BRAD

Chapter 2

EXPLAINING THE FULL IMPUTATION SYSTEM OF COMPANY TAX

BRAD

Chapter 2: explaining Brad's country's full imputation system of company tax

Brad and the others in the Tax Department's tax policy team, Claudia and Sami, continue with the excitement, wonder and intrigue involved in the the taxing of investment income: the income that comes from saving for future living rather than consuming now.

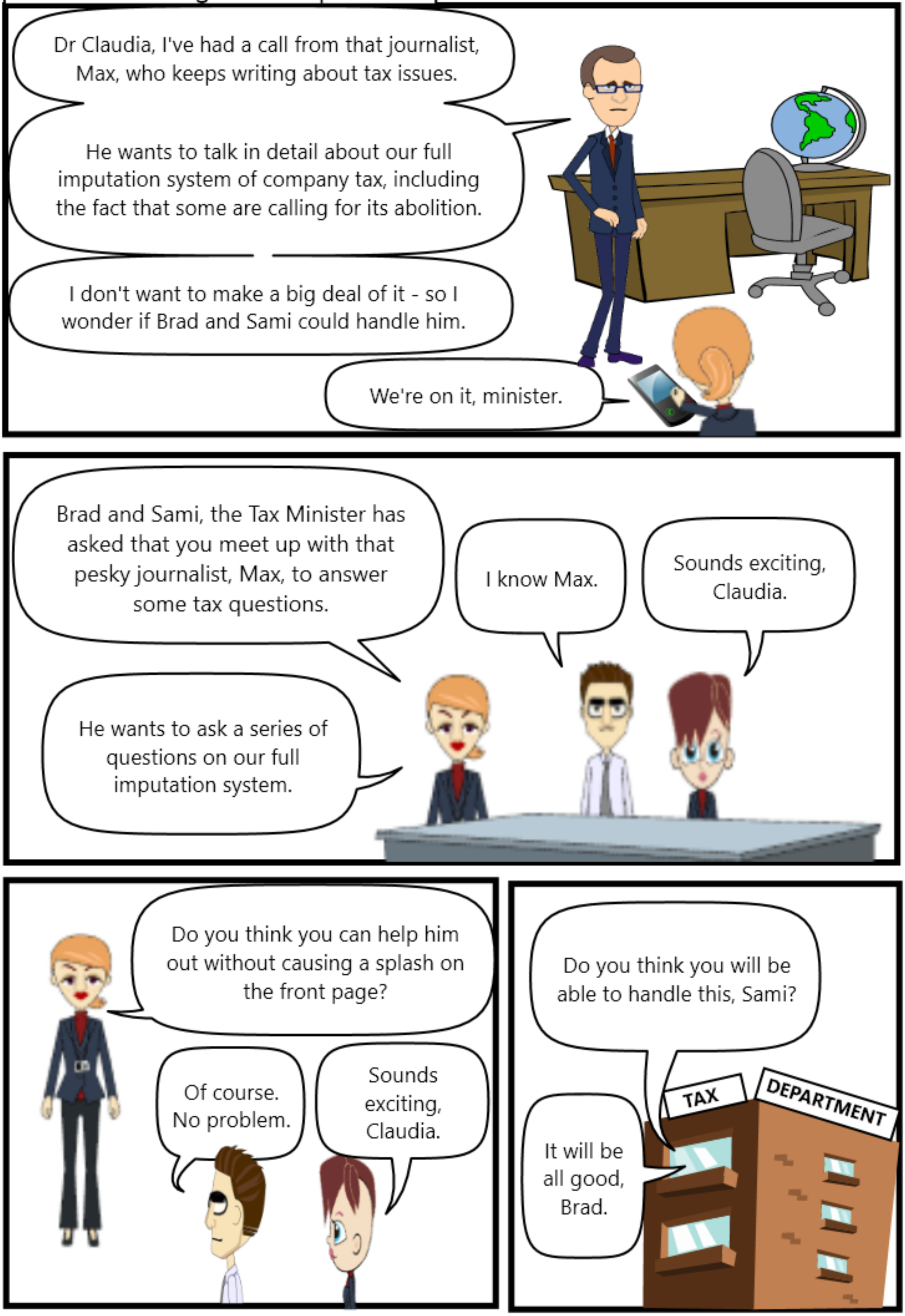
In this chapter, Brad and Sami are interviewed by a journalist on their country's full imputation system of company tax.

The interview produces quite a bit of heat both from Claudia and the Tax Minister. Nevertheless, from watching the interview, the Tax Minister understood better the full imputation system and its shortcomings, as well as options for future changes to it.

The full imputation system in Brad's country is strikingly similar the that in Australia, which was announced in the then government's 1985 Draft White Paper (see Preface) and and commenced 1 July 1987 in somewhat different format to that originally announced. The full imputation system removes the double taxation of company income that applied under the prior classical system of company tax: first at the company level and again in the hands of individual shareholders when distributed as dividends.

In contrast, the 2009 Henry Review, recommends (recommendation 37) that alternatives to imputation should be considered 'as part of a further consideration of company income tax arrangements' (p 198). TTPI (2020) canvasses a dual income tax system as an alternative to full imputation.

Officer (1990) specifically addresses the question of the cost of capital under full imputation in a country like Australia with a small, open capital market.


Dr Claudia, I've had a call from that journalist, Max, who keeps writing about tax issues.
He wants to talk in detail about our full imputation system of company tax, including the fact that some are calling for its abolition.
I don't want to make a big deal of it - so I wonder if Brad and Sami could handle him.
We're on it, minister.
Brad and Sami, the Tax Minister has asked that you meet up with that pesky journalist, Max, to answer some tax questions.
He wants to ask a series of questions on our full imputation system.
I know Max.
Sounds exciting, Claudia.
Do you think you can help him out without causing a splash on the front page?
Of course. No problem.
Sounds exciting, Claudia.
Do you think you will be able to handle this, Sami?
It will be all good, Brad.
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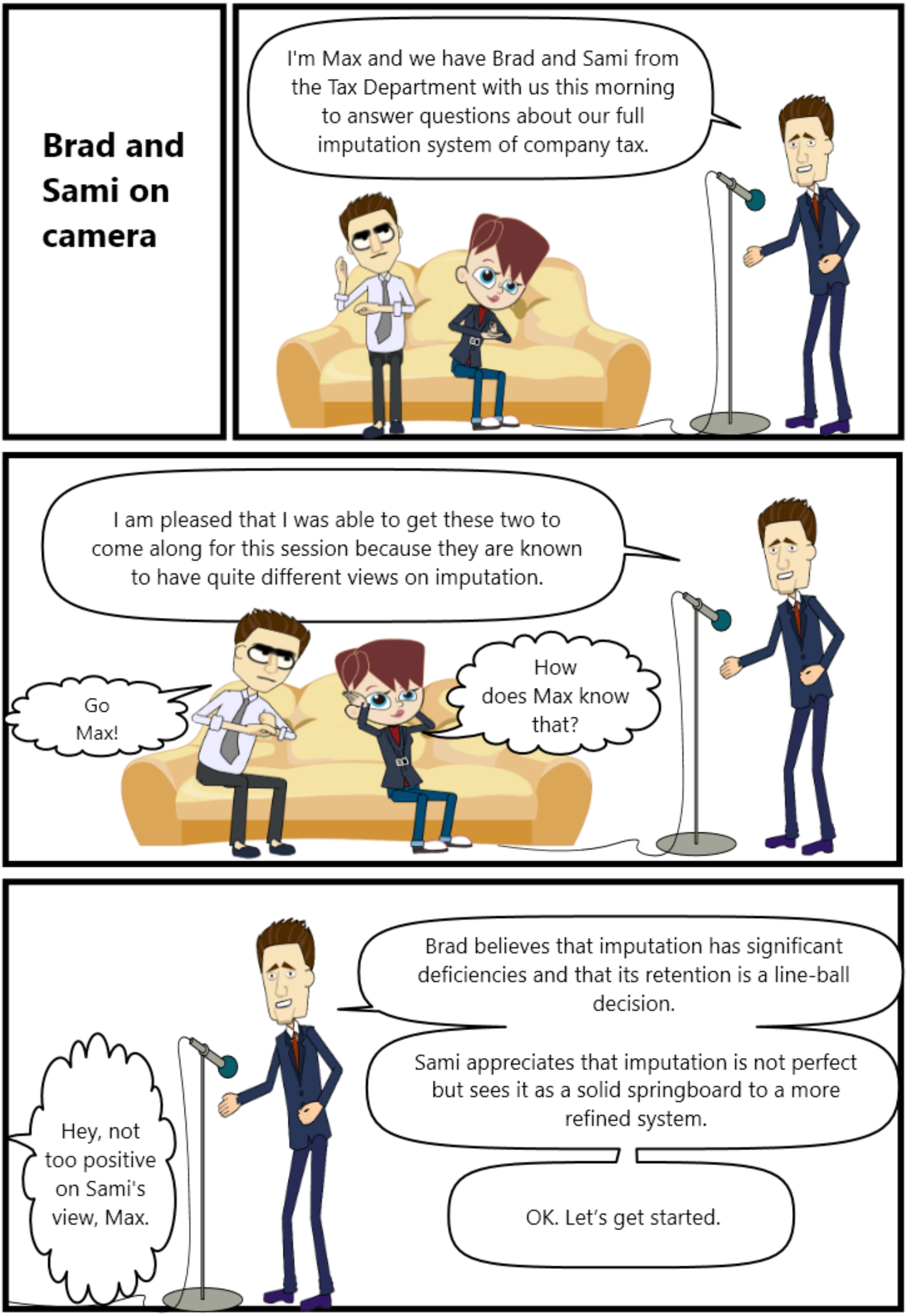
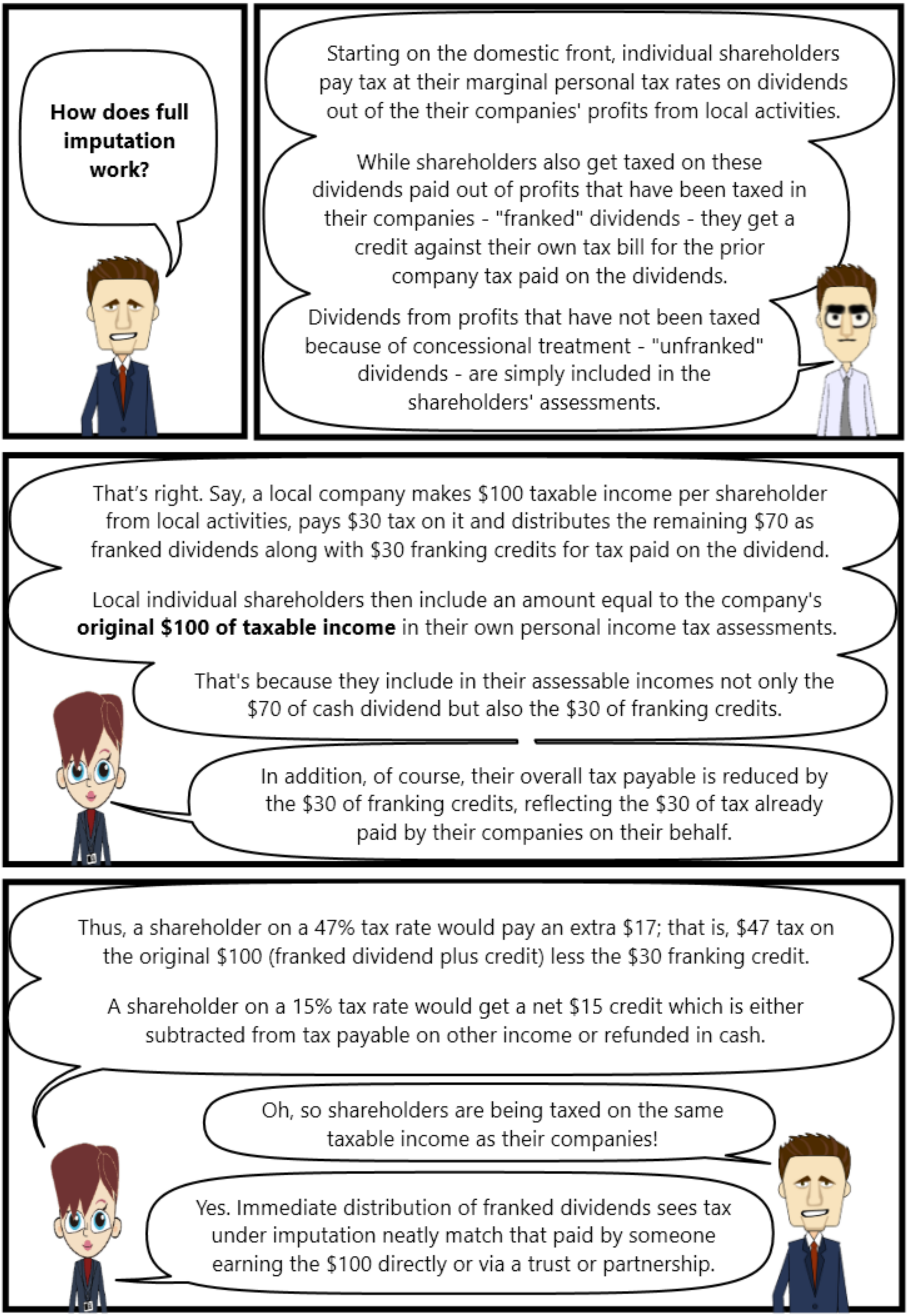
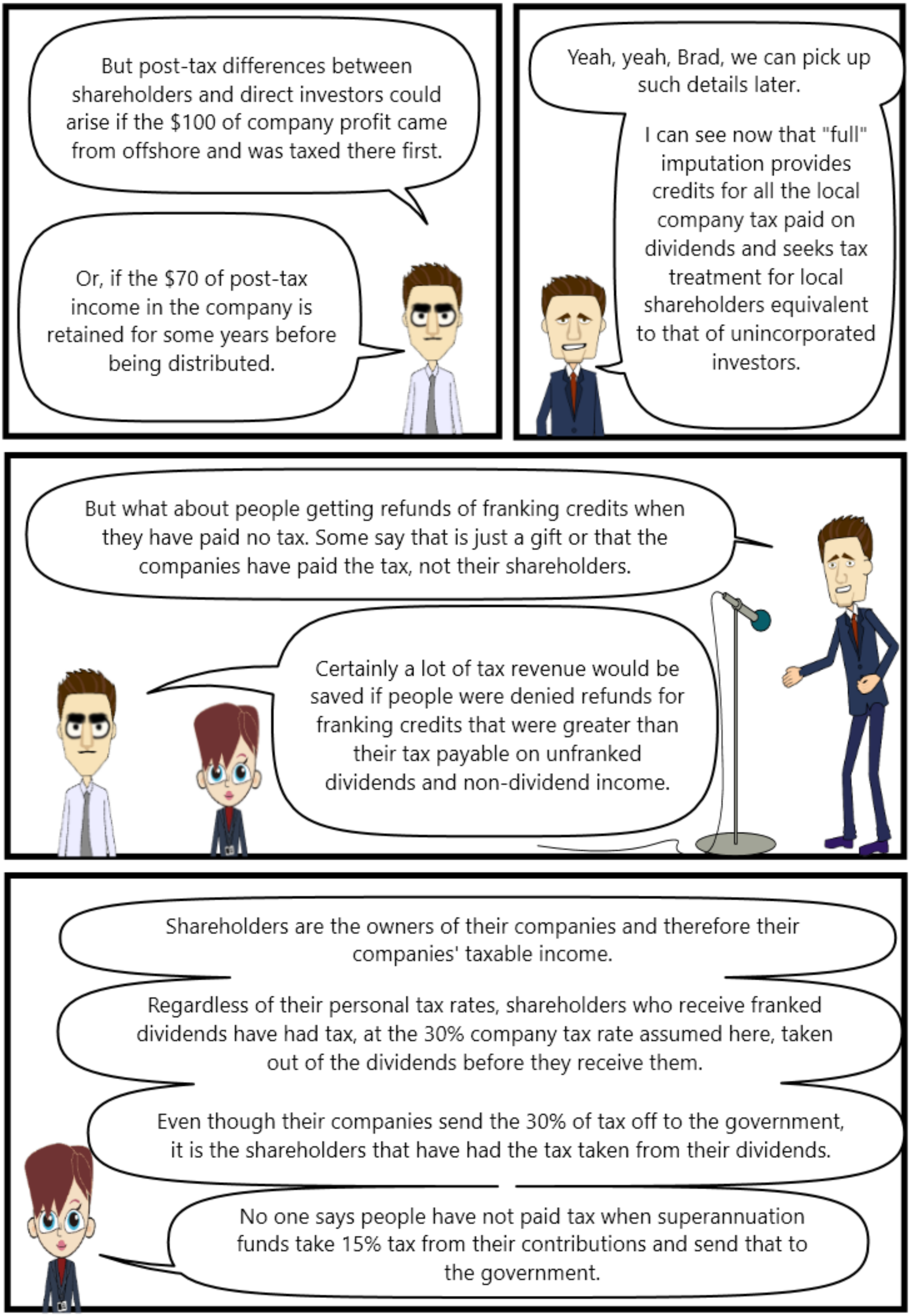
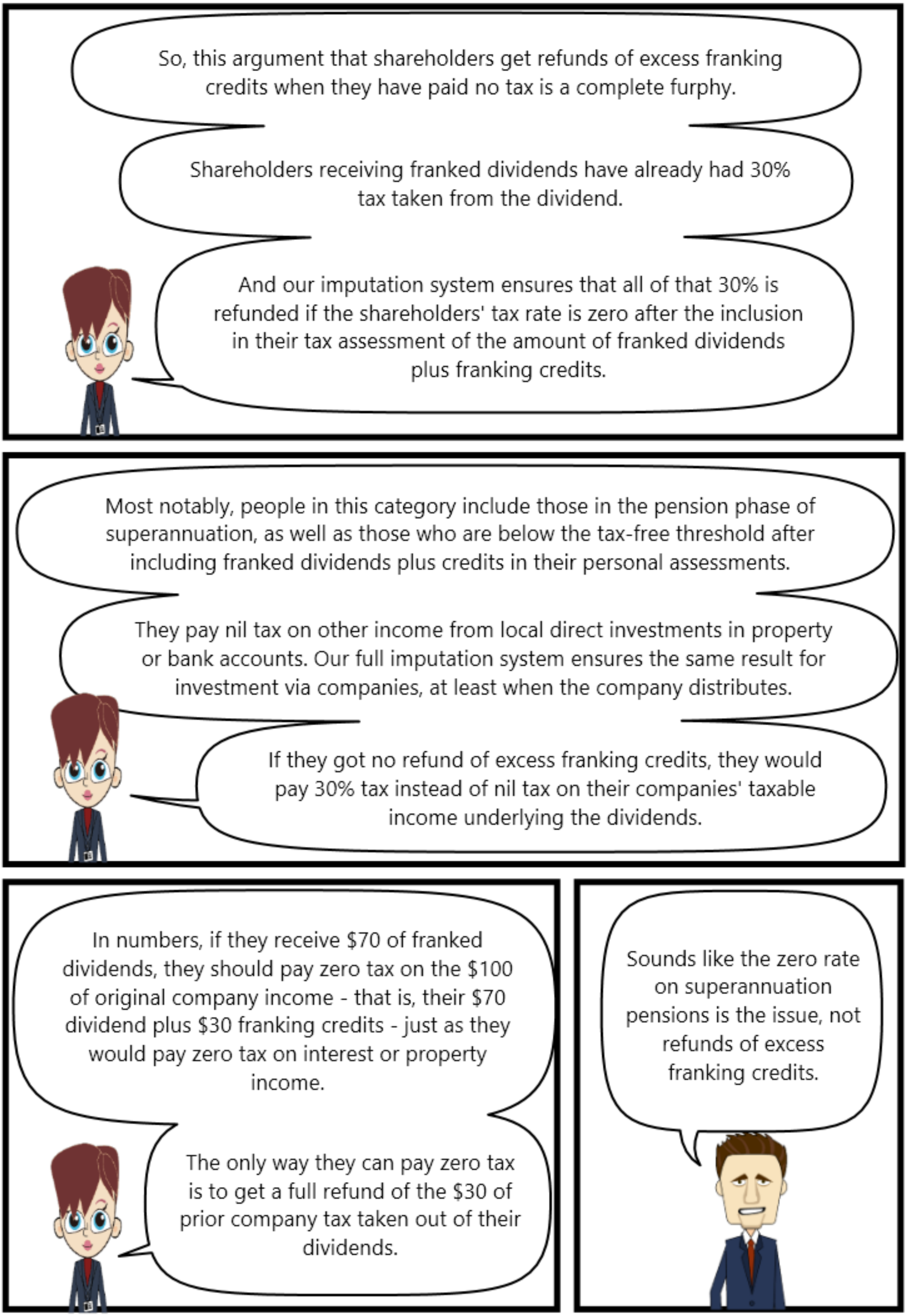
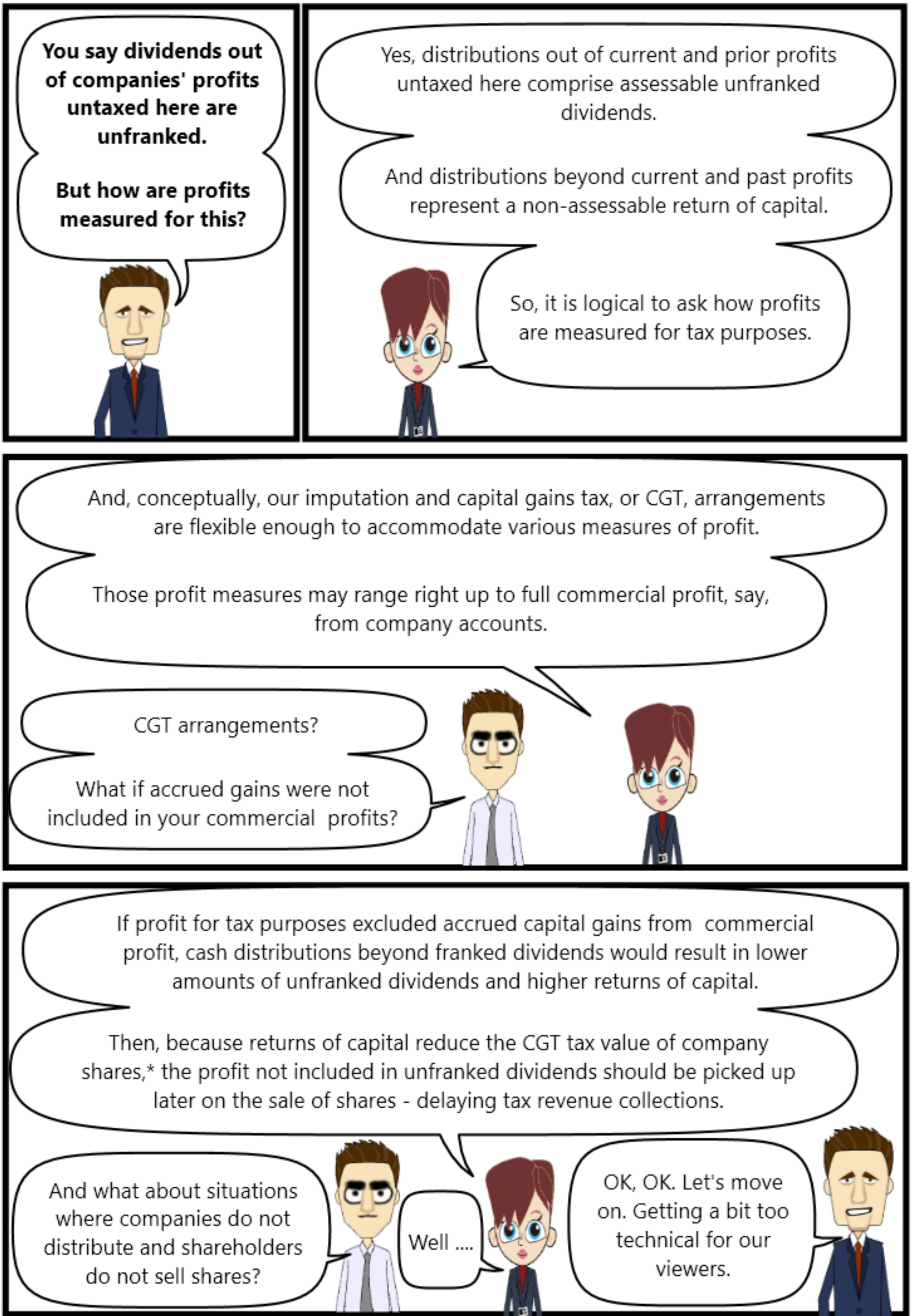

