Chapter 17

HOW A REDESIGNED IMPUTATION SYSTEM WOULD APPLY TO ENTITIES

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Introduction

17.1 Chapter 15 sets out three options to improve the integrity down the entity chain of the redesigned system:

- Option 1: impose a deferred company tax;
- Option 2: apply a resident dividend withholding tax (RDWT); and
- Option 3: tax unfranked inter-entity distributions.

17.2 The purpose of this chapter is to consider some of the mechanics associated with these options.

Key policy issues associated with Option 1

How should deferred company tax be calculated?

17.3 Deferred company tax would be levied where the profit distributed by an entity has not previously been subject to company tax at the entity level. This could be determined using the franking account system. The deferred company tax would be the amount of deficit in the franking account at a specified time (assuming the use of a tax-paid basis, which is discussed in the next section).

17.4 To illustrate, assume an entity earns $100 of income in a year, $75 of which is taxable (that is tax of $27) and $25 tax-preferred. The entire profits are distributed. Figure 17.1 illustrates how the franking account (on a tax-paid basis) could be used to calculate the deferred company tax.

Figure 17.1: How deferred company tax could be calculated

Tax-paid franking account	
Debit	**Credit**
Dividend paid $36 (i.e. $64 x 0.36/0.64)	Company tax $27 (i.e. $75 x 0.36)
	Deferred company tax $9 (Balance — i.e. $36 – $27)

17.5 Although the franking account may be used to determine deferred company tax, the system should be much simpler than at present. All profit distributions would be franked. So the current complex rules to determine whether a dividend is franked or unfranked could be removed, including the

required franking amount, anticipation of franking credits, franking deficit tax and franking additional tax.

17.6 Companies would be able to continue to use existing franking account balances. The current credits to the franking account would continue, such as for payments of tax (including instalments) and distributions received from other entities. Similarly, current debits to the franking account would also continue, such as for distributions made and refunds of tax.

17.7 Those entities which would be subject to an imputation system for the first time, such as trusts and some co-operatives, would need to establish a franking account.

17.8 For these entities, there is a transitional issue in relation to transactions which affect the franking account, such as payments or refunds of tax, which relate to a period before the commencement of the new entity regime but are made after commencement. Such transactions should not be reflected in the new franking account.

How should the franking account operate?

Option 1: Taxed-income basis

17.9 The current franking account is operated on a 'taxed-income' basis — that is, the balance in the franking account reflects the amount of franked dividends that can be paid. This suits the current imputation system where the focus of the franking account is on the extent to which dividends are franked or unfranked.

Option 2: Tax-paid basis

17.10 Under a deferred company tax, with all distributions franked, the focus would instead be on whether the entity is liable for deferred company tax. Therefore, a 'tax-paid' basis may be more relevant, because a debit balance in a tax-paid account will reflect a potential liability for deferred company tax. A further reason for change is to avoid the creation of the complex multiple franking accounts (the Class A, B and C franking accounts) which arose under the current approach.

17.11 When an entity wants to make a distribution, it may wish to determine the maximum amount of distribution it can pay without giving rise to potential deferred company tax (similar to the maximum franked dividend which can be paid under the existing law). To determine the maximum amount of distribution, the franking surplus in the tax-paid franking account would be grossed-up using the formula:

$$\text{Tax-paid franking surplus x } \frac{1 - \text{Company tax rate}}{\text{Company tax rate}}$$

17.12 Because companies are now used to operating on a taxed-income basis, changing to a tax-paid basis may inconvenience some companies. However, there will be other entities such as some trusts and co-operatives which will commence using a franking account under the redesigned imputation system. These entities would benefit from the advantages of a tax-paid basis without transitional effects.

17.13 If a tax-paid basis were adopted, existing franking account balances could be converted to a tax-paid basis at the commencement of the new arrangements. An existing franking account balance of $64 credit would convert to a tax-paid franking account balance for tax paid of $36 credit. There would be no loss of franking credits.

Would the proposed deferred company tax be the same as the UK Advance Corporation Tax (ACT)?

17.14 The proposed deferred company tax would not be the same as the Advance Corporation Tax (ACT) which has applied in the United Kingdom. The UK has announced that the ACT is to be removed from 1999 and replaced with a self-assessment system with payment of company tax by instalments.

17.15 Even though the ACT clawed back some tax on tax-preferred income on distribution, its main purpose was to collect company tax in advance of assessment. In the UK, companies were not required to pay mainstream company tax until assessed by the revenue authority. Hence, company tax was received only after a considerable delay. The ACT on distribution was effectively an instalment system for company tax. Therefore, on assessment, ACT was deducted from the company tax to determine the final tax payable. Companies found the ACT arrangements to be very complex and commercially unworkable.

