BRAD

Chapter 3

UPGRADING IMPUTATION TO INTEGRATION OF TAXABLE INCOME

BRAD

Chapter 3: upgrading Brad's country's full imputation system to integration of taxable income

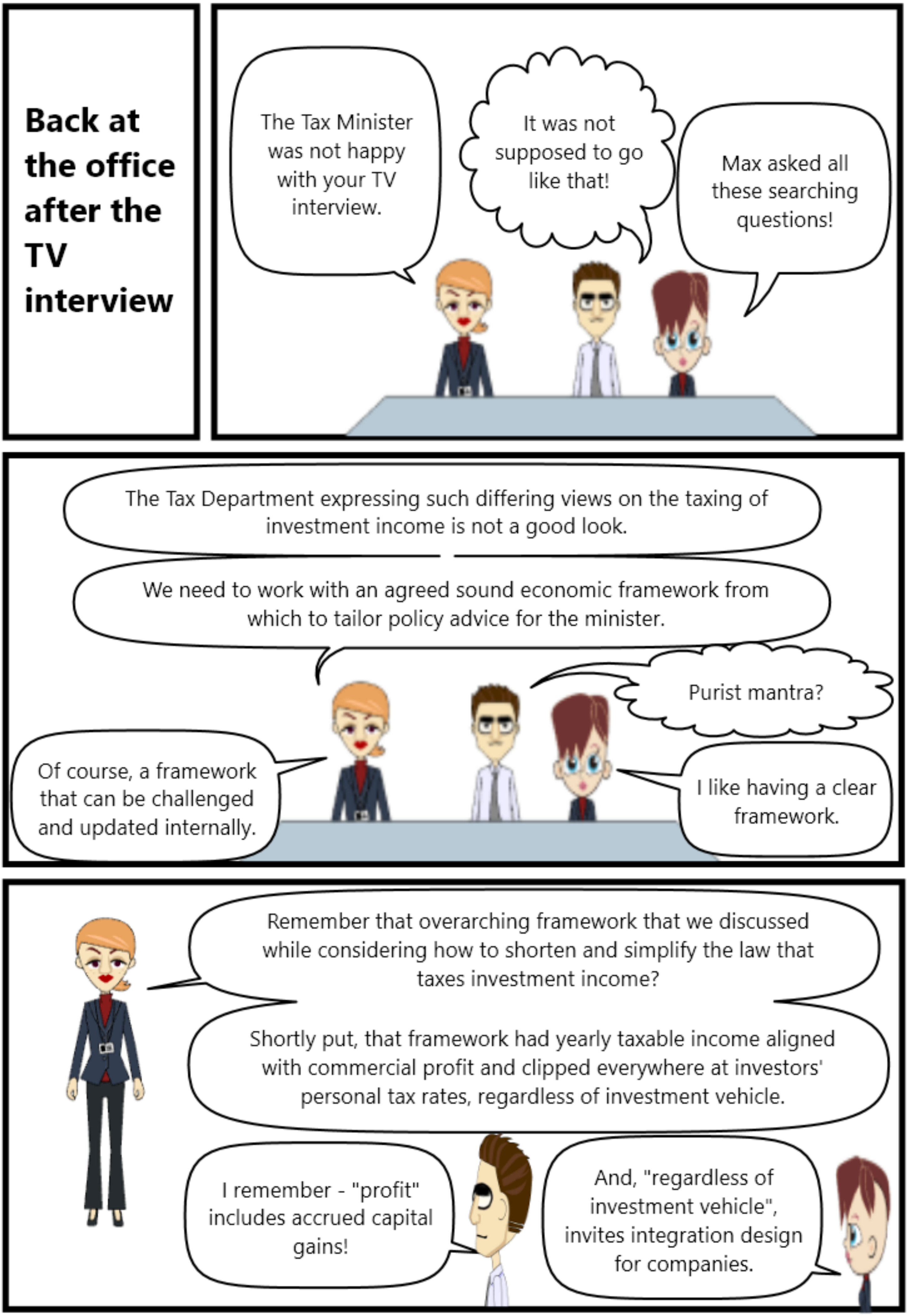
Excitement and funny business continues on with Brad and the rest of the Tax Department's intrepid tax policy team, Claudia and Sami.