Brad and Sami on camera
I'm Max and we have Brad and Sami from the Tax Department with us this morning to answer questions about our full imputation system of company tax.
I am pleased that I was able to get these two to come along for this session because they are known to have quite different views on imputation.
Go Max!
How does Max know that?
Brad believes that imputation has significant deficiencies and that its retention is a line-ball decision.
Sami appreciates that imputation is not perfect but sees it as a solid springboard to a more refined system.
OK. Let's get started.
Hey, not too positive on Sami's view, Max.

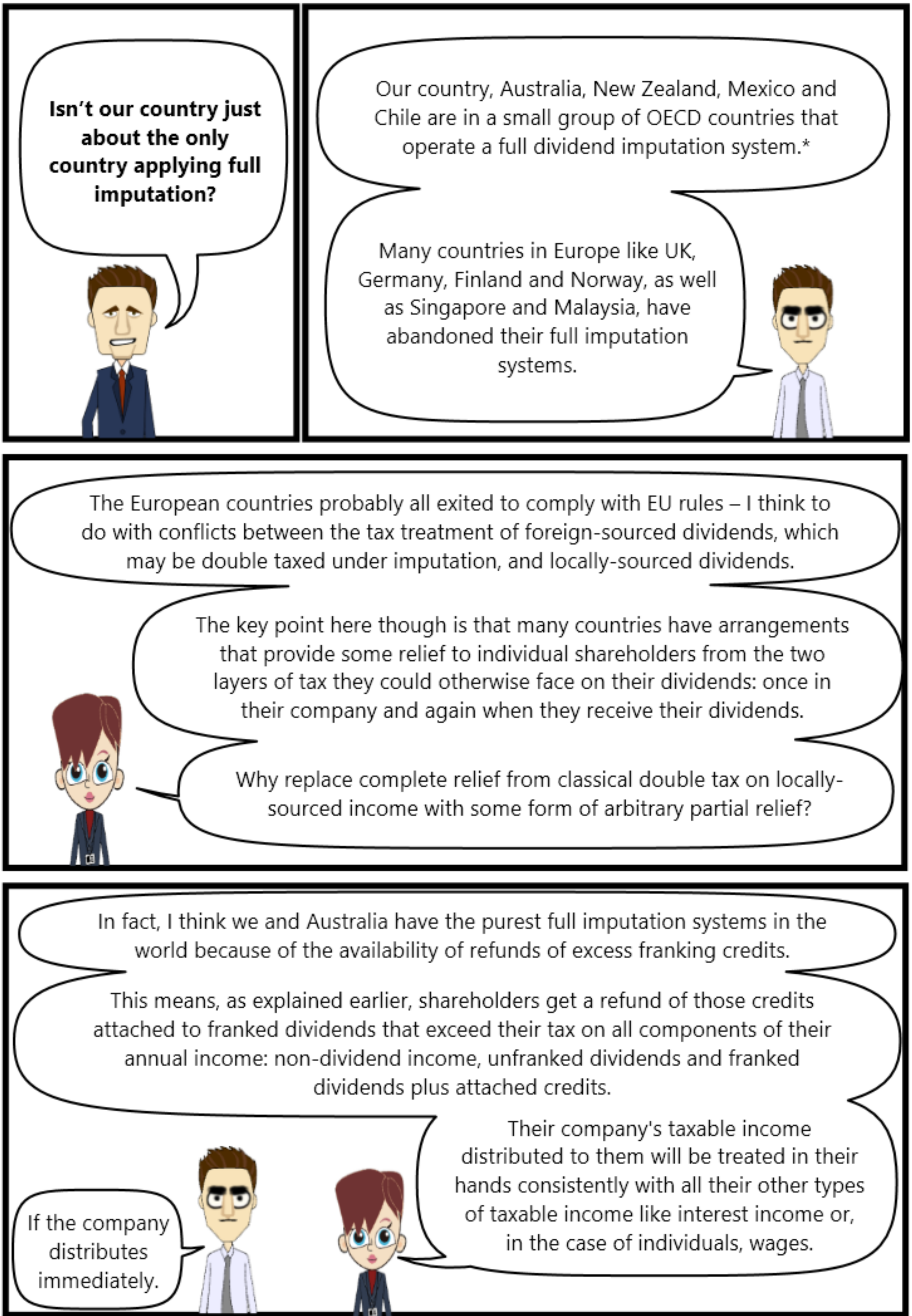

How does full imputation work?
Starting on the domestic front, individual shareholders pay tax at their marginal personal tax rates on dividends out of the their companies' profits from local activities.
While shareholders also get taxed on these dividends paid out of profits that have been taxed in their companies - "franked" dividends - they get a credit against their own tax bill for the prior company tax paid on the dividends.
Dividends from profits that have not been taxed because of concessional treatment - "unfranked" dividends - are simply included in the shareholders' assessments.
That's right. Say, a local company makes $100 taxable income per shareholder from local activities, pays $30 tax on it and distributes the remaining $70 as franked dividends along with $30 franking credits for tax paid on the dividend.
Local individual shareholders then include an amount equal to the company's **original $100 of taxable income** in their own personal income tax assessments.
That's because they include in their assessable incomes not only the $70 of cash dividend but also the $30 of franking credits.
In addition, of course, their overall tax payable is reduced by the $30 of franking credits, reflecting the $30 of tax already paid by their companies on their behalf.
Thus, a shareholder on a 47% tax rate would pay an extra $17; that is, $47 tax on the original $100 (franked dividend plus credit) less the $30 franking credit.
A shareholder on a 15% tax rate would get a net $15 credit which is either subtracted from tax payable on other income or refunded in cash.
Oh, so shareholders are being taxed on the same taxable income as their companies!
Yes. Immediate distribution of franked dividends sees tax under imputation neatly match that paid by someone earning the $100 directly or via a trust or partnership.


But post-tax differences between shareholders and direct investors could arise if the $100 of company profit came from offshore and was taxed there first.
Or, if the $70 of post-tax income in the company is retained for some years before being distributed.
Yeah, yeah, Brad, we can pick up such details later.
I can see now that "full" imputation provides credits for all the local company tax paid on dividends and seeks tax treatment for local shareholders equivalent to that of unincorporated investors.
But what about people getting refunds of franking credits when they have paid no tax. Some say that is just a gift or that the companies have paid the tax, not their shareholders.
Certainly a lot of tax revenue would be saved if people were denied refunds for franking credits that were greater than their tax payable on unfranked dividends and non-dividend income.
Shareholders are the owners of their companies and therefore their companies' taxable income.
Regardless of their personal tax rates, shareholders who receive franked dividends have had tax, at the 30% company tax rate assumed here, taken out of the dividends before they receive them.
Even though their companies send the 30% of tax off to the government, it is the shareholders that have had the tax taken from their dividends.
No one says people have not paid tax when superannuation funds take 15% tax from their contributions and send that to the government.