17.16 In contrast, Australia has a self-assessment system and a company tax instalment system to collect company tax. Unlike the ACT, the purpose of a deferred company tax is not to act as a *de facto* entity tax collection system. It is a separate measure to achieve the full franking of distributed profits. For this reason, it is not appropriate to apply deferred company tax to reduce

mainstream company tax. To do so would result in the effective reinstatement of the tax-preferred status of some distributions. This issue is dealt with in the discussion in Chapter 15 concerning potential double taxation of distributed tax-preferred income.

17.17 One aspect of the ACT that could be adopted is the determination of deferred company tax at the time of each distribution. This option is not preferred, however. It is simpler to determine the deferred company tax once during the year — that is, as the balance of the tax-paid franking account at a particular point in time during the year.

When should deferred company tax be determined — the 'balancing day'?

17.18 A company, trust, co-operative, life company or limited partnership would self-assess its liability to deferred company tax. The liability for deferred company tax would be the amount of deficit in the tax-paid franking account at a specified time (the 'balancing day'). A question is when should the balancing day occur.

17.19 The ideal balancing day would be a specified time when it is possible to link:

- income derived;
- company tax paid on that income, including by instalments; and
- distributions of the income derived.

17.20 Such a balancing day would enable determination of the amount of any tax-preferred income derived and distributed in the year.

17.21 This does not happen under the existing law. The franking year is basically aligned with the year of income. Company tax is now collected partly in the year of income and partly in the following year so that the link between income, tax on the income and distribution of the income is unclear. A further factor is that some entities distribute only out of prior year profits while other entities distribute out of both current year and prior year profits, or solely out of current year profits (in the case of most trusts).

17.22 In considering options for determining the balancing day it is necessary to decide the extent of alignment between the year of income, the period in which distributions of that income are made and the period in which tax payments on that income are made. Some of the options for determining the balancing day are set out below.

Option 1: Align franking year and income year

17.23 This option is similar to the existing law. Currently the 'franking year' is:

- if a standard year or late balancing company — year ended 30 June; or
- if an early balancing company (that is, one balancing on or before 31 May in lieu of the following 30 June) — year of income or year ended 31 December, whichever is the later.

17.24 Under this option, the franking year would be aligned with the income year in all cases so that the balancing day is the end of the year of income. This would include removing any current differences between the end of the franking year and the end of the year of income.

17.25 An advantage of this option is that it would be generally consistent with the existing law. It would also remove the current complexities for some late balancing companies where the franking year can be different to the income year (the franking year can end no later than 30 June even if the income year ends after that date).

17.26 A disadvantage is that there may be no alignment of income, tax and distributions because:

- the new pay-as-you-go (PAYG) collection system will still straddle the year of income, although the income and payment years will be more closely aligned; and
- some entities distribute out of both current year and prior year profits.

17.27 Therefore, there would be no accurate calculation of the amount of tax-preferred income in a year. Another disadvantage is that provisions may be necessary to prevent entities deliberately or inadvertently avoiding deferred company tax. For example, rules similar to the current deficit deferral tax may be necessary to prevent entities avoiding liability for deferred company tax. Otherwise, entities could overpay instalments of company tax so that there is no debit balance in the franking account at year end, and then obtain a refund of tax in the next year.

Option 2: Align franking year and income year and exclude current year instalments

17.28 This option is similar to the previous option. However, instalments relating to the current year would not be included in the franking account until after the year of income. This would be consistent with all distributions being out of prior year profits, not current year profits.

17.29 An advantage of this option is that it offers less scope than the previous option for avoiding deferred company tax. A disadvantage is that entities which distribute out of current year profits would be penalised, especially if the entity has paid company tax instalments relating to the income, or the income is later subject to company tax.

Option 3: Align franking year to the payment year

17.30 The franking year could be the payment year. The balancing day would be the day on which the final payment of tax was due or made.

17.31 This option has similar advantages and disadvantages to the previous option. A further disadvantage is that the period of the franking year extending into the income year could vary greatly, especially if the final payment is delayed until after the normal due date (for example, due to an extension of time to lodge or pay).

Option 4: Ascertain tax at time of distribution

17.32 Similar to collection of the UK's Advance Corporation Tax, the balancing day could be when each distribution is made.

17.33 The advantage of this option is that the distributing entity would know its potential liability for deferred company tax at the time of distribution. The disadvantage is that it would fail to take account of potential tax payments relating to the distributed income which may be made during that year to offset a deficit in the franking account. This could be overcome through anticipating credits. However, that would lead to the complexities of the existing imputation system.