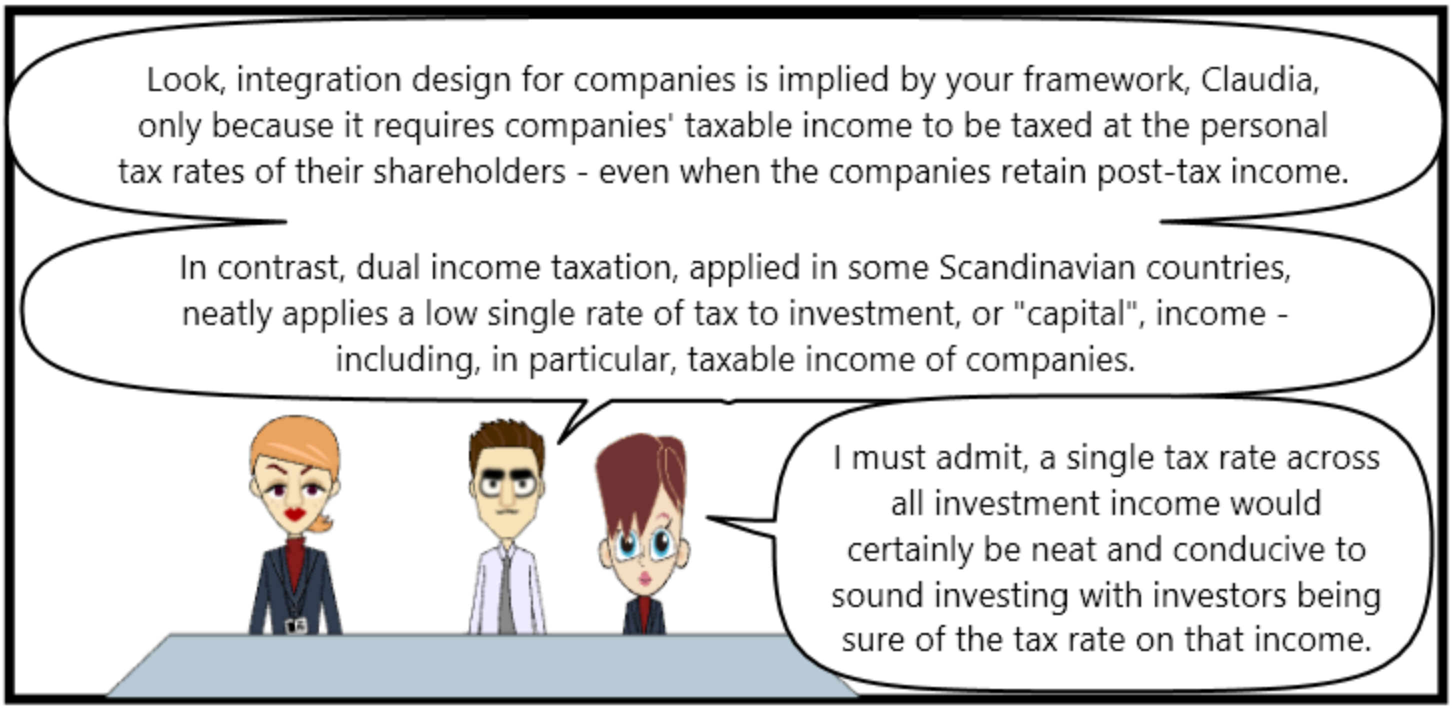
After the heat settles down from the TV interview on imputation in Chapter 2, at the Tax Minister's request, the team sets about working on a briefing for the minister on Sami's suggestion in the interview to upgrade imputation to integration.

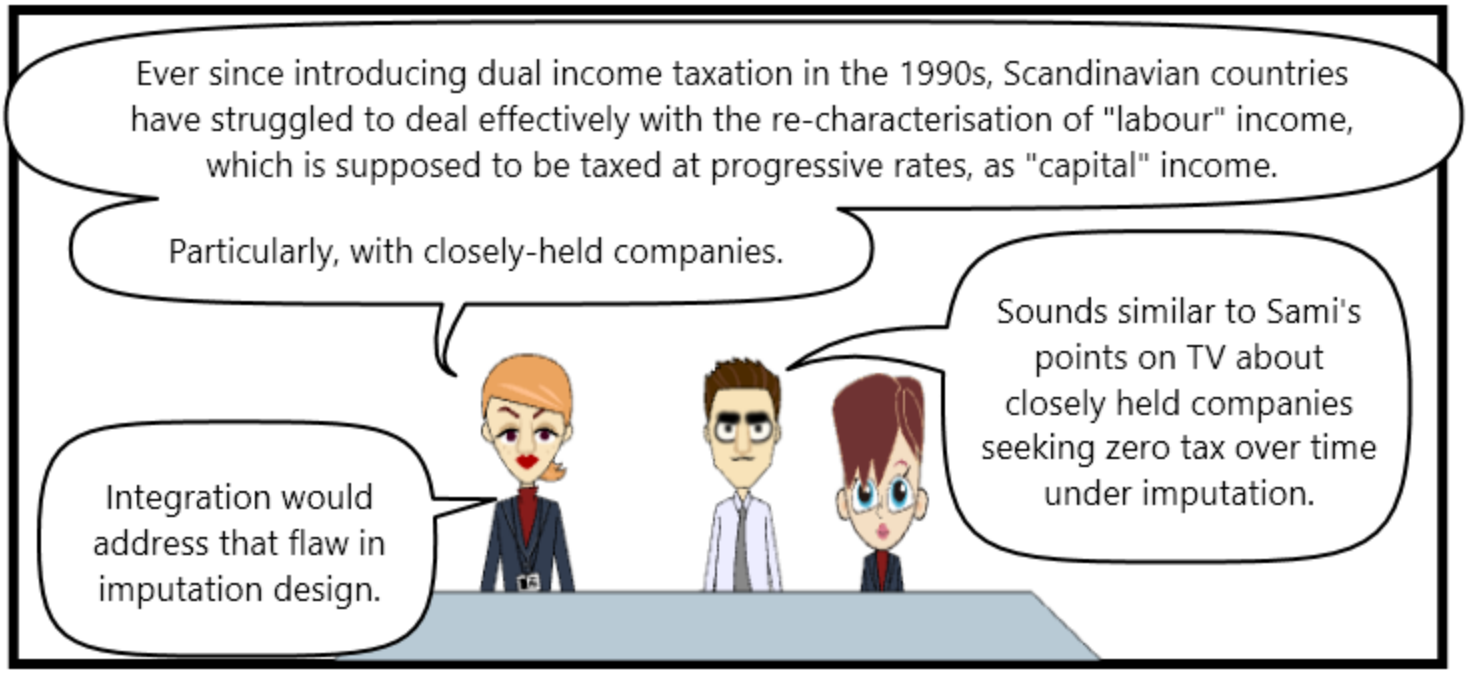
Integration is a design that tax purists say is the ideal interface between companies and their shareholders. The Carter Commission (see Preface) concluded that "full integration ... is without doubt the best system" (p 6). The Asprey review referred to integration as "perhaps the theoretical ideal" (p 228). The Campbell Committee recommended it. The government Draft White Paper initiating the full imputation system in Australia saw imputation as "an appropriate basis for extension to a full integration system were the practical difficulties of that system eventually adequately resolved" (p 199).