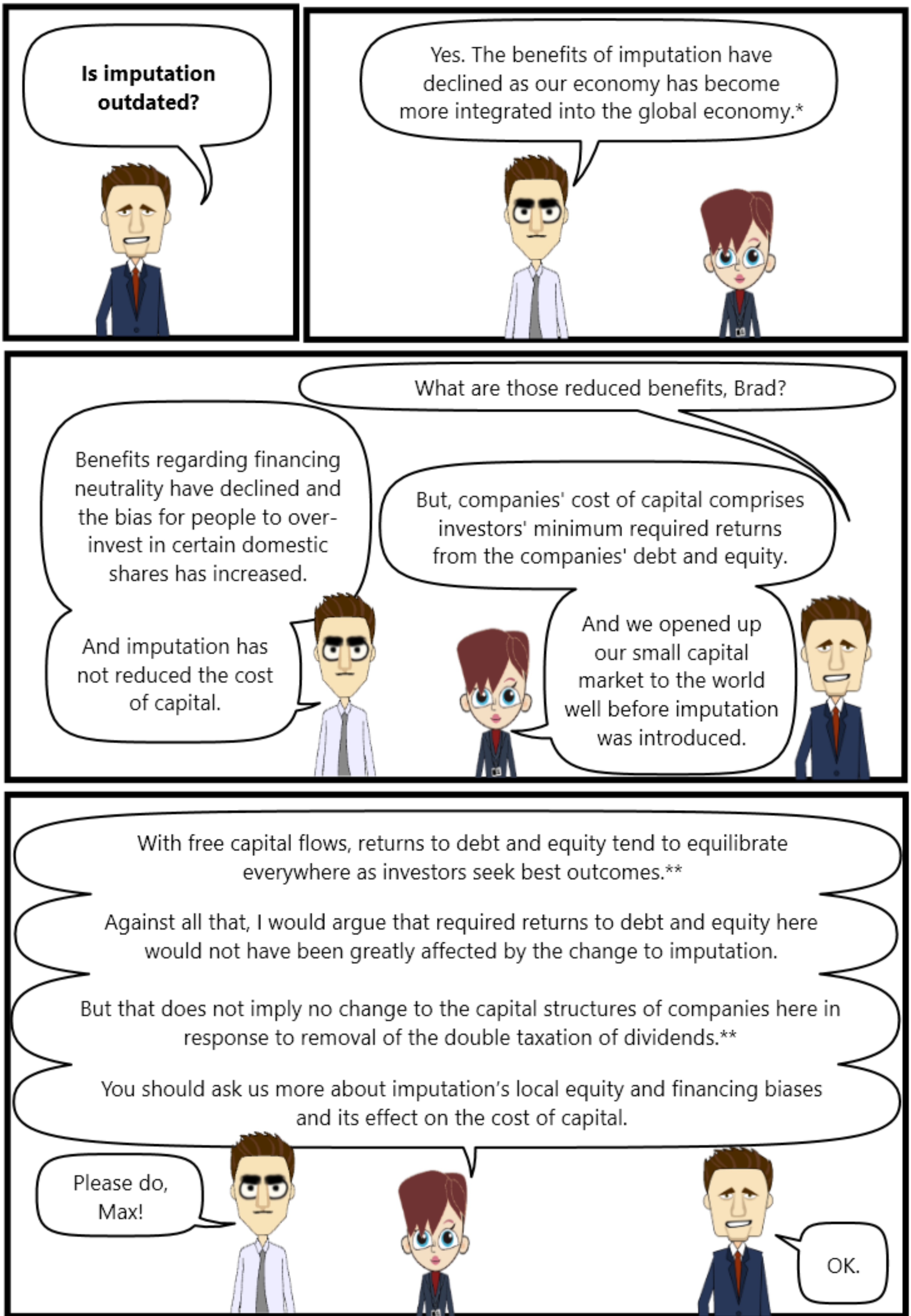

So, this argument that shareholders get refunds of excess franking credits when they have paid no tax is a complete furphy.
Shareholders receiving franked dividends have already had 30% tax taken from the dividend.
And our imputation system ensures that all of that 30% is refunded if the shareholders' tax rate is zero after the inclusion in their tax assessment of the amount of franked dividends plus franking credits.
Most notably, people in this category include those in the pension phase of superannuation, as well as those who are below the tax-free threshold after including franked dividends plus credits in their personal assessments.
They pay nil tax on other income from local direct investments in property or bank accounts. Our full imputation system ensures the same result for investment via companies, at least when the company distributes.
If they got no refund of excess franking credits, they would pay 30% tax instead of nil tax on their companies' taxable income underlying the dividends.
In numbers, if they receive $70 of franked dividends, they should pay zero tax on the $100 of original company income - that is, their $70 dividend plus $30 franking credits - just as they would pay zero tax on interest or property income.
The only way they can pay zero tax is to get a full refund of the $30 of prior company tax taken out of their dividends.
Sounds like the zero rate on superannuation pensions is the issue, not refunds of excess franking credits.


You say dividends out of companies' profits untaxed here are unfranked.
But how are profits measured for this?
Yes, distributions out of current and prior profits untaxed here comprise assessable unfranked dividends.
And distributions beyond current and past profits represent a non-assessable return of capital.
So, it is logical to ask how profits are measured for tax purposes.
And, conceptually, our imputation and capital gains tax, or CGT, arrangements are flexible enough to accommodate various measures of profit.
Those profit measures may range right up to full commercial profit, say, from company accounts.
CGT arrangements?
What if accrued gains were not included in your commercial profits?
If profit for tax purposes excluded accrued capital gains from commercial profit, cash distributions beyond franked dividends would result in lower amounts of unfranked dividends and higher returns of capital.
Then, because returns of capital reduce the CGT tax value of company shares,* the profit not included in unfranked dividends should be picked up later on the sale of shares - delaying tax revenue collections.
And what about situations where companies do not distribute and shareholders do not sell shares?
Well ....
OK, OK. Let's move on. Getting a bit too technical for our viewers.

* See Ch7, pp 5-6.

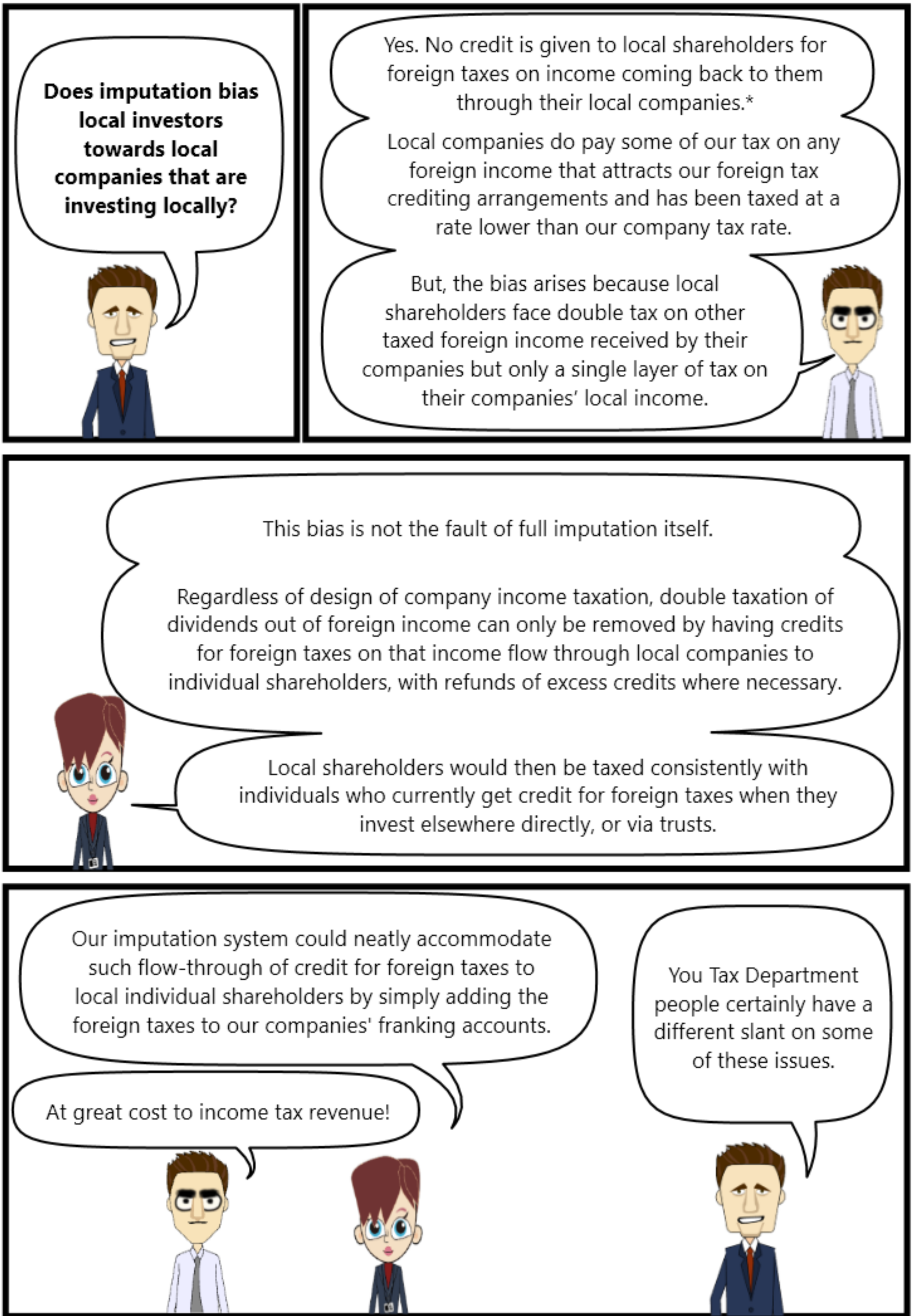


* Henry Review, p 191.

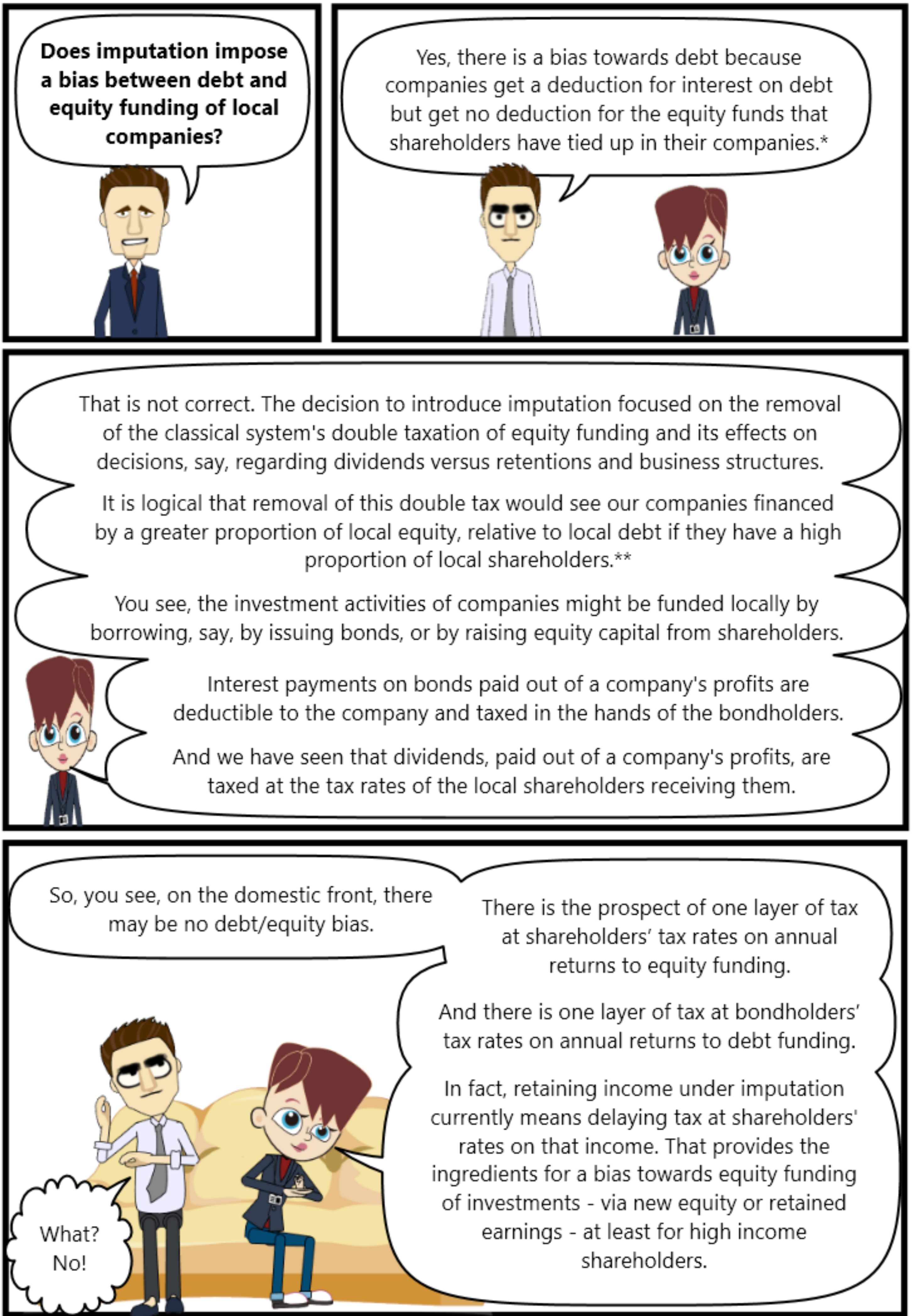


* Henry Review, p 198.

** Officer (1990), pp 369-371.

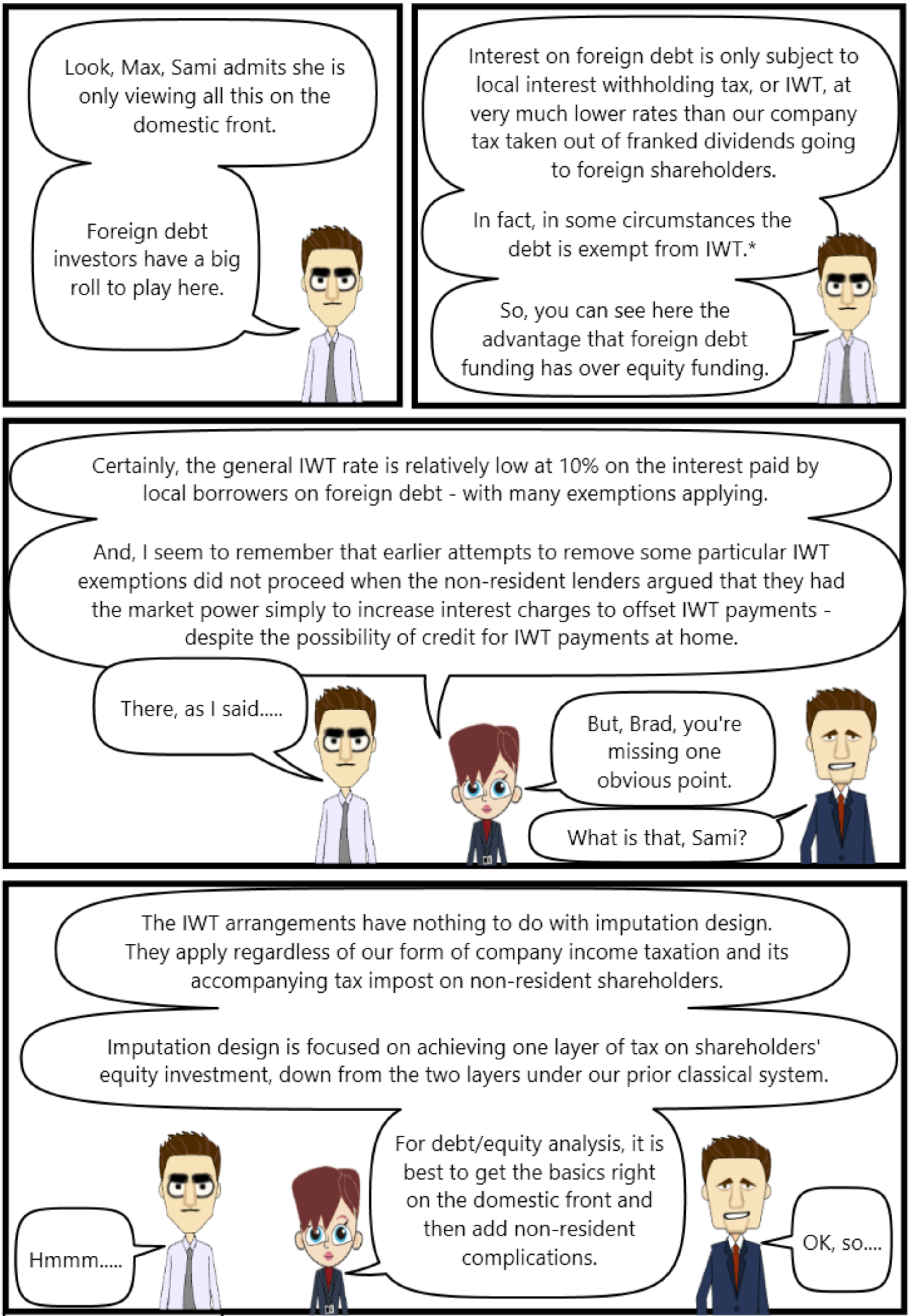


* Henry Review, pp 196-197.