What would be the interaction between deferred company tax and company tax?

17.34 An entity's total income tax liability would be the sum of its company tax and deferred company tax. These two components would be calculated separately and then added together to determine the entity's total tax liability. Deferred company tax would not be creditable against the future income tax liability of the entity (based on an assumption that the double tax problem outlined in Chapter 15 is not considered significant enough to address further). Tax offsets (that is, rebates and credits) would only be available to reduce company tax but not deferred company tax. These measures would be necessary to ensure that the deferred company tax on the distribution of untaxed profits is not reversed. The deferred company tax effectively makes up the shortfall in company tax on distributed profits.

17.35 If the company tax for a year were amended, a corresponding adjustment would be made to the franking account. This adjustment may affect a previously assessed amount of deferred company tax. In such a case, the original deferred company tax assessment could also be amended.

Example 17.1: Amendment of assessment

Assume the following:

- At the commencement of the franking year the franking account for an entity has a nil balance.
- The entity is not liable for company tax during the franking year because it made a tax loss.
- During the year the entity makes a distribution of $64 which gives rise to a debit in the tax-paid franking account of $36.
- Deferred company tax of $36 is paid because of the deficit in the franking account.
- After the franking year, a subsequent review of the entity's tax liability reveals that it did not make a loss but in fact made a taxable profit of $100.
- The entity receives an amended company tax assessment which requires the payment of $36 company tax.

On payment of the $36 company tax, the franking account would be amended as though the company tax was paid in the correct year. Had the payment been made in the correct year the entity would not have been liable for deferred company tax. Therefore, an amended deferred company tax assessment would issue refunding the deferred company tax. In practice, it may be possible to net out the two amended assessments so that no tax is payable and no refund is due.

The shareholder is not affected by these adjustments.

How should deferred company tax be collected?

17.36 Under the reforms to tax administration proposed in *A New Tax System*, company tax instalments will be replaced by the PAYG system. The Government has proposed that instalments would be calculated on businesses' turnover, by applying a ratio of tax payable to turnover from the most recent year.

17.37 Maintaining a single instalment system for the collection of company tax would have simplicity and compliance cost advantages, from the point of view of both the Australian Taxation Office and taxpaying entities.

17.38 Entities distributing taxed profits will be paying most of their tax liability within the year of income under the proposed PAYG arrangements. In contrast, if deferred company tax is collected on assessment, companies distributing tax-preferred income would pay their company tax liability outside the year of income. Maintaining a single system would result in deferred company tax payments better matching the current timing of tax payments on unfranked distributions collected under the quarterly provisional tax system.

17.39 Some options for collecting deferred company tax by instalment are set out below, as well as the alternative of collecting only on assessment.

Option 1a: Build deferred company tax payments into the turnover ratio

17.40 The proposed PAYG ratio could include both company tax and deferred company tax. Take the case of an entity with total sales of $1 million in a year, taxable income of $90,000 (grossed up) and distributions of $100,000. The entity's income tax liability for the year is $36,000 – company tax of $32,400 ($90,000 x 36 per cent) and deferred company tax of $3,600 ($10,000 x 36 per cent). This is 3.6 per cent of its goods and services tax (GST) sales of $1 million for the year. Its PAYG ratio (ignoring other factors which affect the PAYG ratio) would therefore be 3.6 per cent. This option would involve collecting 3.6 per cent of the entity's quarterly GST sales as an instalment of total entity tax (that is, both company tax and deferred company tax).

17.41 For entities with a regular distribution policy and a stable amount of tax-preferred income, the turnover ratio would not need to be adjusted over time. However, changes to these factors could change the ratio, as with other factors affecting the ratio.

17.42 As a transitional measure, in the first year of operation, the last year's value of unfranked dividends could be used to determine the liability for deferred company tax, which would feed into the turnover ratio. For trusts, a similar measure may be able to be determined by subtracting trust distributions from the net income of the trust, in the previous year.

17.43 This option would require a reconciliation of the final liability to deferred company tax with the paid instalments. This may require a separate record of deferred company tax instalments.

Option 1b: Base instalments on previous year's liability to deferred company tax

17.44 Entities could be required to pay instalments of deferred company tax based on the previous year's liability, similar to the existing company tax instalment system. In the first year of operation, this could be based on the amount of unfranked dividends paid in the previous year. However, this option would be inconsistent with, and erode some of the benefits of, the reforms to tax administration set out in *A New Tax System* (such as the PAYG) by introducing another payment system.