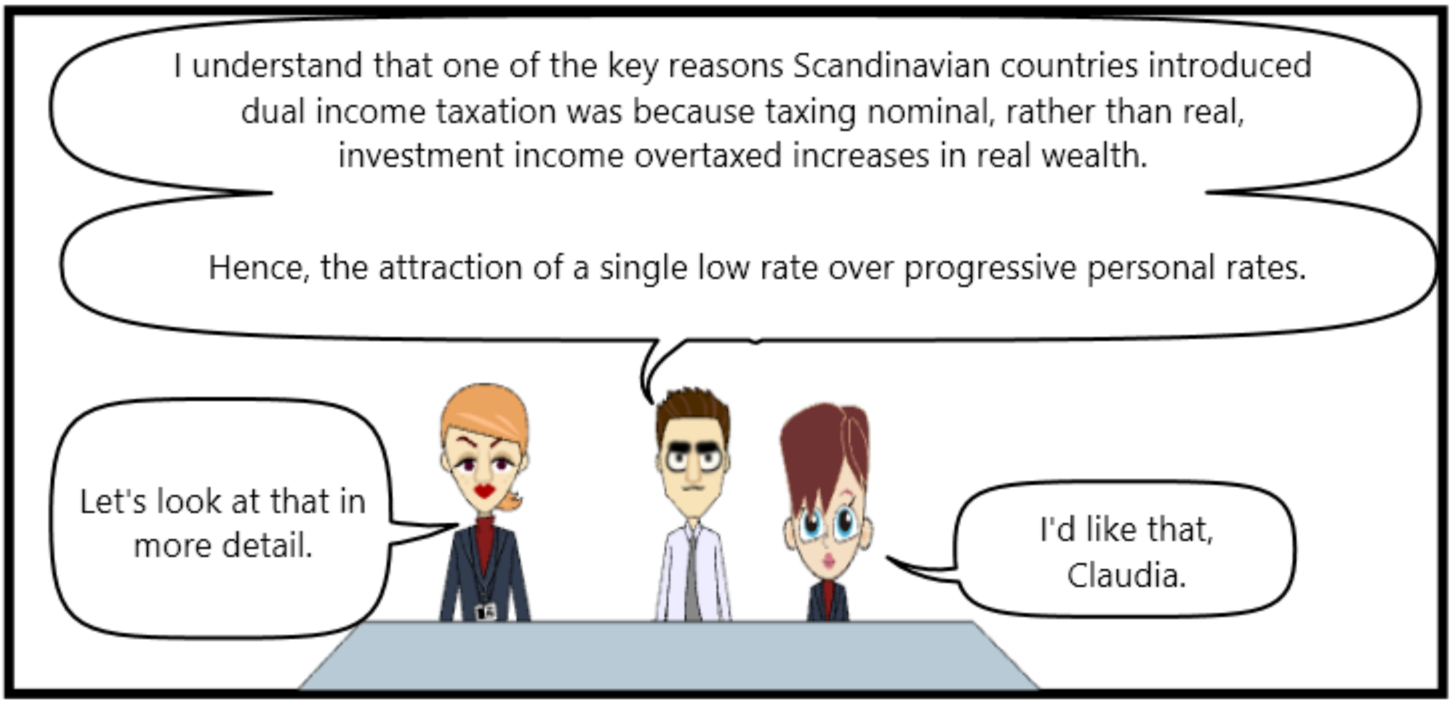
Brad sees those practical problems as insurmountable. Claudia, however, believes integration is practicable.

If you are so moved by the tax policy team's fun on the topic of integration that you want more information, discussion and lots of related references have a look at a Mayo (2018). Worked examples are in his so called "book of numbers" (Mayo, 2011). Other papers by him - Mayo (1984) - and by Swan (1978) are relevant to Brad's claims that dual income taxation, instead of integration, would be better because of the effects of inflation in a tax system that taxes nominal, rather than real, investment income.


Back at the office after the TV interview
The Tax Minister was not happy with your TV interview.
It was not supposed to go like that!
Max asked all these searching questions!
The Tax Department expressing such differing views on the taxing of investment income is not a good look.
We need to work with an agreed sound economic framework from which to tailor policy advice for the minister.
Purist mantra?
Of course, a framework that can be challenged and updated internally.
I like having a clear framework.
Remember that overarching framework that we discussed while considering how to shorten and simplify the law that taxes investment income?
Shortly put, that framework had yearly taxable income aligned with commercial profit and clipped everywhere at investors' personal tax rates, regardless of investment vehicle.
I remember - "profit" includes accrued capital gains!
And, "regardless of investment vehicle", invites integration design for companies.


Look, integration design for companies is implied by your framework, Claudia, only because it requires companies' taxable income to be taxed at the personal tax rates of their shareholders - even when the companies retain post-tax income.
In contrast, dual income taxation, applied in some Scandinavian countries, neatly applies a low single rate of tax to investment, or "capital", income - including, in particular, taxable income of companies.
I must admit, a single tax rate across all investment income would certainly be neat and conducive to sound investing with investors being sure of the tax rate on that income.