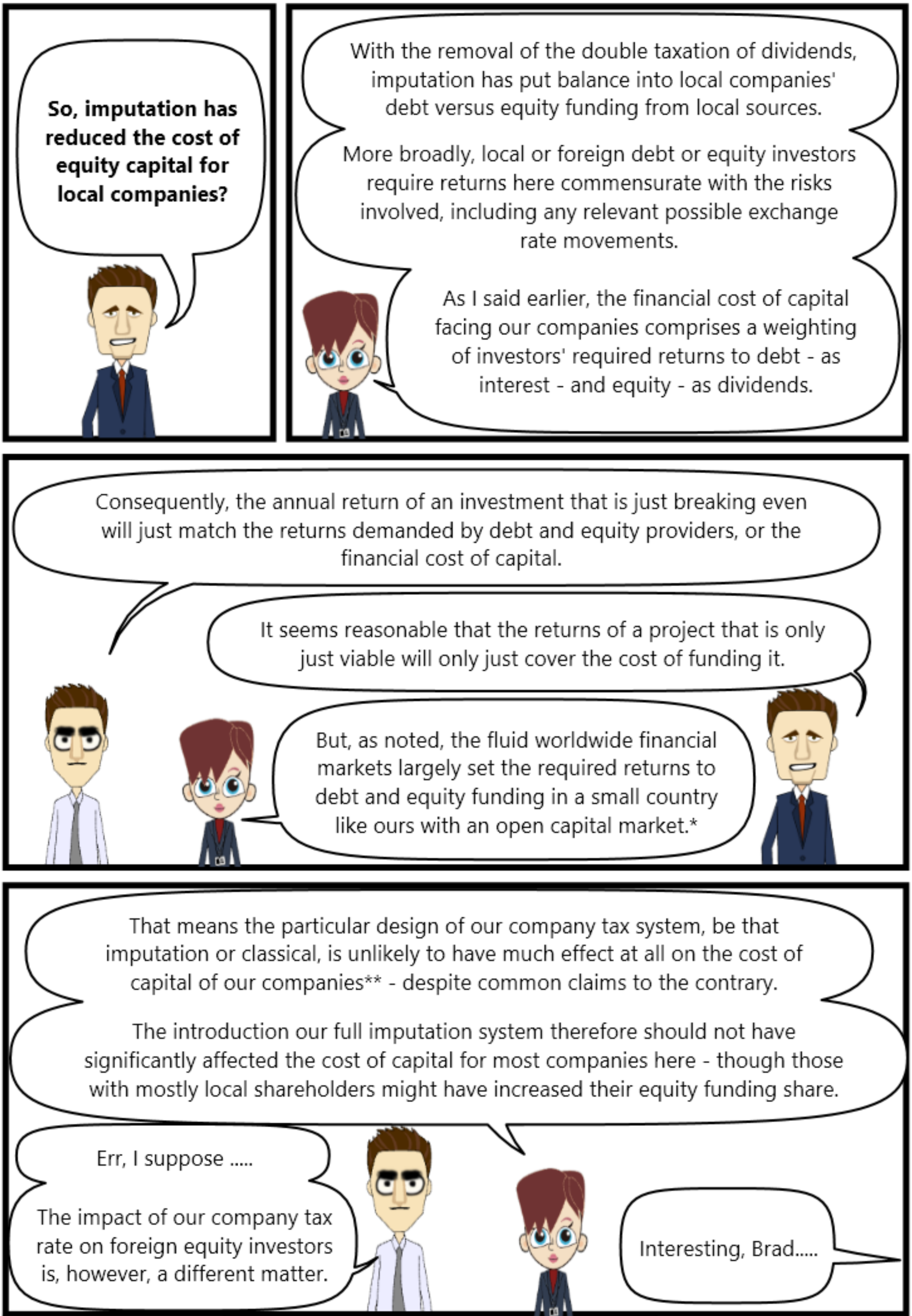


* Henry Review, pp 178-179.

** Officer (1990), p 366, 371.

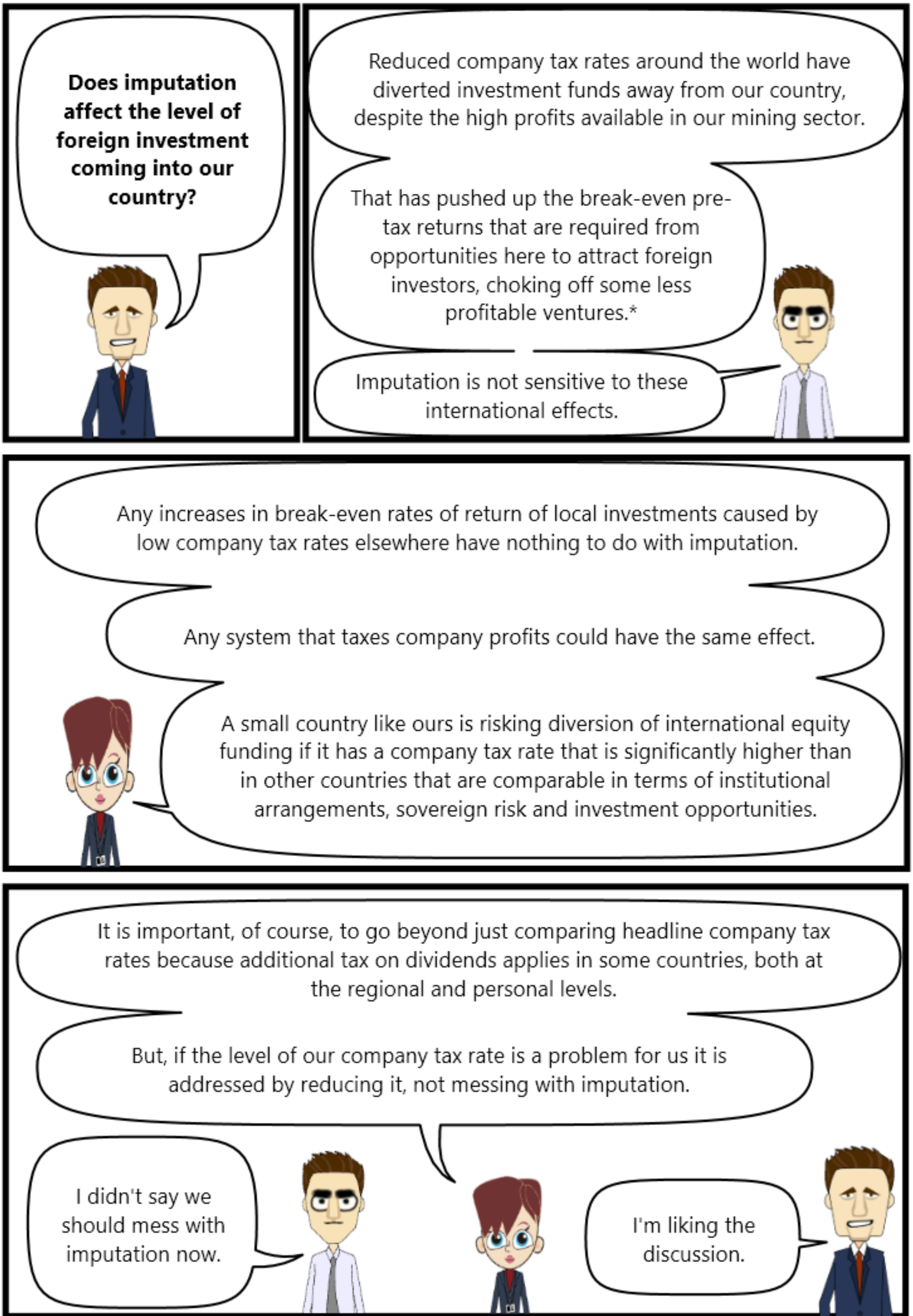


* Henry Review, pp 180-182.

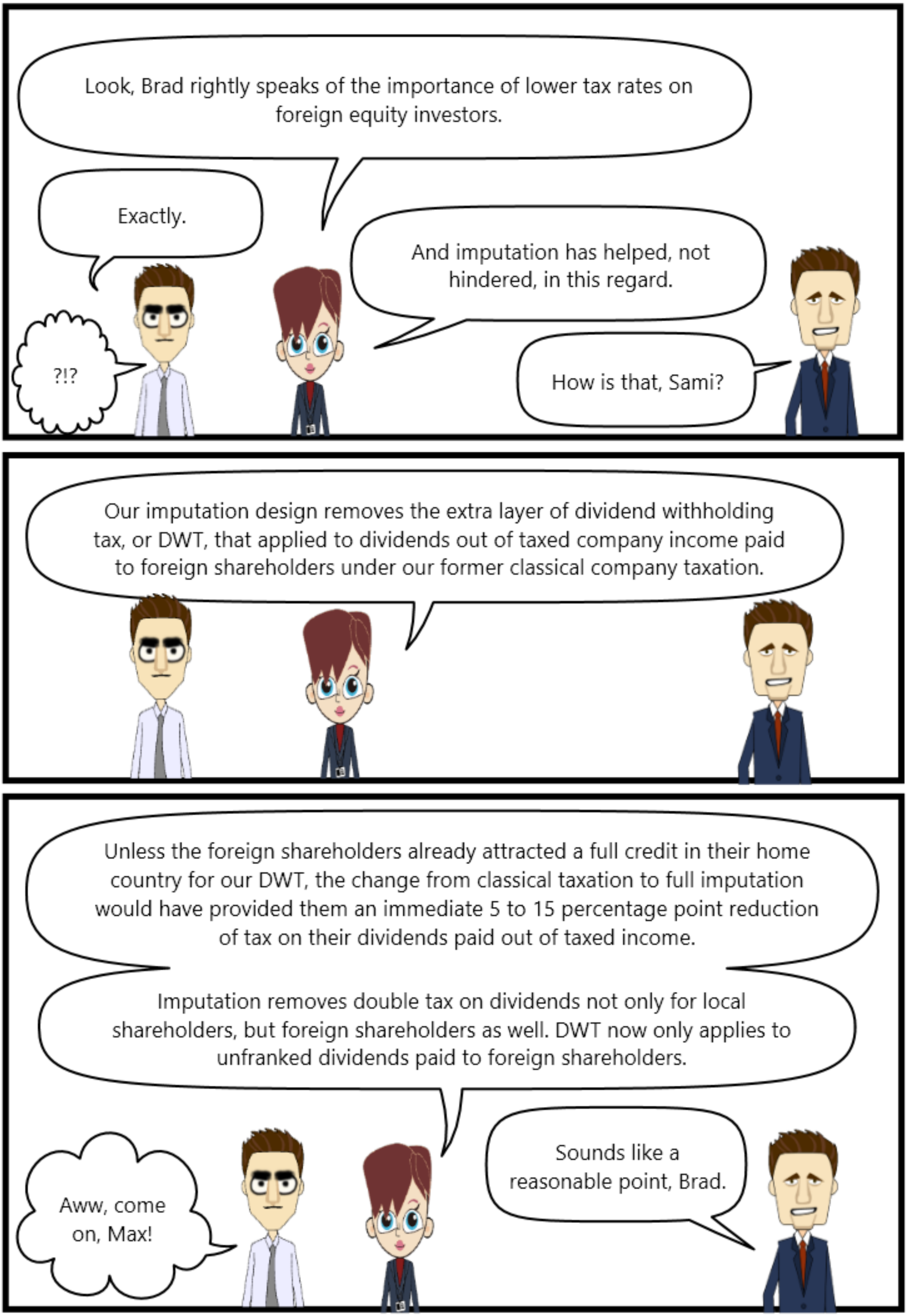


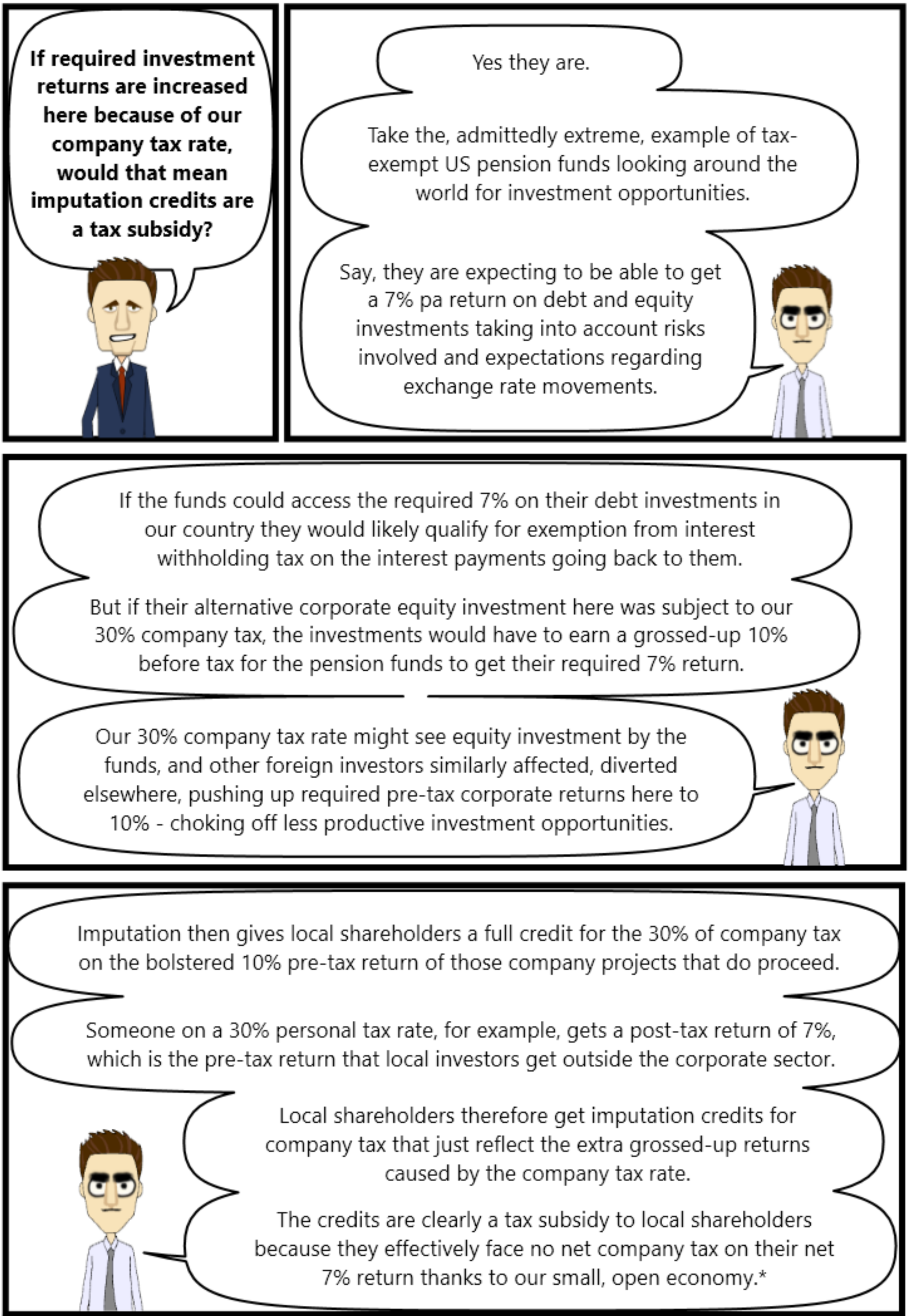
* Officer (1990), pp 368-369.