Option 1c: Require instalments at the time of distribution

17.45 Entities could be required to make an instalment of deferred company tax at the time of distributions, depending on the franking account balance. Entities could be permitted to anticipate franking credits that would be earned later in the year, subject to penalty tax, similar to the current arrangements.

17.46 This option suffers from the complexities of the present system by requiring the anticipation of franking credits. Therefore, it would erode much of the simplicity benefits for entities in removing the distinction between franked and unfranked distributions.

Option 2: Collect on assessment

17.47 The alternative to collecting deferred company tax by instalments is to collect it as soon as possible after assessment of deferred company tax liability on the 'balancing day' (discussed earlier). The payment date could be, say, one month after the balancing day.

17.48 This option is simple because the amount of deferred company tax is certain and does not require a reconciliation between final deferred company tax and instalments of the tax. A disadvantage is that it would result in a delay in tax payments relative to the current timing of quarterly provisional tax payments on unfranked dividends.

How should deferred company tax be collected on in-kind distributions by a liquidator?

17.49 If a liquidator makes an in-kind distribution, and that distribution is deemed to be a profit distribution, the distribution would need to be fully franked. An insufficient franking account balance at the time of distribution would create a liability for deferred company tax. An issue arises as to the

ability of the liquidator to provide for the payment of deferred company tax where the final distribution is in-kind.

17.50 The existing law currently requires the Commissioner to notify a liquidator of any existing or expected tax liabilities. The liquidator is then required to set aside sufficient assets to meet that debt. It may be possible to rely on a similar rule to ensure the payment of deferred company tax on in-kind distributions.

17.51 A similar issue arises on the full vesting of all assets in a trust. A rule similar to the rule on liquidation may also be possible on the vesting of trust assets.

Key policy issues associated with Option 2

How should a resident dividend withholding tax be calculated?

17.52 An RDWT would be levied on unfranked distributions paid from a resident entity to a resident individual investor. It would also apply to unfranked distributions paid from one resident entity to another (other than in the case of consolidated groups).

17.53 The franking account system would be used for determining the amount of unfranked distributions. When an entity makes a distribution to a resident investor and the distribution is not able to be franked from its franking account, the entity would withhold RDWT and this would allow the net distribution paid to the investor to be fully franked. In this way the distribution would be either franked by credits from its franking account or by the withholding of RDWT (the RDWT would not impact on the franking amount in the same way that the non-resident DWT does not affect the franking amount).

17.54 Where an entity receives a distribution that is franked by the payment of RDWT, it would credit its franking account in the same manner as other franked distributions.

17.55 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).

17.56 Where distributions that are paid between resident entities would be subject to RDWT and are subsequently passed to foreign members, the domestic dividend withholding tax would be refunded as explained in Chapter 15. In order to provide a refund should a distribution be made to

foreign investors, entities would have to maintain an additional franking account to record the amount of RDWT attached to a distribution. A distribution would also have to separately identify the proportion that is franked from the franking account and the proportion franked by the RDWT account. This would give rise to significant complexity and compliance costs.

17.57 Chapter 15 noted the disadvantage under the RDWT option of the continuation of the existing complex provisions required to determine franked and unfranked distributions. These problems could be partly overcome by adopting a franking account allocation rule similar to the New Zealand system. Under such a rule, an entity would, prior to the first distribution, establish a standard rate of the franked portion of distributions made during the year. All distributions during the year would be franked using that rate.

17.58 This would overcome some of the problems relating to the required franking rules. However, it would lock entities into a standard rate of franking for the entire year.

How should a resident dividend withholding tax be collected?

17.59 RDWT could be collected in the same way as the existing dividend withholding tax which applies to unfranked dividends paid to non-residents. Under the current law, a paying entity self-assesses its liability to dividend withholding tax. The tax is due and payable 21 days after the end of the month in which the income was derived. Therefore, RDWT could be assessed and collected in a similar way. It would require the determination of the amount of unfranked distributions paid to residents. The paying entity would then withhold at the company tax rate from those distributions. The RDWT continues to require the calculation of franked and unfranked distributions at the time of each distribution. Having made those calculations, it is logical to withhold the tax and require payment at that time.

17.60 In contrast, under the deferred company tax there is a simplification of the operation of the franking account due to the removal of the distinction between franked and unfranked dividends. Having removed the distinction, the issue then is when to determine the liability and to decide when to collect the tax.

Key policy issues associated with Option 3

17.61 Unlike the other options, taxing unfranked inter-entity distributions does not give rise to significant calculation or collection issues.