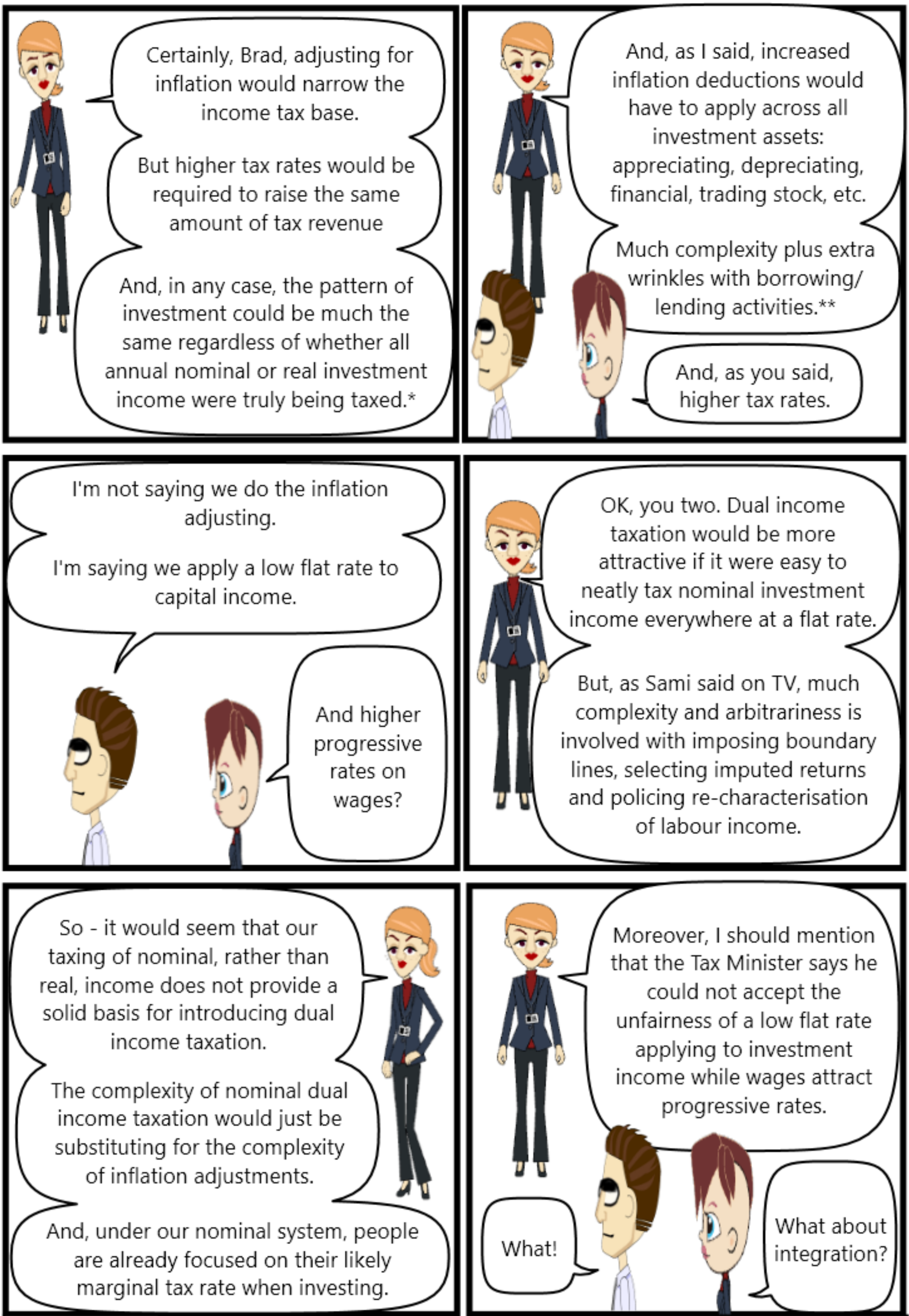

Ever since introducing dual income taxation in the 1990s, Scandinavian countries have struggled to deal effectively with the re-characterisation of "labour" income, which is supposed to be taxed at progressive rates, as "capital" income.
Particularly, with closely-held companies.
Sounds similar to Sami's points on TV about closely held companies seeking zero tax over time under imputation.
Integration would address that flaw in imputation design.


I understand that one of the key reasons Scandinavian countries introduced dual income taxation was because taxing nominal, rather than real, investment income overtaxed increases in real wealth.
Hence, the attraction of a single low rate over progressive personal rates.
Let's look at that in more detail.
I'd like that, Claudia.

* Ch4, p 10, Mayo (1984), pp 34-37.