** See Henry Review, pp 193-194.

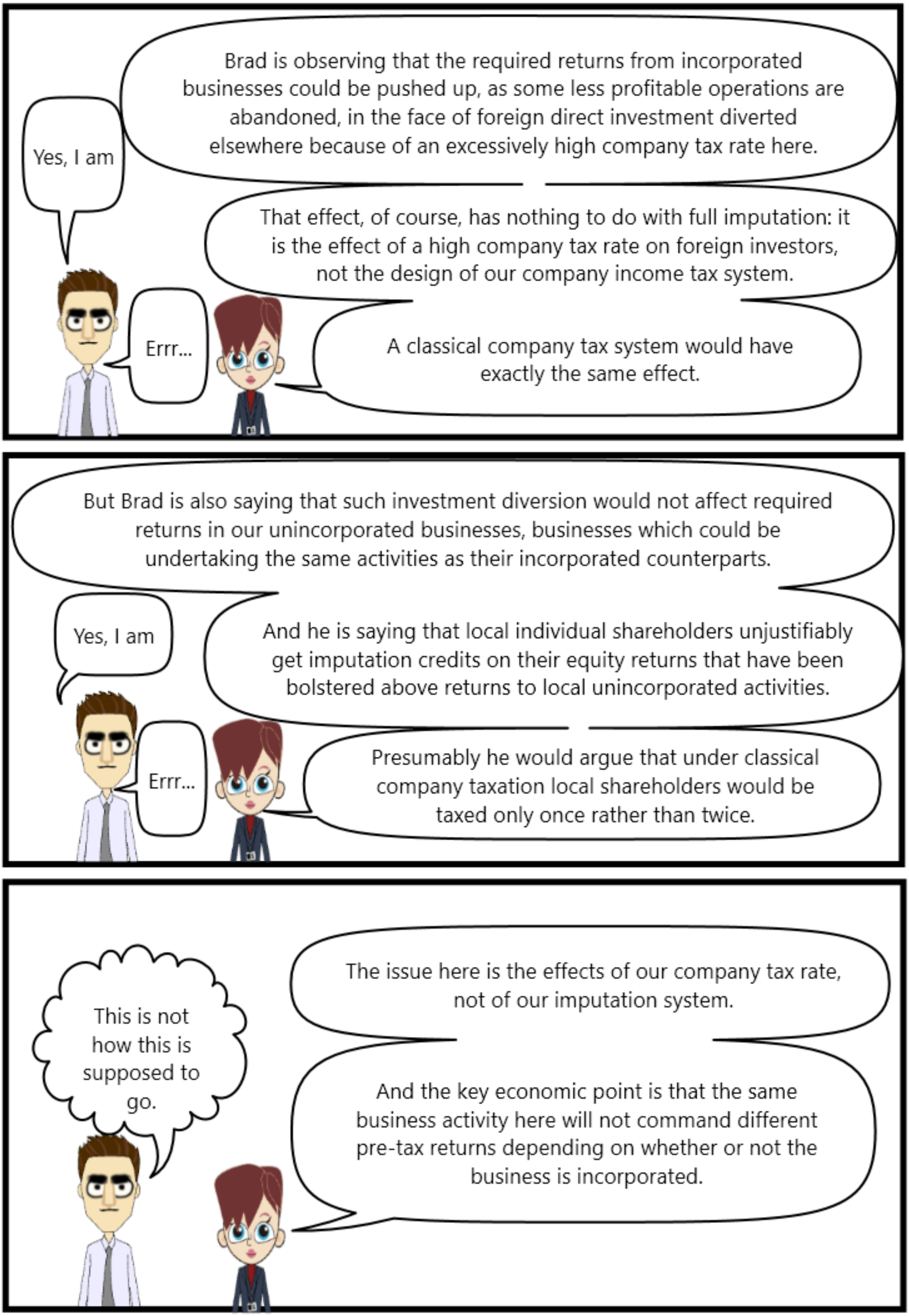


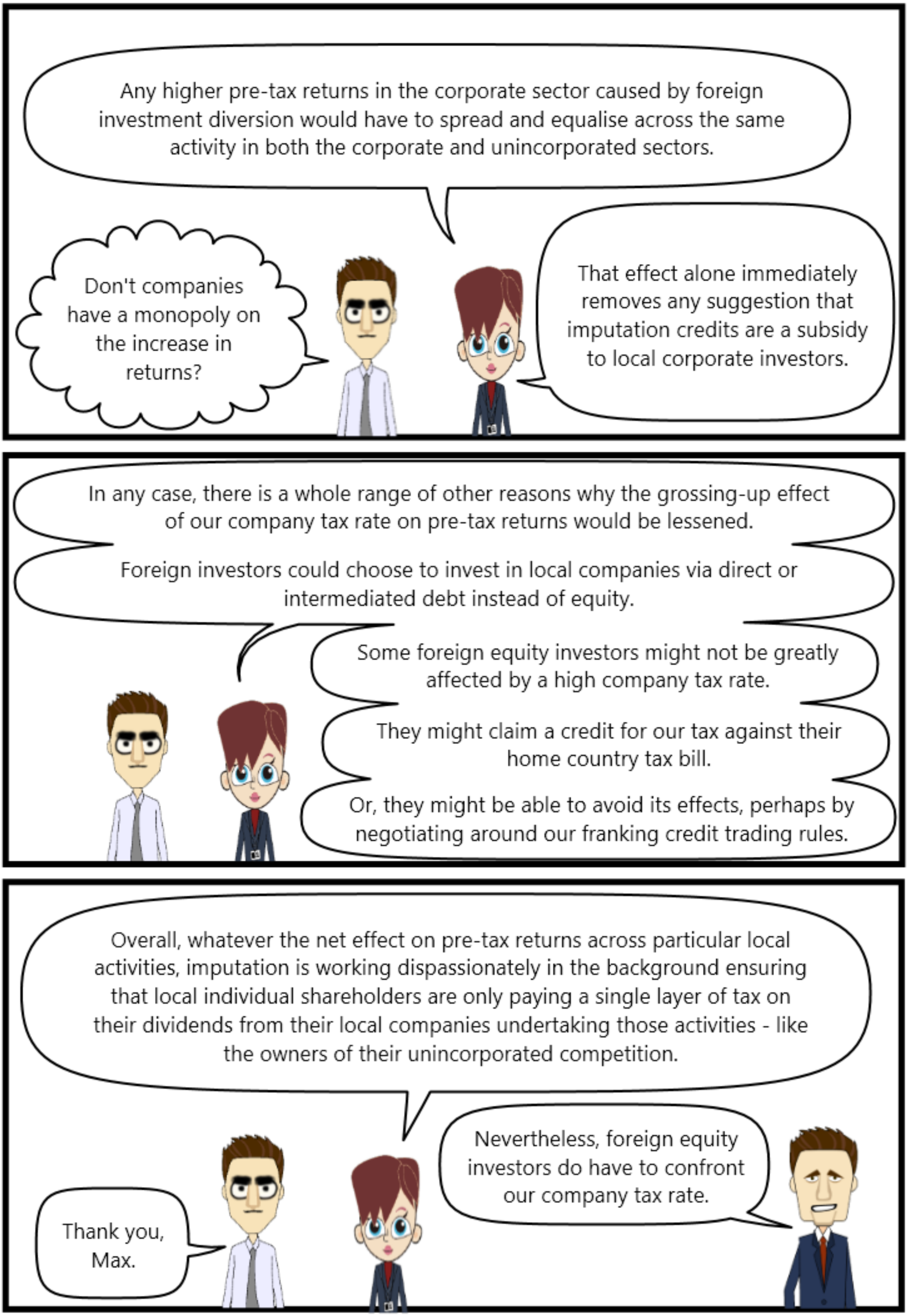
* Henry Review, pp 152-153.

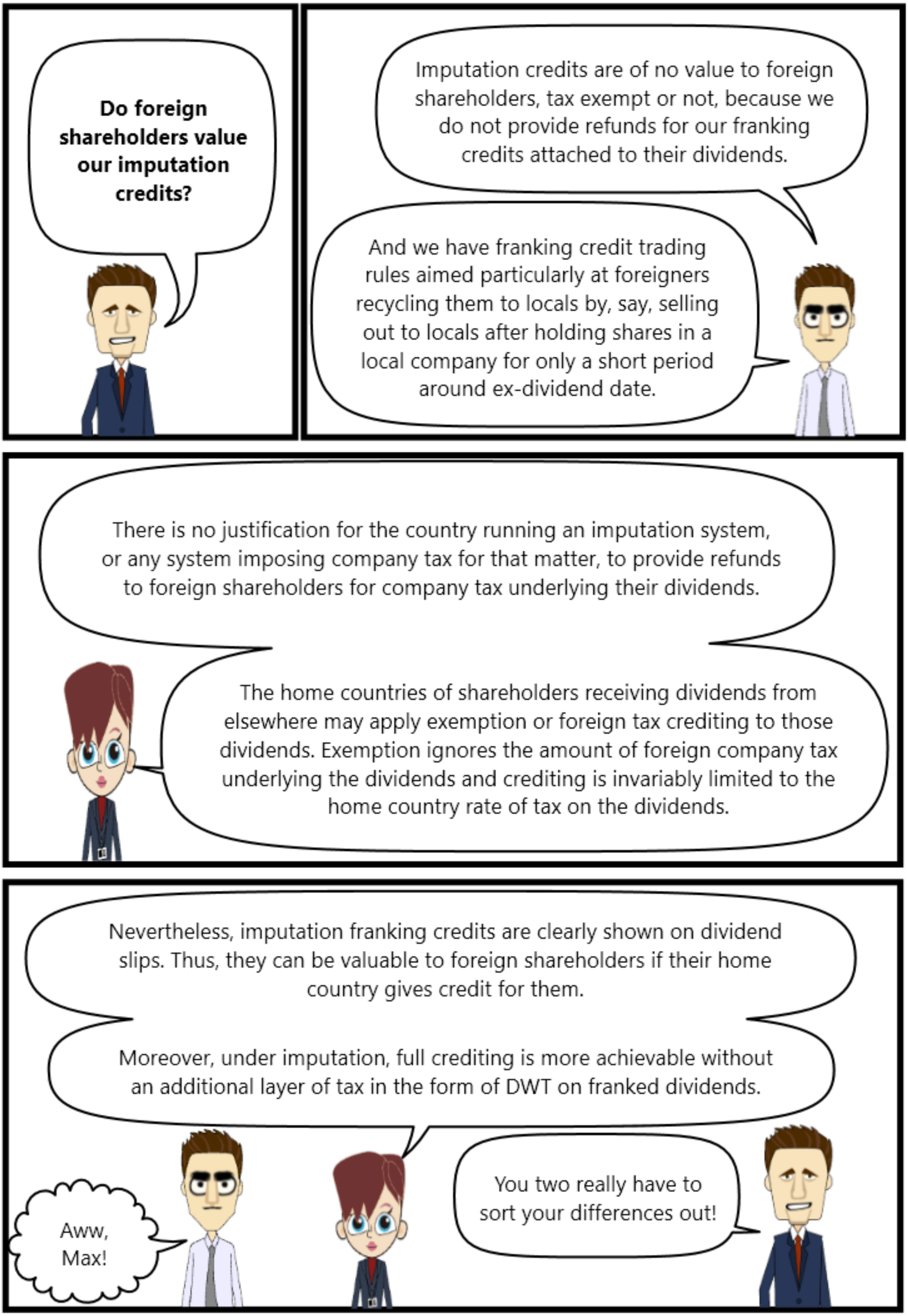

Look, Brad rightly speaks of the importance of lower tax rates on foreign equity investors.
Exactly.
?!?
And imputation has helped, not hindered, in this regard.
How is that, Sami?
Our imputation design removes the extra layer of dividend withholding tax, or DWT, that applied to dividends out of taxed company income paid to foreign shareholders under our former classical company taxation.
Unless the foreign shareholders already attracted a full credit in their home country for our DWT, the change from classical taxation to full imputation would have provided them an immediate 5 to 15 percentage point reduction of tax on their dividends paid out of taxed income.
Imputation removes double tax on dividends not only for local shareholders, but foreign shareholders as well. DWT now only applies to unfranked dividends paid to foreign shareholders.
Aww, come on, Max!
Sounds like a reasonable point, Brad.

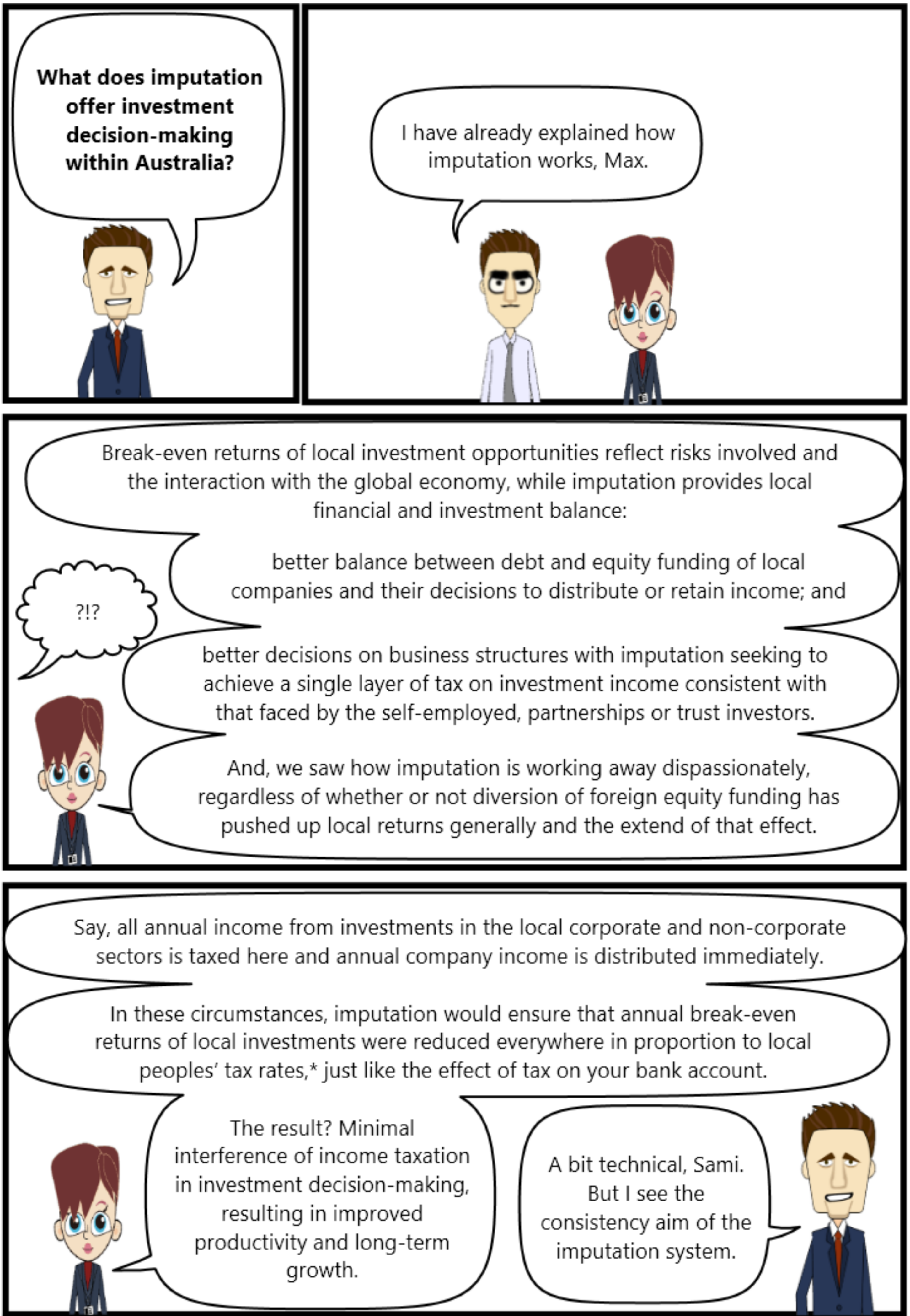


* Henry Review, p 76.

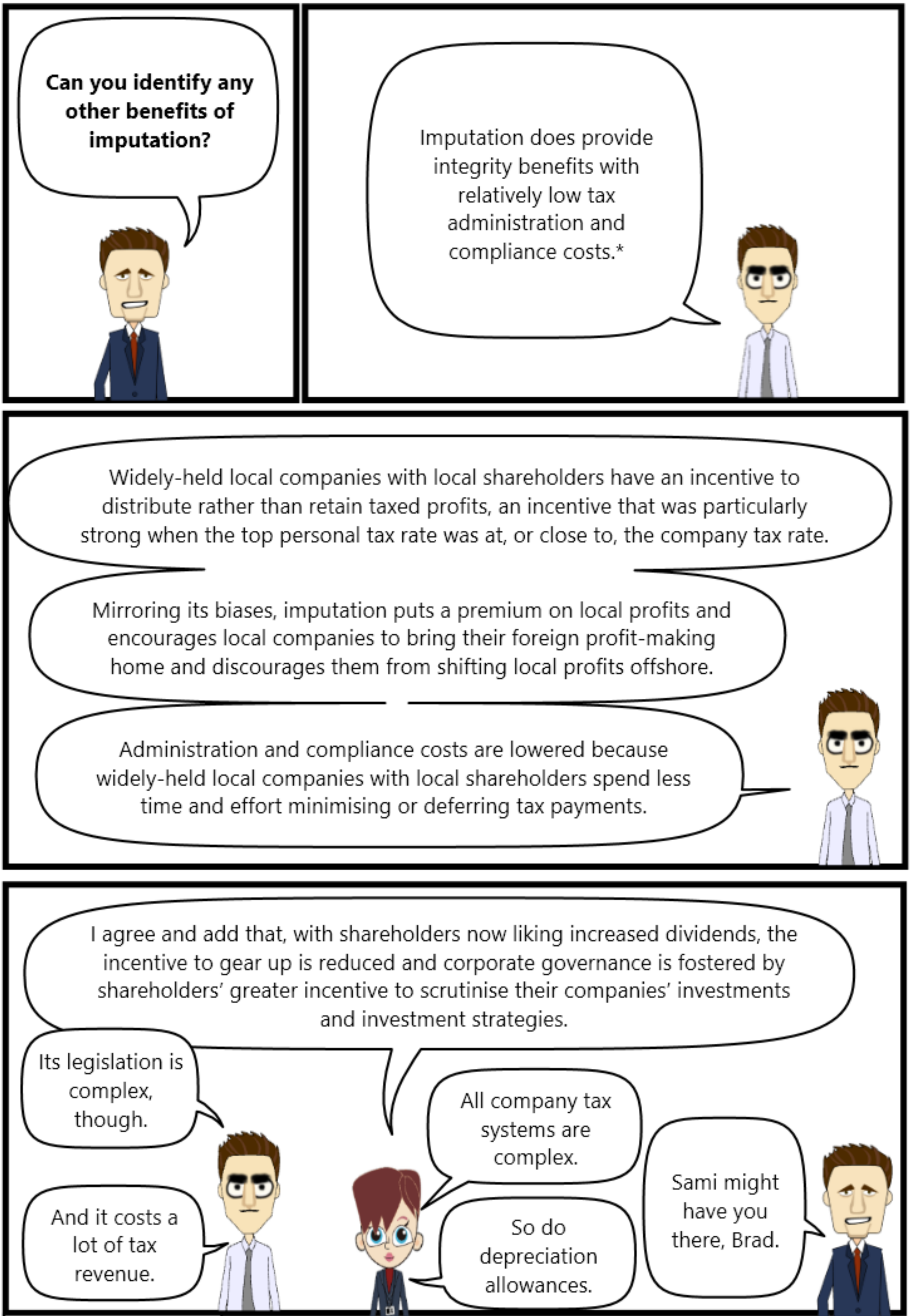

Brad is observing that the required returns from incorporated businesses could be pushed up, as some less profitable operations are abandoned, in the face of foreign direct investment diverted elsewhere because of an excessively high company tax rate here.
Yes, I am
That effect, of course, has nothing to do with full imputation: it is the effect of a high company tax rate on foreign investors, not the design of our company income tax system.
Errr...
A classical company tax system would have exactly the same effect.
But Brad is also saying that such investment diversion would not affect required returns in our unincorporated businesses, businesses which could be undertaking the same activities as their incorporated counterparts.
Yes, I am
And he is saying that local individual shareholders unjustifiably get imputation credits on their equity returns that have been bolstered above returns to local unincorporated activities.
Errr...
Presumably he would argue that under classical company taxation local shareholders would be taxed only once rather than twice.
This is not how this is supposed to go.
The issue here is the effects of our company tax rate, not of our imputation system.
And the key economic point is that the same business activity here will not command different pre-tax returns depending on whether or not the business is incorporated.


