income and therefore more likely to remain eligible for refunds from year to year. However, even with this targeting, it is likely that the amount of refunds that an individual could claim would vary from year to year, so that some individuals could be required to repay some of the refunds after the end of the year (while others would be eligible for additional refunds on assessment). Under the self-assessment system, similar penalties as apply under the current provisional tax system, such as for underpayment of instalments, may also be appropriate.

15.92 A further disadvantage of this option would be the administration costs of making regular refunds to taxpayers.