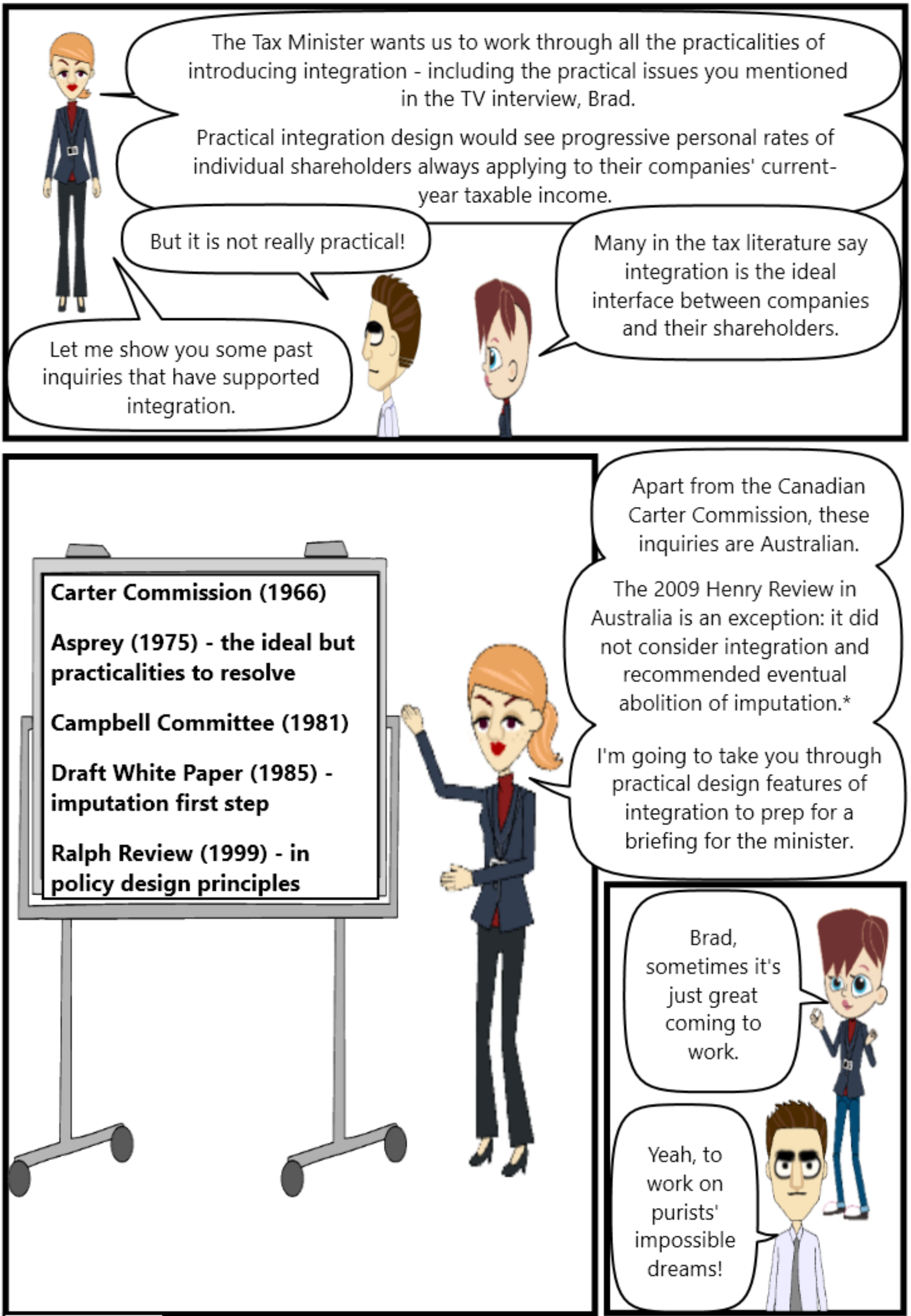
** Swan (1978), p4. Mayo (1984), pp 39-42.