17.62 Under the current law, unfranked and franked distributions are subject to the section 46 inter-corporate dividend rebate. This effectively frees the distributions from tax through the entity chain. The rebate does not apply to unfranked dividends paid to private companies unless the dividend is an intra-group dividend.

17.63 This option proposes that any entity which receives an unfranked distribution will be subject to tax (apart from distributions paid within a consolidated group). Unfranked distributions would simply be included in the assessable income of the entity. Once tax has been paid on the distribution, it should not be subject to further tax through the entity chain. Possible mechanisms for this are discussed next.

Further policy issues

How should double tax through the entity chain be prevented under the full franking system?

17.64 Under each of the three options for achieving full franking and/or reforming the treatment of inter-entity distributions, distributions of tax-preferred income between entities (including companies, trusts and co-operatives) not part of the same consolidated group would be taxed.

17.65 The Review is interested in obtaining a better appreciation of the range of circumstances that might be affected by the taxation of inter-entity distributions (outside of a consolidated group).

17.66 One effect of taxing inter-entity distributions is that a mechanism needs to be developed to prevent double taxation through an entity chain.

17.67 A mechanism is not needed for distributions between entities within a consolidated group. A reform proposal — discussed in Chapters 25 to 27 — is to allow wholly owned groups of entities to choose to be taxed on a consolidated basis (as a single entity). Intra-group dealings (including distributions) of consolidated groups would be ignored for tax purposes and the group would have a single franking account. Therefore, the redesigned imputation system would not apply to intra-group distributions, unless the group elects not to consolidate. This would allow tax-preferred income to be distributed within the group with no tax consequences.

17.68 Possible options for preventing double tax through an entity chain are discussed below. Table 17.2 at the end of this section provides a summary comparison of the options.

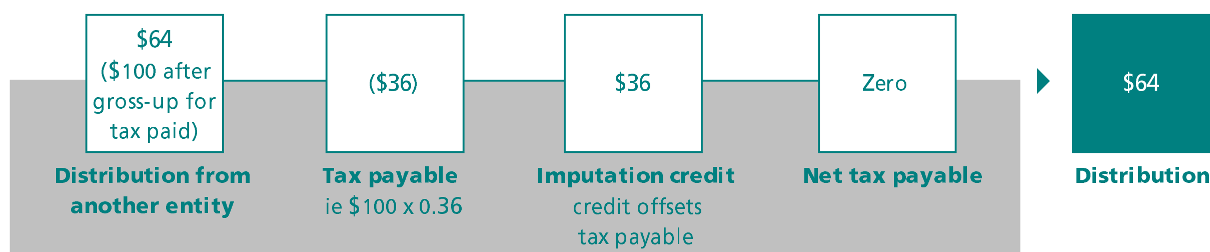
Option 1: Gross-up and credit

17.69 Under this option, a gross-up and credit approach would replace the current section 46 inter-corporate dividend rebate. As is currently the case for individuals, distributions to entities would be grossed up for tax paid by the distributing entity and would be taxable in the receiving entity's hands. A corresponding credit equal to the amount of the gross-up would be available to offset tax payable on the distribution or other income.

17.70 Therefore, as Figure 17.2 illustrates, a distribution of $64 to an entity would be treated as follows:

- the $64 distribution would be included in the entity's assessable income, grossed up by the $36 company tax paid (including any deferred company tax or RDWT) on the $100 of underlying profits — so that $100 is included in the entity's assessable income; and
- company tax would then be payable on that $100 and a credit of $36 would be allowed for the $36 tax already paid.

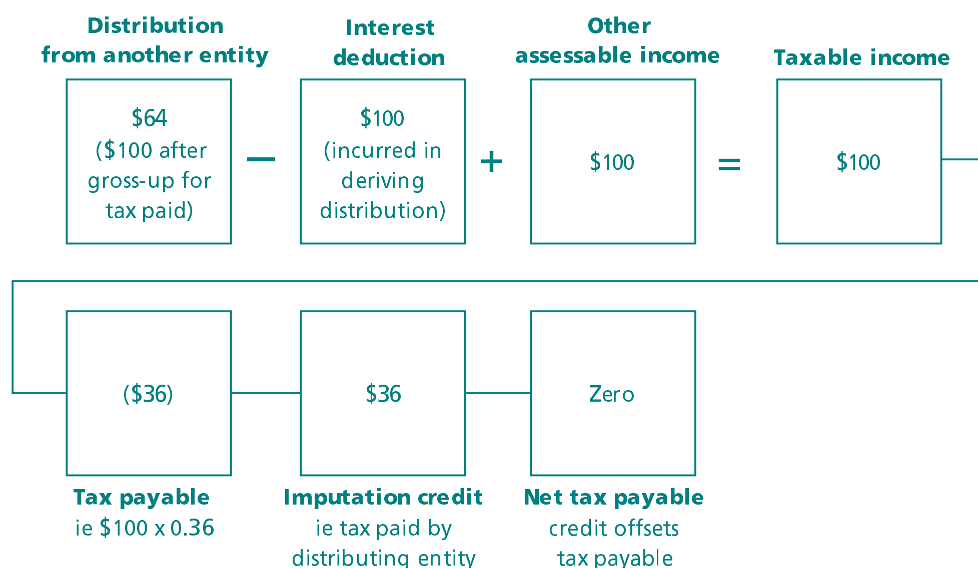
Figure 17.2: How imputation could apply to a distribution between entities