Any higher pre-tax returns in the corporate sector caused by foreign investment diversion would have to spread and equalise across the same activity in both the corporate and unincorporated sectors.
Don't companies have a monopoly on the increase in returns?
That effect alone immediately removes any suggestion that imputation credits are a subsidy to local corporate investors.
In any case, there is a whole range of other reasons why the grossing-up effect of our company tax rate on pre-tax returns would be lessened.
Foreign investors could choose to invest in local companies via direct or intermediated debt instead of equity.
Some foreign equity investors might not be greatly affected by a high company tax rate.
They might claim a credit for our tax against their home country tax bill.
Or, they might be able to avoid its effects, perhaps by negotiating around our franking credit trading rules.
Overall, whatever the net effect on pre-tax returns across particular local activities, imputation is working dispassionately in the background ensuring that local individual shareholders are only paying a single layer of tax on their dividends from their local companies undertaking those activities - like the owners of their unincorporated competition.
Nevertheless, foreign equity investors do have to confront our company tax rate.
Thank you, Max.

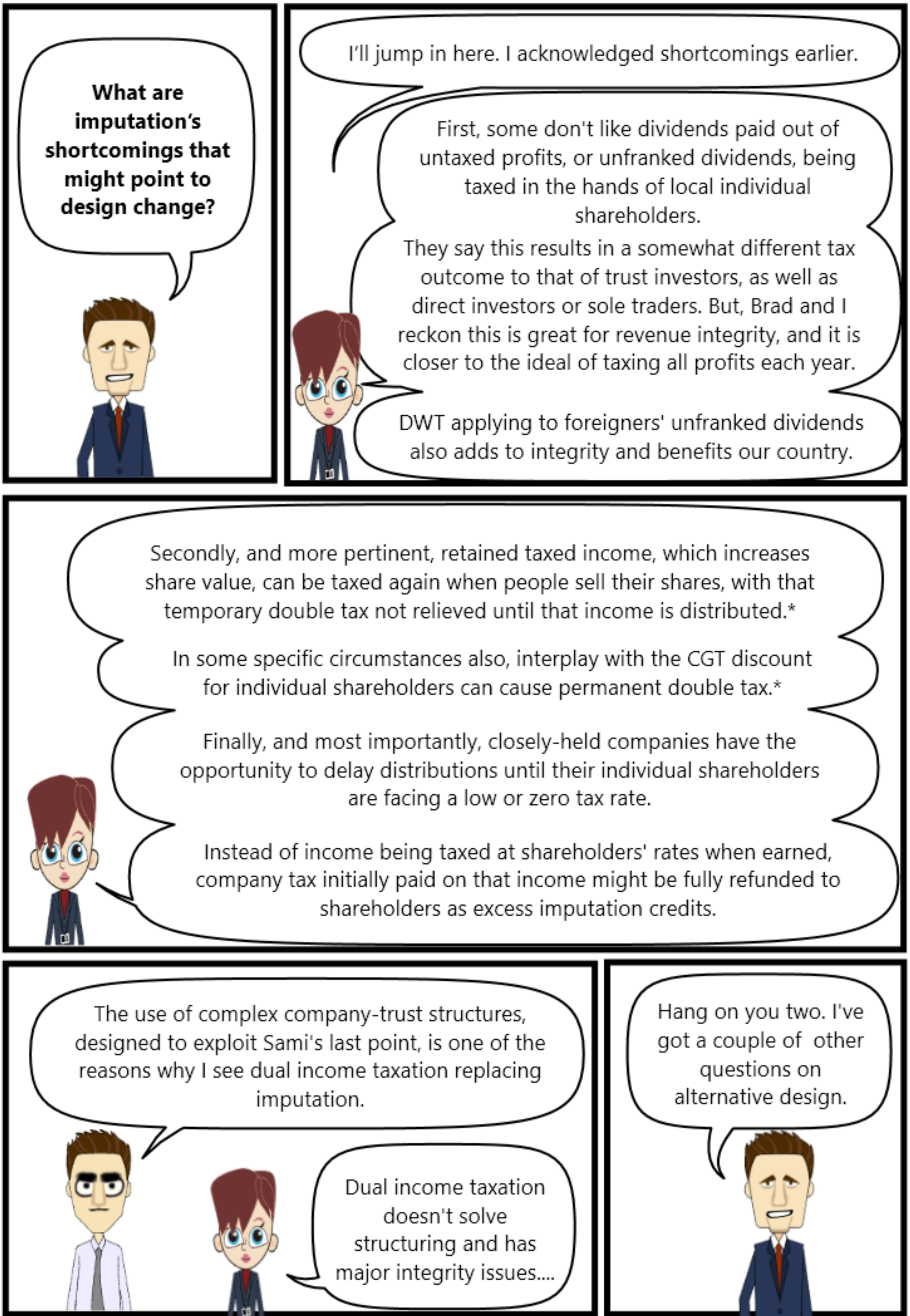

Do foreign shareholders value our imputation credits?
Imputation credits are of no value to foreign shareholders, tax exempt or not, because we do not provide refunds for our franking credits attached to their dividends.
And we have franking credit trading rules aimed particularly at foreigners recycling them to locals by, say, selling out to locals after holding shares in a local company for only a short period around ex-dividend date.
There is no justification for the country running an imputation system, or any system imposing company tax for that matter, to provide refunds to foreign shareholders for company tax underlying their dividends.
The home countries of shareholders receiving dividends from elsewhere may apply exemption or foreign tax crediting to those dividends. Exemption ignores the amount of foreign company tax underlying the dividends and crediting is invariably limited to the home country rate of tax on the dividends.
Nevertheless, imputation franking credits are clearly shown on dividend slips. Thus, they can be valuable to foreign shareholders if their home country gives credit for them.
Moreover, under imputation, full crediting is more achievable without an additional layer of tax in the form of DWT on franked dividends.
Aww, Max!
You two really have to sort your differences out!



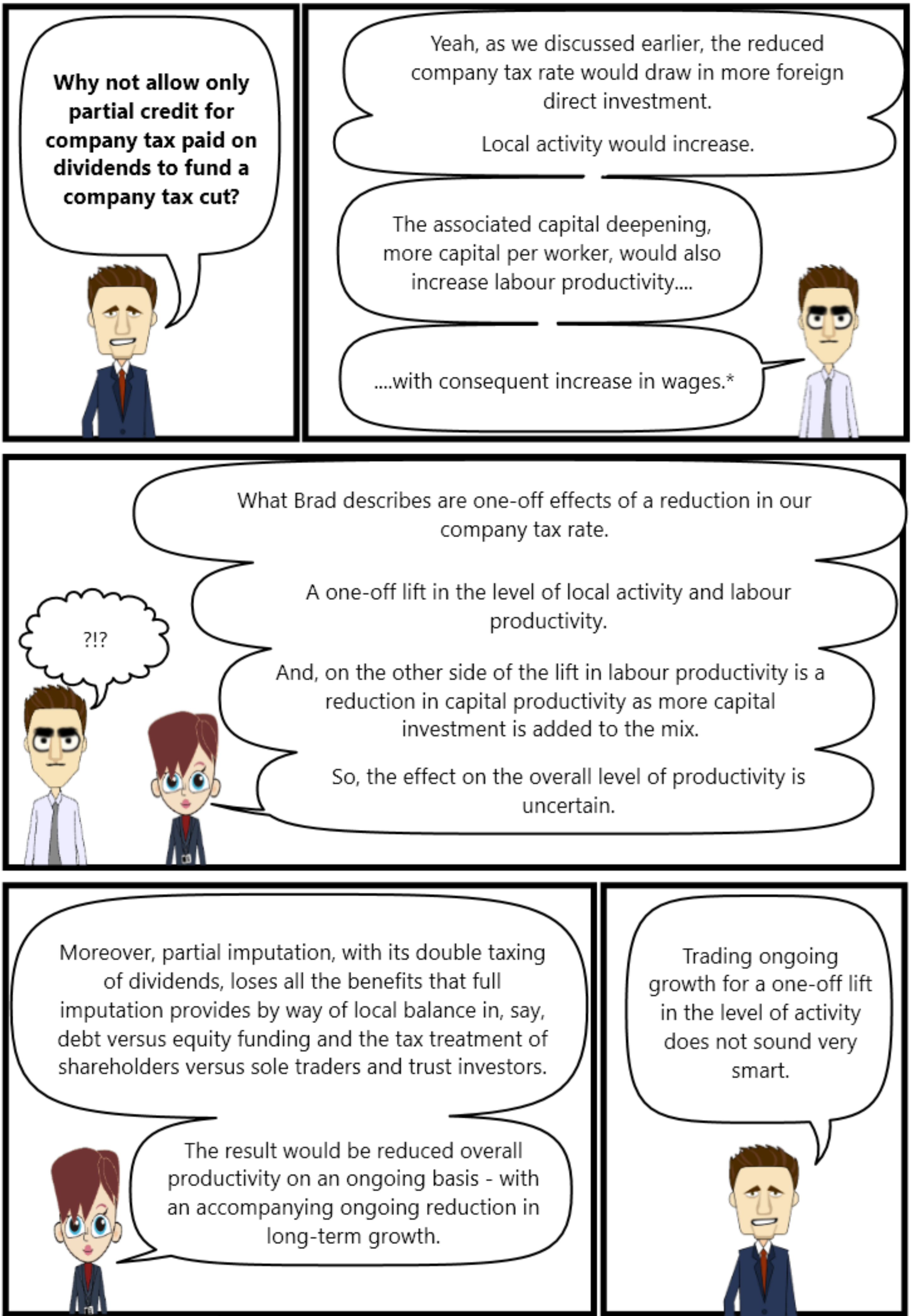
* Swan (1976), p 172.



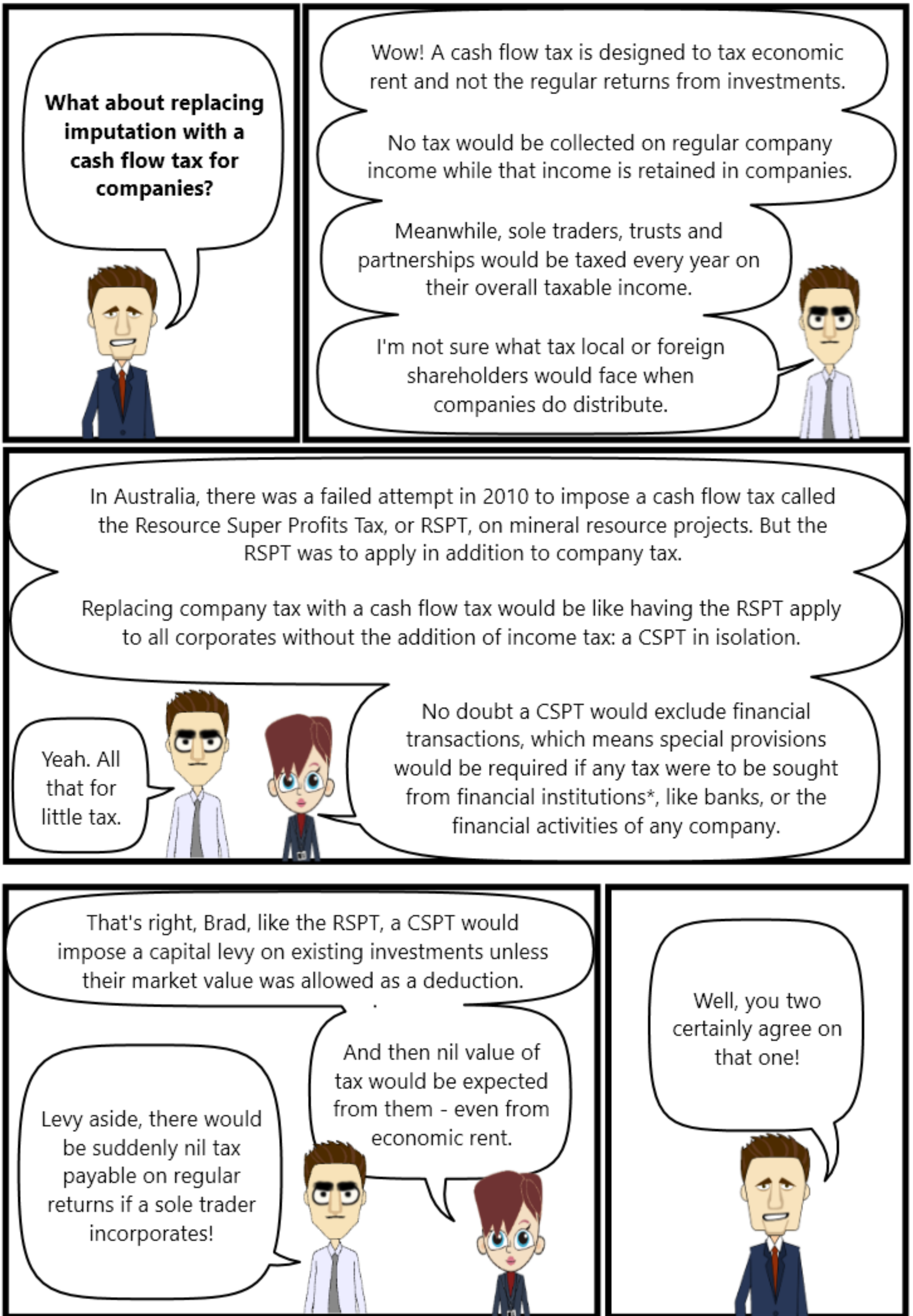
* Henry Review, pp 194-195.