*** Draft White Paper (1985), Ch 18.

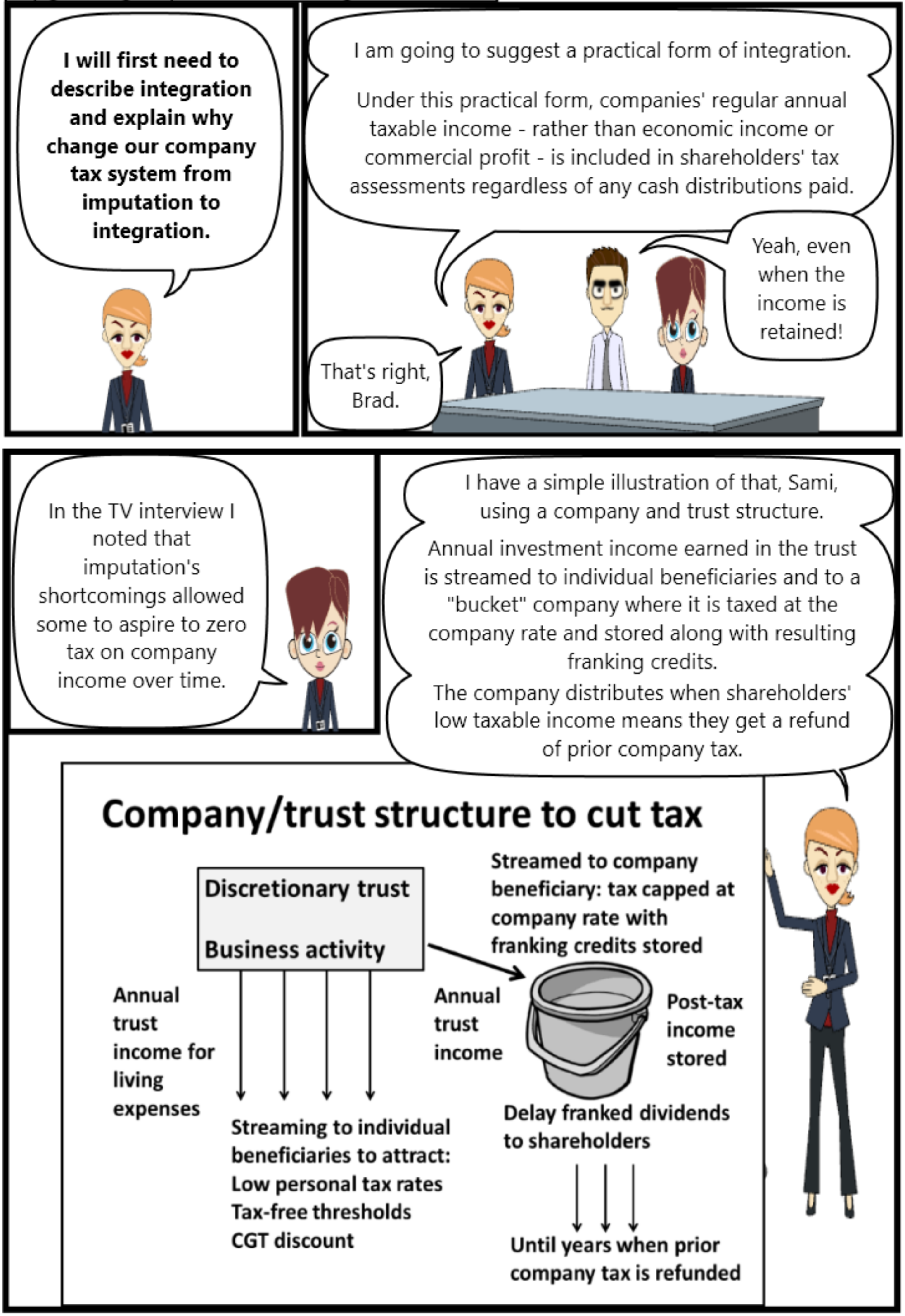


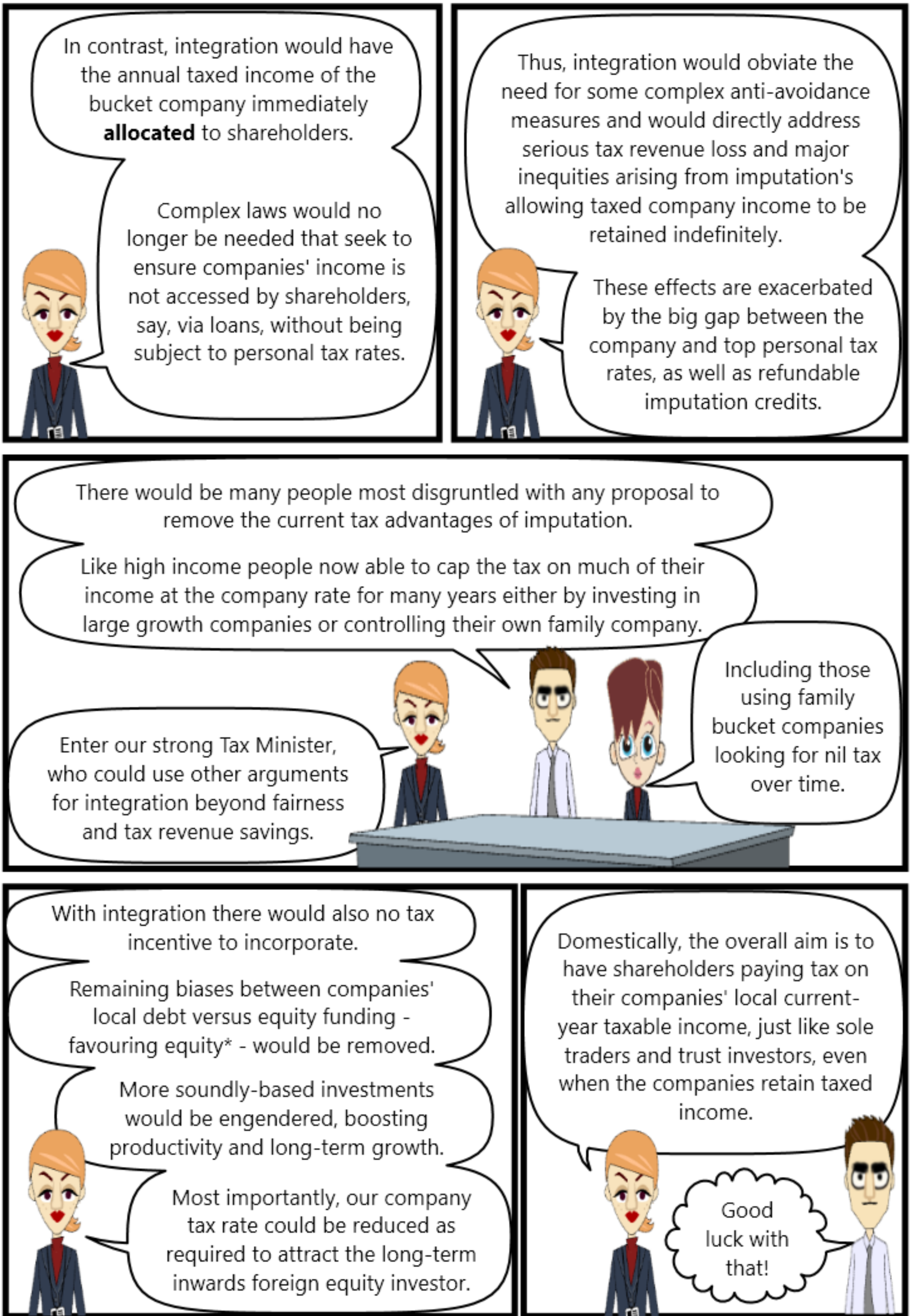
* Mayo (1984), p 30.