17.71 The gross-up and credit approach prevents double taxation on the distribution. Under either of the two full franking options discussed in Chapter 15, the distribution is effectively free of tax in the receiving entity's hands because the distribution has already been subject to tax at the distributing entity level at the same rate applying to the receiving entity. Under the third option, of taxing unfranked inter-entity distributions, an unfranked distribution paid to an entity will be taxed in the receiving entity's hands.

17.72 Imputation credits attached to distributions would be available to offset company tax payable by the entity, even if the credits are not needed to offset company tax payable on the distribution itself. This could arise where the receiving entity has deductions associated with deriving the distribution (for example, interest expenses incurred on debt used to purchase shares in the distributing entity) or current year or carried forward losses that reduce the net amount of that distribution. This treatment is similar to the existing law. Figure 17.3 illustrates this.

Figure 17.3: Credits used to offset tax payable on other income of the recipient entity



17.73 Unlike individuals and superannuation funds, entities that have excess imputation credits would not be entitled to the refund of excess credits proposed in Chapter 15. This would apply equally to tax exempt entities, except for resident *registered charitable organisations* which would be entitled to refunds on tax paid on certain trust distributions. (This issue is discussed in Chapter 15.) The franking credits attached to the distribution would still be credited to the entity's franking account and could be available for use in franking future distributions.

17.74 When distributions pass through a chain of loss entities, all of the approaches, as well as the current law, reduce losses through the chain. With a distribution passing through an entity with a tax loss, the gross-up and credit approach would result in a reduction of the loss equal to the grossed-up amount of the distribution. This is a greater reduction than under the present inter-corporate dividend rebate — but a result that is consistent with outcomes in relation to other income. This result stems from fully franked dividend income reducing losses in the same proportion as other income (such as interest) reduces losses. It is also consistent with dividends received by individuals.

17.75 If, for example, an entity has a carry-forward loss of $100 and receives interest income of $100, the loss will be reduced to nil. If instead the entity receives a fully franked distribution of $64, under the gross-up and credit approach the distribution is grossed up to $100 so that the loss is also reduced to nil. However, under the existing inter-corporate dividend rebate only the net amount of the distribution ($64) is included in assessable income so the $100 carry-forward loss is only reduced to $36. This is illustrated in Table 17.1.

Table 17.1: Comparison between 'gross-up and credit' and 'inter-corporate dividend rebate' approaches where the receiving entity has a loss

	Existing inter-corporate divident rebate $	Gross-up and credit $	Interest $
Distributing entity			
Taxable income	100	100	
Company tax	-36	-36	
Distribution	**64**	**64**	
Receiving entity			
Distribution or interest received	64	100[(a)]	100
Loss carried forward	-100	-100	-100
Loss remaining to be carried forward	**-36**	**nil**	**nil**

(a) The distribution of $64, grossed up to include the tax of $36 paid.

Option 2: Exempt distributions between entities

17.76 An alternative to the gross-up and credit approach would be to exempt distributions between entities. In the absence of special provisions, the exemption of distributions would mean that outgoings associated with deriving the distributions would not be deductible because they would be incurred in deriving exempt income. In particular, this would be a disadvantage to entities where the associated outgoings were greater than the actual distributions. This outcome is inappropriate as the distribution is effectively no different from other income except that the distribution has been taxed at an earlier point of time in the hands of the distributing entity prior to distribution. The exemption approach would use up tax losses in the same way as the other two options, although only to the same extent as the inter-corporate dividend rebate approach.

Option 3: Provide an inter-entity dividend rebate

17.77 Under this option, an inter-entity dividend rebate would apply to the franked portion only of an inter-entity distribution, rather than applying to the entire distribution.