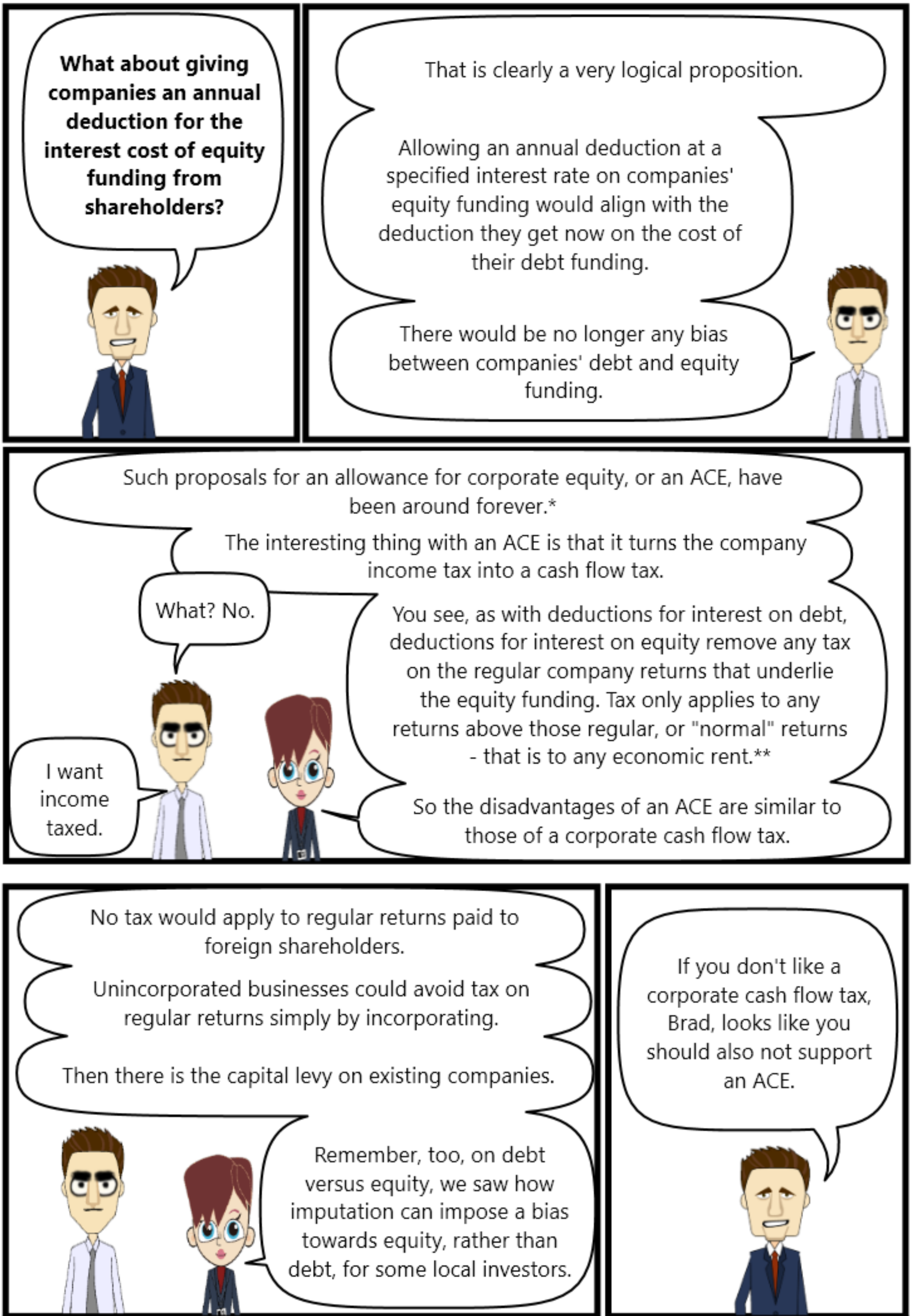
* Mayo (2011), pp 179-194.



* Henry Review, p 152, 199.



* Garnaut (2020), pp 471-472,

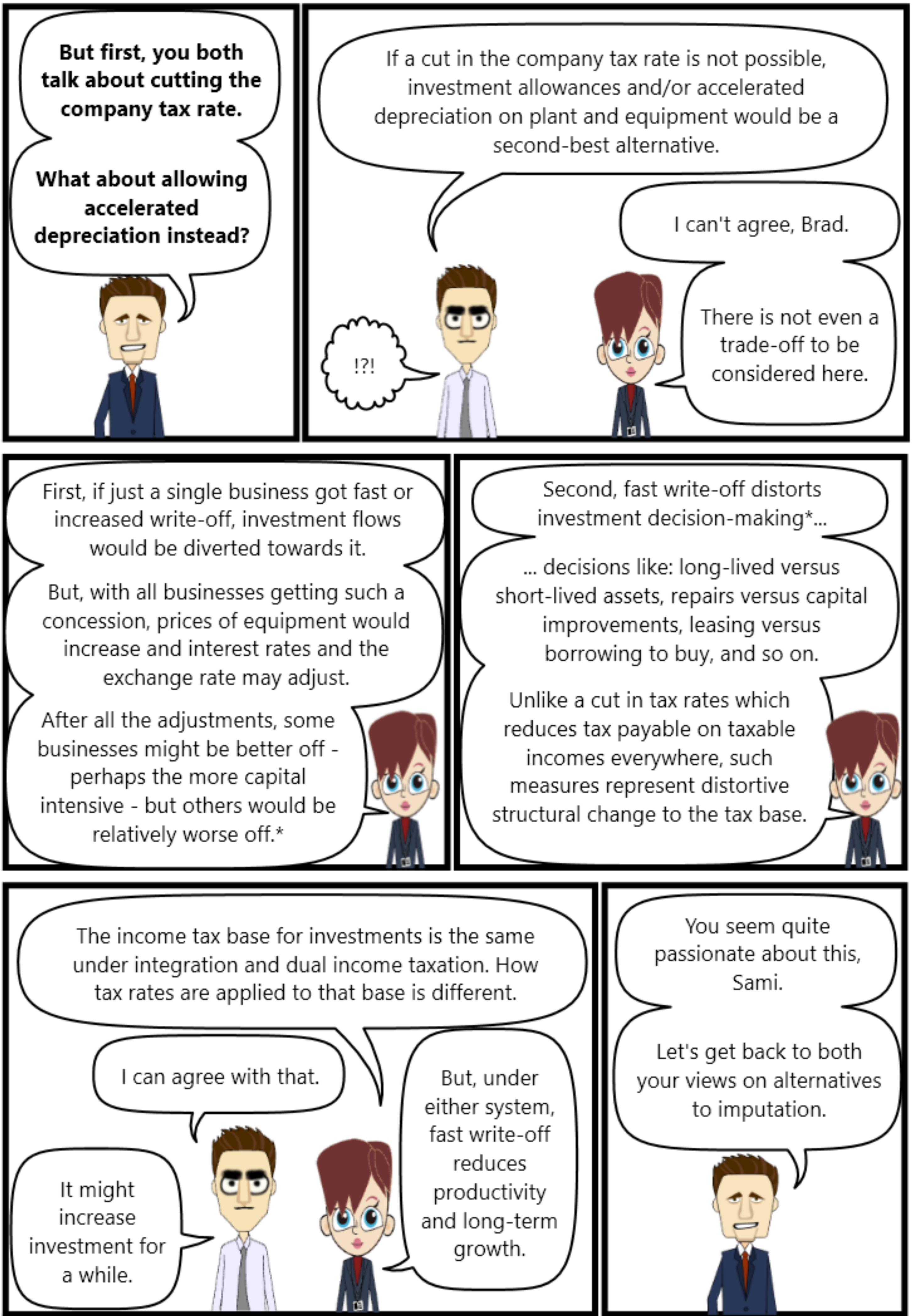


* See, for example, Henry Review, pp 164-165, p 199.

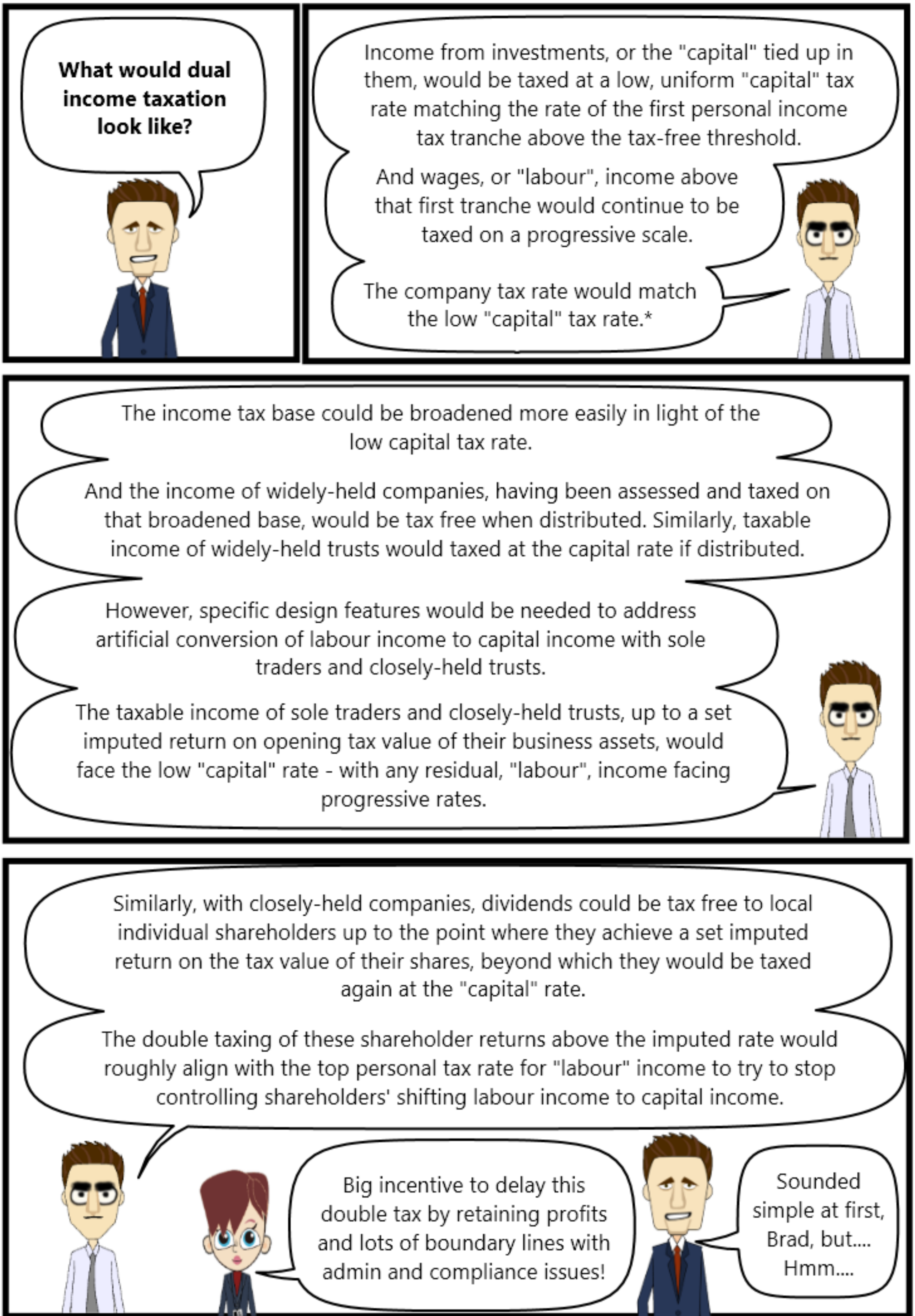
** Swan (1976), p 176.

* Henry Review, pp 71-72.

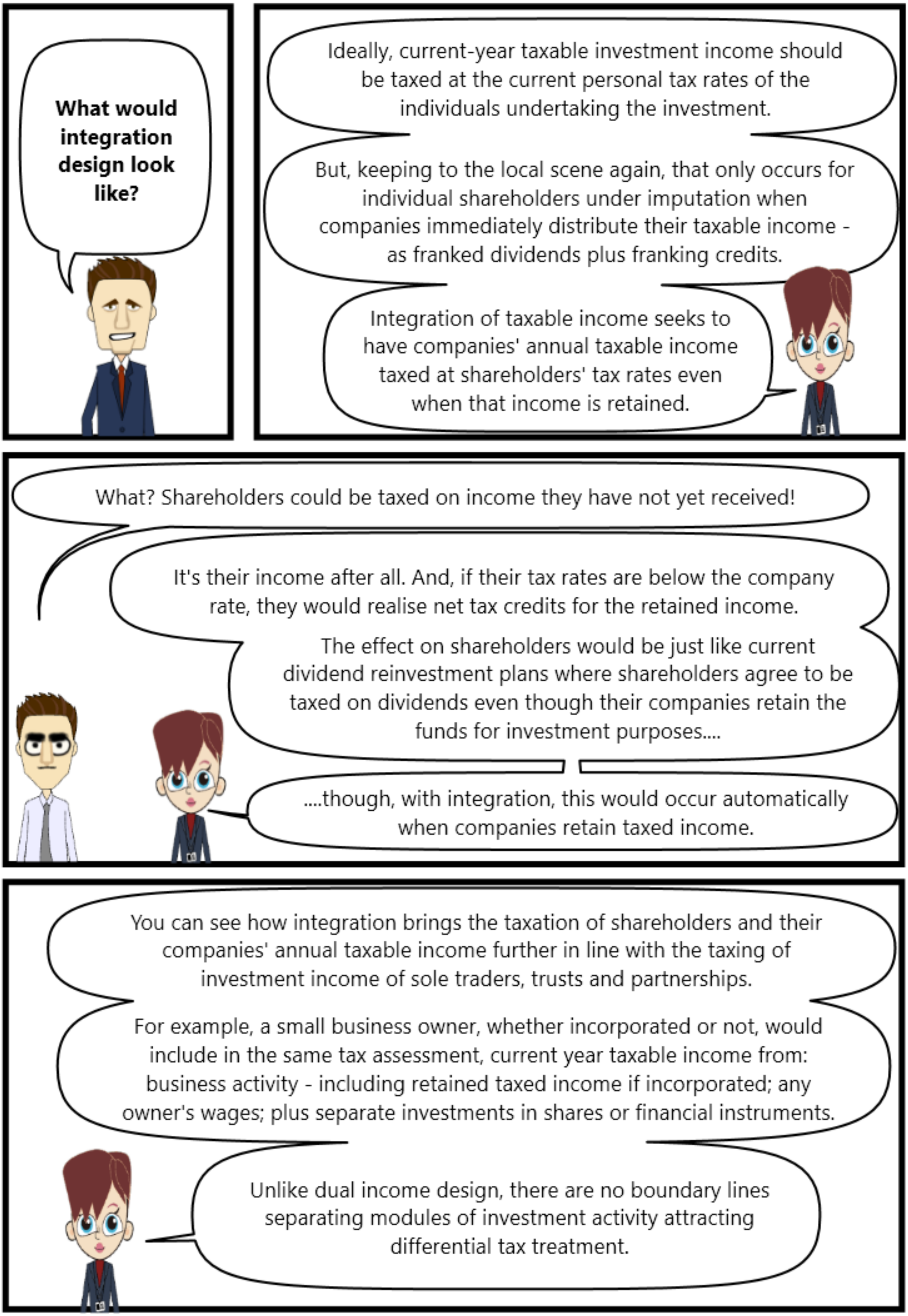
** Mayo (2011), pp 210-240.