** Draft White Paper (1985), pp 211-214.



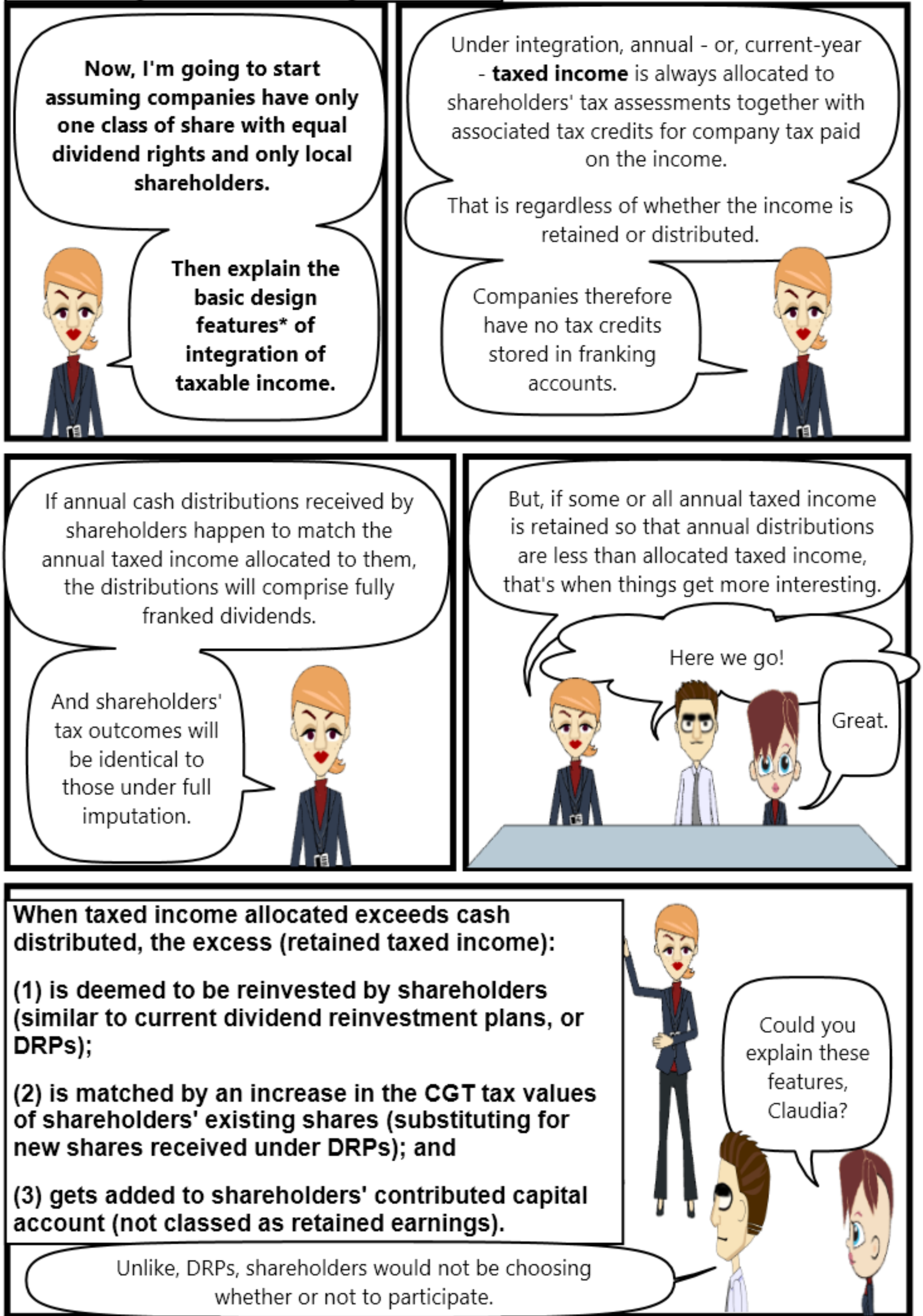
* See Ch2, p 2, p 27.


I will first need to describe integration and explain why change our company tax system from imputation to integration.
I am going to suggest a practical form of integration.
Under this practical form, companies' regular annual taxable income - rather than economic income or commercial profit - is included in shareholders' tax assessments regardless of any cash distributions paid.
Yeah, even when the income is retained!
That's right, Brad.
In the TV interview I noted that imputation's shortcomings allowed some to aspire to zero tax on company income over time.
I have a simple illustration of that, Sami, using a company and trust structure.
Annual investment income earned in the trust is streamed to individual beneficiaries and to a "bucket" company where it is taxed at the company rate and stored along with resulting franking credits.
The company distributes when shareholders' low taxable income means they get a refund of prior company tax.
Company/trust structure to cut tax
Discretionary trust
Business activity
Streamed to company beneficiary: tax capped at company rate with franking credits stored
Annual trust income for living expenses
Annual trust income
Post-tax income stored
Streaming to individual beneficiaries to attract:
Low personal tax rates
Tax-free thresholds
CGT discount
Delay franked dividends to shareholders
Until years when prior company tax is refunded



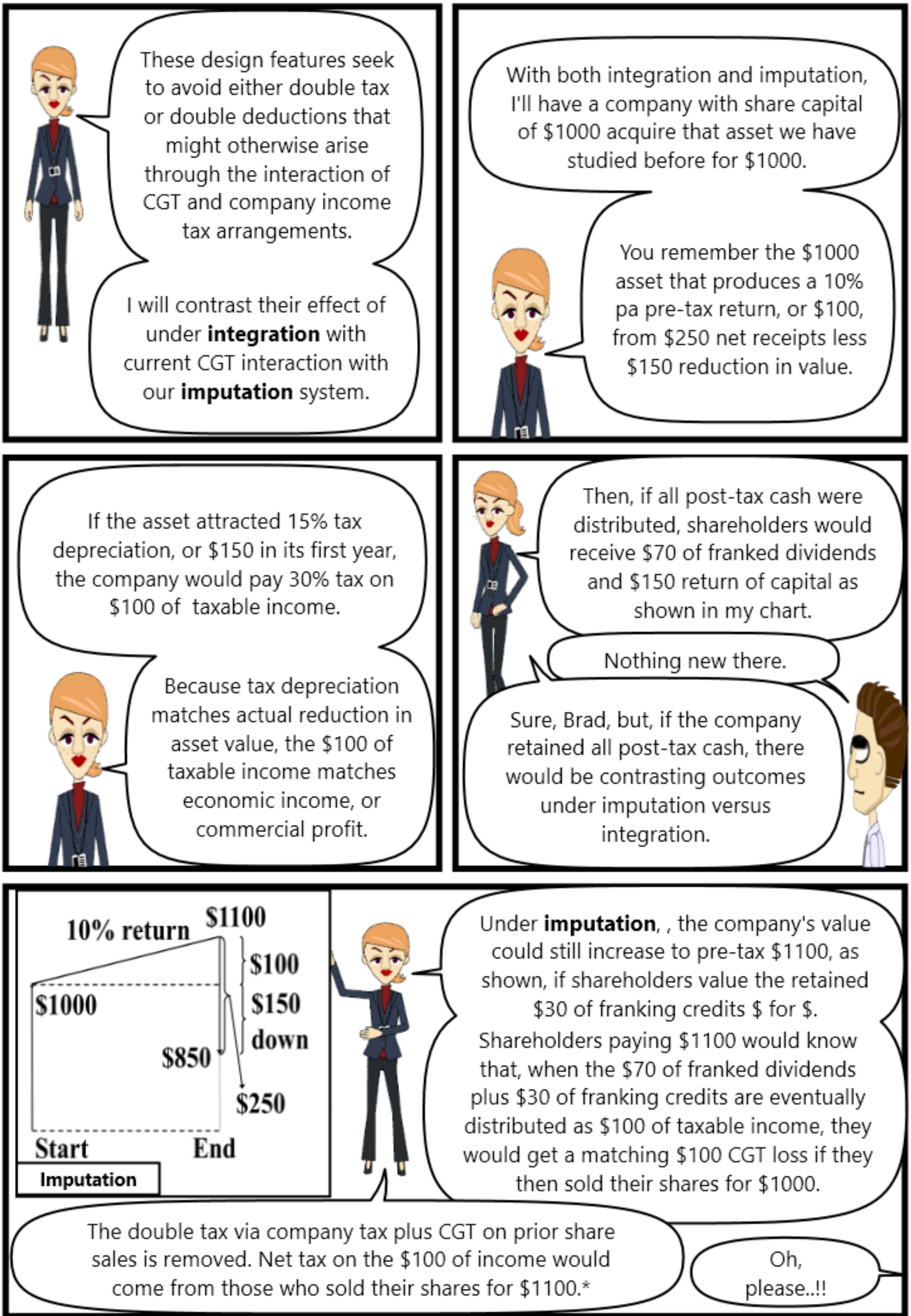
* See Ch2, pp 12-13.