Discussion of the options

17.78 Table 17.2 illustrates the impact of each of the three options on:

- distributions through the entity chain;

- deductions against distributions and other income; and
- carry-forward losses.

17.79 The deferred company tax approach has been used in these illustrations. The results would be the same under the RDWT option. However, under the option of taxing unfranked distributions between entities, tax-preferred income would be treated as an unfranked distribution, taxable to the receiving entity. While this changes the incidence of tax between the distributing and receiving entities, it does not change the overall tax.

17.80 All the options for ensuring there is no double tax on inter-entity distributions have the same outcome at both the entity and individual investor level for a simple distribution through the entity chain — Table 17.2(a). The final outcome is that the individual investor is taxed at his or her marginal tax rate.

17.81 However, the outcome is not the same under each of the options if one of the entities in the chain incurs expenses in deriving the distribution as well as having other income — Table 17.2(b). The gross-up and credit and inter-entity dividend rebate approaches ensure the correct outcome for the individual investor. Under the exemption approach double taxation can arise due to the non-deductibility of expenses incurred in deriving the exempt distributions.

17.82 A similar issue was considered when the existing imputation system was introduced. The inter-corporate dividend rebate approach could have the same outcome as the exemption approach if the rebate was on a net basis (basing the rebate on the distribution less expenses incurred in deriving that distribution) rather than on a gross basis. The effect of using the net basis is that no recognition is given for the tax already paid on the dividend so that double taxation can arise. This is why the current section 46 inter-corporate dividend rebate is on a gross basis.

17.83 In the case of carry-forward losses, the gross-up and credit approach would absorb the losses in the receiving entity earlier than under the other approaches — Table 17.2(c). However, each of the options would equal out over time as extra income is derived and distributed by the receiving entity. The benefit to entities under the inter-entity dividend rebate and exemption approaches is that the remaining carry-forward loss would defer tax on income derived in a later year until the income is distributed to the individual investor.

Table 17.2: Comparison of mechanisms to prevent double company tax
(a) Distributions through the entity chain to an individual investor

	Gross-up and credit $	Exemption $	Inter-entity rebate $
Distributing entity			
Taxable income	75	75	75
Tax-preferred income	25	25	25
Total income	**100**	**100**	**100**
Company tax	-27	-27	-27
Deferred company tax	-9	-9	-9
Dividend paid	**64**	**64**	**64**
Receiving entity			
Dividend received	64	64	64
Gross-up/exemption	36	-64	0
Taxable income	**100**	**0**	**64**
Company tax	-36	0	-23
Credit/rebate	36	0	23
Net tax payable	**0**	**0**	**0**
Dividend paid (based on dividend received less net tax payable)	**64**	**64**	**64**
Investor — 30 per cent rate			
Dividend received	64	64	64
Gross-up	36	36	36
Taxable dividend	**100**	**100**	**100**
Personal tax	-30	-30	-30
Credit	36	36	36
Net tax payable/refund	**6**	**6**	**6**
Overall tax			
Distributing entity	-36	-36	-36
Receiving entity	0	0	0
Investor	6	6	6
Total tax	**-30**	**-30**	**-30**

Table 17.2: Comparison of mechanisms to prevent double company tax
(b) Deductions against dividend income and other income

(Assuming $100 other income and $100 interest incurred in deriving the dividend.)

	Gross-up and credit $	Exemption $	Inter-entity rebate $
Distributing entity			
Taxable income	75	75	75
Tax-preferred income	25	25	25
Total income	**100**	**100**	**100**
Company tax	-27	-27	-27
Deferred company tax	-9	-9	-9
Dividend paid	**64**	**64**	**64**
Receiving entity			
Dividend received	64	64	64
Gross-up/exemption	36	-64	0
Taxable dividend	**100**	**0**	**64**
Other income	100	100	100
Interest deduction[(a)]	-100	0	-100
Taxable income	**100**	**100**	**64**
Company tax	-36	-36	-23
Credit/rebate	36	0	23
Net tax payable	**0**	**-36**	**0**
Dividend paid (based on dividend received less net tax payable)	**64**	**28**	**64**
Investor — 30 per cent rate			
Dividend received	64	28	64
Gross-up	36	16	36
Taxable income	**100**	**44**	**100**
Personal tax	-30	-13	-30
Credit	36	16	36
Net tax payable/refund	**6**	**3**	**6**
Overall tax			
Distributing entity	-36	-36	-36
Receiving entity	0	-36	0
Investor	6	3	6
Total tax[(b)]	**-30**	**-69**	**-30**

(a) Exemption option — interest is not deductible as it is incurred in earning exempt dividend income.