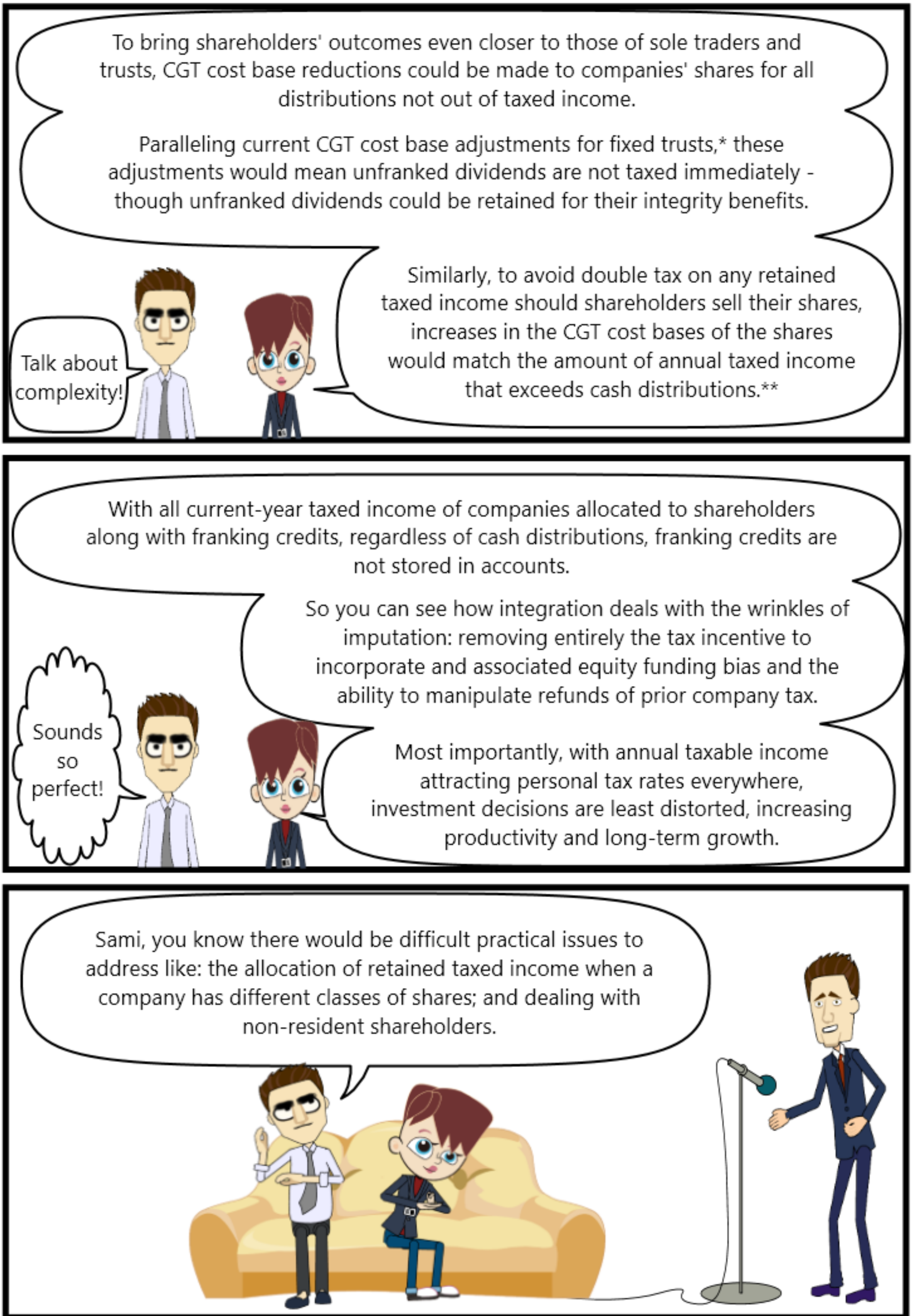


* Mayo (1984), pp 38-39, p 44.



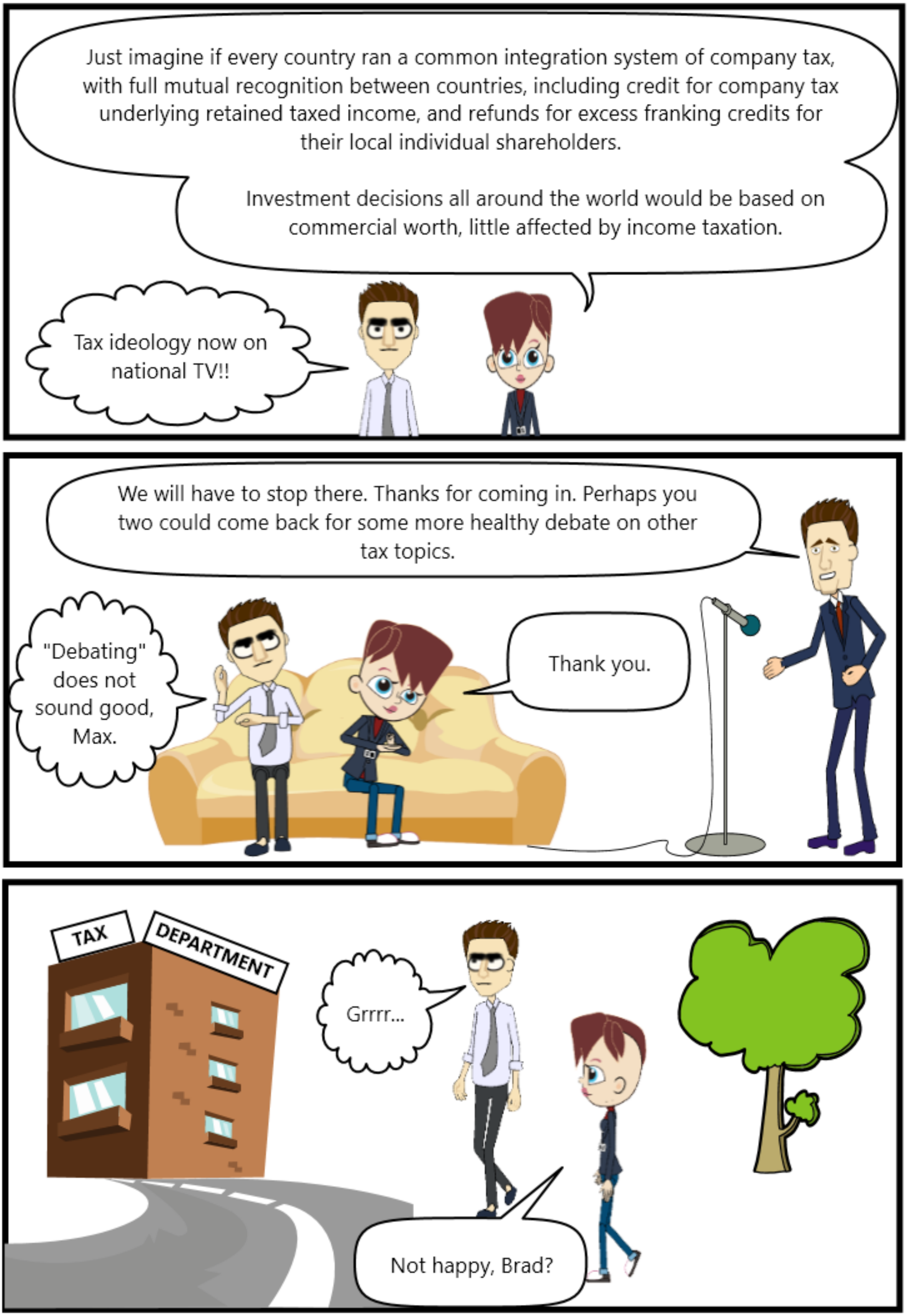
* See one design in TTPI (2020), pp 53-57.


What would integration design look like?
Ideally, current-year taxable investment income should be taxed at the current personal tax rates of the individuals undertaking the investment.
But, keeping to the local scene again, that only occurs for individual shareholders under imputation when companies immediately distribute their taxable income - as franked dividends plus franking credits.
Integration of taxable income seeks to have companies' annual taxable income taxed at shareholders' tax rates even when that income is retained.
What? Shareholders could be taxed on income they have not yet received!
It's their income after all. And, if their tax rates are below the company rate, they would realise net tax credits for the retained income.
The effect on shareholders would be just like current dividend reinvestment plans where shareholders agree to be taxed on dividends even though their companies retain the funds for investment purposes....
....though, with integration, this would occur automatically when companies retain taxed income.
You can see how integration brings the taxation of shareholders and their companies' annual taxable income further in line with the taxing of investment income of sole traders, trusts and partnerships.
For example, a small business owner, whether incorporated or not, would include in the same tax assessment, current year taxable income from: business activity - including retained taxed income if incorporated; any owner's wages; plus separate investments in shares or financial instruments.
Unlike dual income design, there are no boundary lines separating modules of investment activity attracting differential tax treatment.



* See Ch6, pp 7-9.

* See Ch6, pp 10-14.


Just imagine if every country ran a common integration system of company tax, with full mutual recognition between countries, including credit for company tax underlying retained taxed income, and refunds for excess franking credits for their local individual shareholders.
Investment decisions all around the world would be based on commercial worth, little affected by income taxation.
Tax ideology now on national TV!!
We will have to stop there. Thanks for coming in. Perhaps you two could come back for some more healthy debate on other tax topics.
"Debating" does not sound good, Max.
Thank you.
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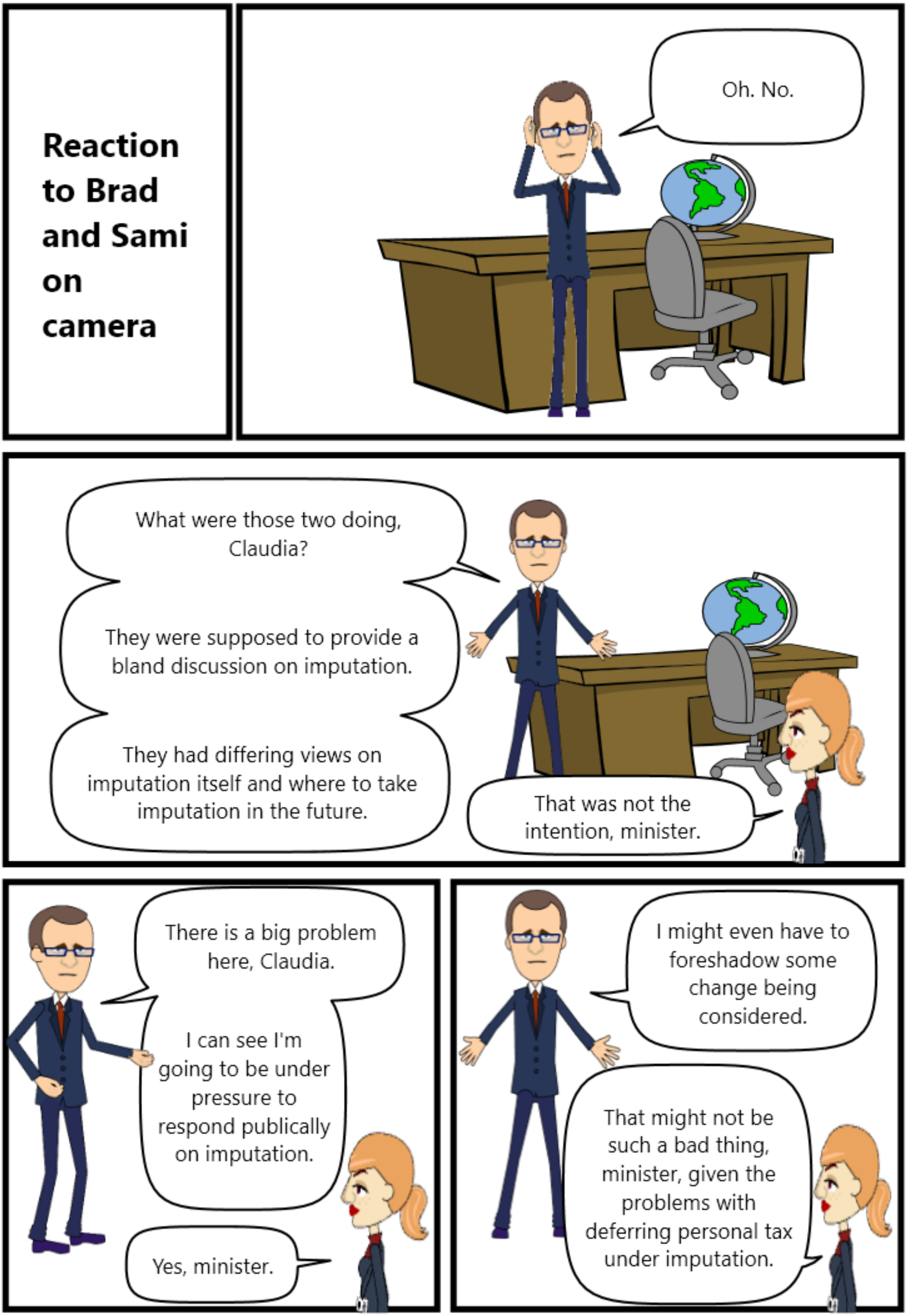
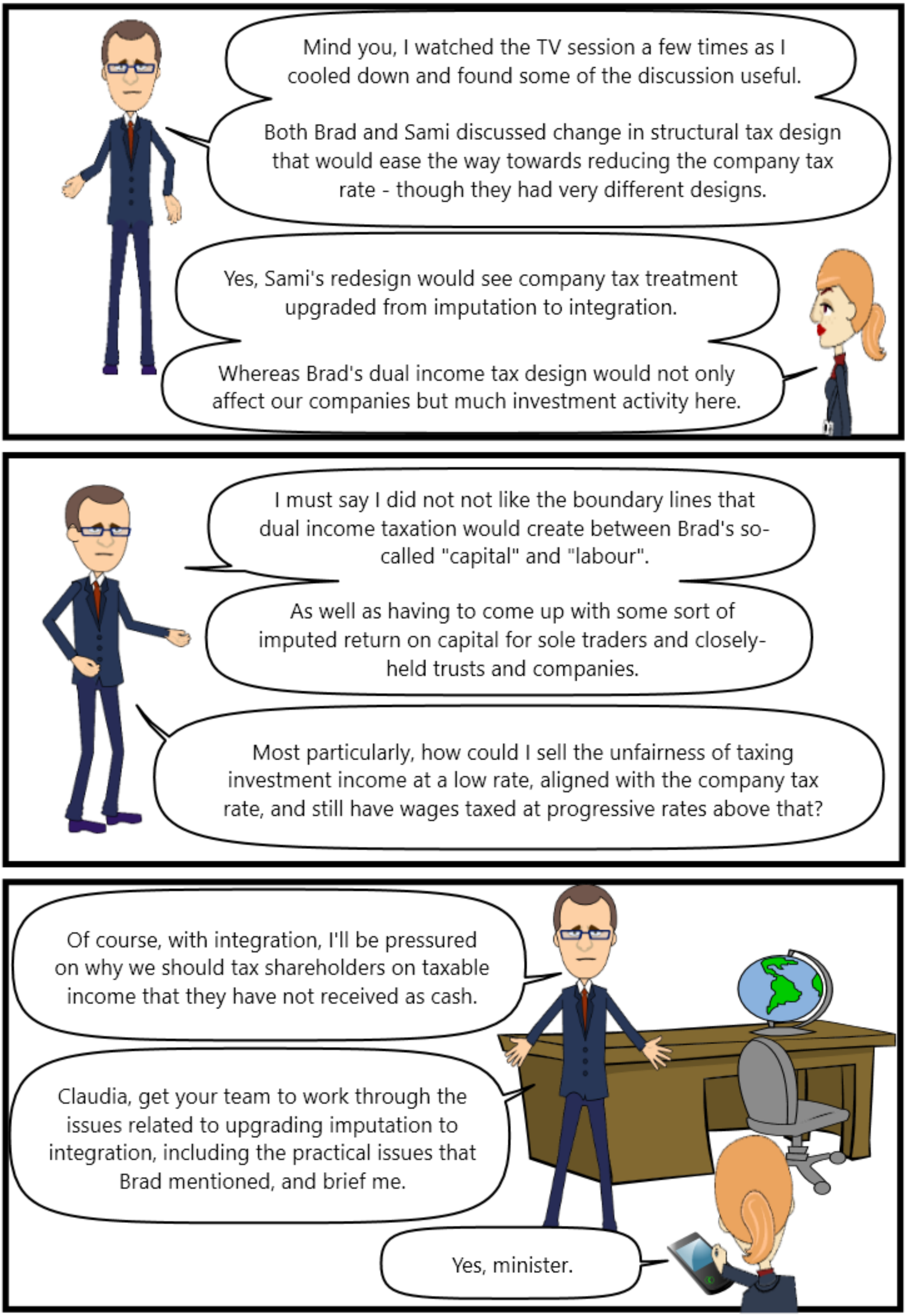
Grrrr...
Not happy, Brad?


Reaction to Brad and Sami on camera
Oh. No.
What were those two doing, Claudia?
They were supposed to provide a bland discussion on imputation.
They had differing views on imputation itself and where to take imputation in the future.
That was not the intention, minister.
There is a big problem here, Claudia.
I can see I'm going to be under pressure to respond publically on imputation.
Yes, minister.
I might even have to foreshadow some change being considered.
That might not be such a bad thing, minister, given the problems with deferring personal tax under imputation.


Mind you, I watched the TV session a few times as I cooled down and found some of the discussion useful.
Both Brad and Sami discussed change in structural tax design that would ease the way towards reducing the company tax rate - though they had very different designs.
Yes, Sami's redesign would see company tax treatment upgraded from imputation to integration.
Whereas Brad's dual income tax design would not only affect our companies but much investment activity here.
I must say I did not not like the boundary lines that dual income taxation would create between Brad's so-called "capital" and "labour".
As well as having to come up with some sort of imputed return on capital for sole traders and closely-held trusts and companies.
Most particularly, how could I sell the unfairness of taxing investment income at a low rate, aligned with the company tax rate, and still have wages taxed at progressive rates above that?
Of course, with integration, I'll be pressured on why we should tax shareholders on taxable income that they have not received as cash.
Claudia, get your team to work through the issues related to upgrading imputation to integration, including the practical issues that Brad mentioned, and brief me.
Yes, minister.