(b) Under the exemption option the distribution is protected from being double taxed. However, because of the interest incurred, the distribution should not be taxed at all. The denial of the deduction for the interest paid by the receiving entity prevents the negation of the tax paid by the distributing entity.

Table 17.2: Comparison of mechanisms to prevent double company tax
(c) Carry-forward losses

	Gross-up and credit $	Exemption $	Inter-entity rebate $
Distributing entity			
Taxable income	75	75	75
Tax-preferred income	25	25	25
Total income	**100**	**100**	**100**
Company tax	-27	-27	-27
Deferred company tax	-9	-9	-9
Dividend paid	**64**	**64**	**64**
Receiving entity			
Dividend received	64	64	64
Gross-up/exemption	36	-64	0
Taxable dividend	**100**	**0**	**64**
Carry-forward loss	-100	-100	-100
Loss remaining to be carried forward[(a)]	**0**	**-36**	**-36**
Dividend paid (based on dividend received less net tax payable)	**64**	**64**	**64**
Investor — 30 per cent rate			
Dividend received	64	64	64
Gross-up	36	36	36
Taxable income	**100**	**100**	**100**
Personal tax	-30	-30	-30
Credit	36	36	36
Net tax payable/refund	**6**	**6**	**6**
Overall tax			
Distributing entity	-36	-36	-36
Receiving entity	0	0	0
Investor	6	6	6
Total tax	**-30**	**-30**	**-30**

(a) Exemption option — assumes that loss is reduced by exempt income which would be equivalent to the amount of distribution received (i.e. $64).

17.84 Distributions from other entities, under any of the options for preventing double company tax, would give rise to a franking credit in the receiving entity's franking account. This would ensure that any distribution of that income by the receiving entity is not again subject to further tax.

17.85 Table 17.3 illustrates the effect on a franking account where:

- Company A derives $100 of income, $75 which is taxable, and the income is paid out as an after tax distribution of $64 to Company B;
- Company B distributes the dividend income from Company A as a fully franked distribution of $64 to individual shareholders.

Table 17.3: Tax-paid franking account for inter-entity distributions (using deferred company tax)

Company A — Tax-paid franking account	
Debit	**Credit**
Dividend paid to Company B $36 (i.e. $64 x 0.36/0.64)	Company tax $27 (i.e. $75 x 0.36)
	Deferred company tax $9 (Balance — i.e. $36 – 27)

Company B — Tax-paid franking account	
Debit	**Credit**
Dividend paid to Shareholders $36 (i.e. $64 x 0.36/0.64)	Dividend received from Company A $36 (i.e. $64 x 0.36/0.64)

What should be the arrangements for entities with substituted accounting periods?

Option 1: Apply the new entity tax system to all entities from their 2000-01 income year

17.86 The new entity tax system is intended to apply from the 2000-01 income year. For entities with early balance dates, this would mean effective implementation of the new entity tax system as early as December 1999 if the new regime applied from the beginning of their 2000-01 income year (requiring early legislaiton). For entities with late balance dates, it is possible that they would not adopt the new entity tax system until later in the year 2000. This would have the disadvantage that for a year there would be some entities operating under the new entity tax system, while other entities would still be applying the old law.

Option 2: Apply the new entity tax system to all entities from 1 July 2000

17.87 An option to address this problem would be to require entities with early and late balancing dates to change to the new entity taxation system on 1 July 2000. This would provide a consistent treatment for all entities, but the compliance costs for entities with early and late balancing dates would be higher because they would effectively have to lodge two separate income tax returns for the 2000-01 income year.

Option 3: Apply the new entity tax system to early balancers from the beginning of their 2001-02 income year

17.88 Another option would be to allow entities with early balance dates to make the change to the new entity regime from the beginning of their 2001-02 income year. This option would mean that some entities would not begin to apply the new regime until June 2001. Again there would be a period when some entities would be operating under the new law and some under the old.

17.89 Against the possibility of Option 2 not being adopted, views are sought on what transitional measures would be necessary for dealing with transactions between early and late balancing entities and other entities. One area for consideration is whether problems will be caused as a result of entities subject to differing regimes transacting with each other. Arguably, problems should not arise in such cases. If one trust is converted on 1 July 2000 and another trust later (say 1 January 2000), a distribution from the first to the second on 30 September 2000 would be a franked dividend which the second trust would account for under current imputation rules. If the second distributes to the first on that date it will not be a franked dividend (as the new system has not started yet) and would be accounted for and taxed like current trust distributions. There would also be issues arising from entities distributing to their members, because the former could be subject to two entity tax regimes during the one income year of the member.