Basic design features of integration........

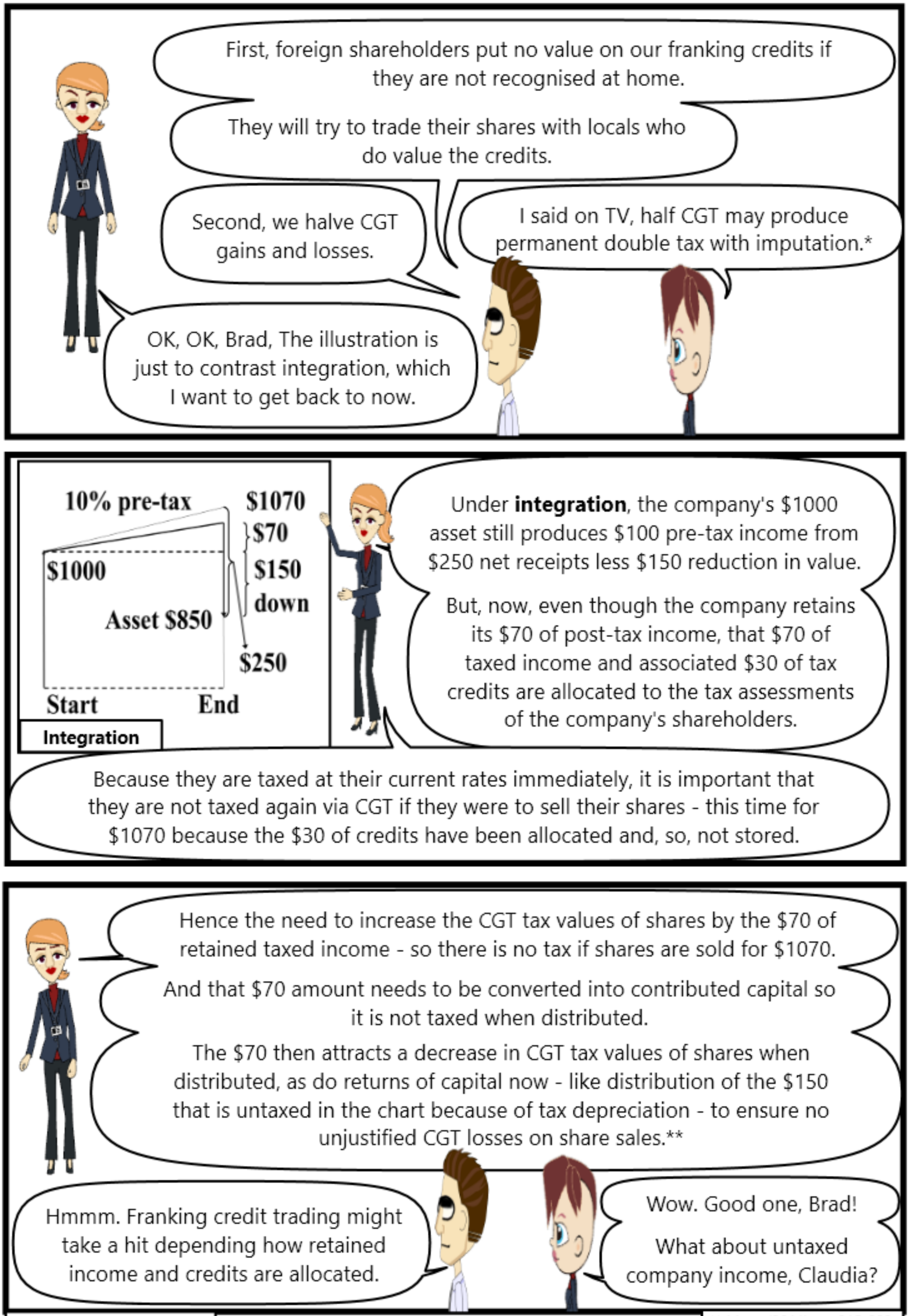


* Mayo (2018), pp 766-772.

* Extra numerical illustrations in Mayo (2011), pp 215-229.

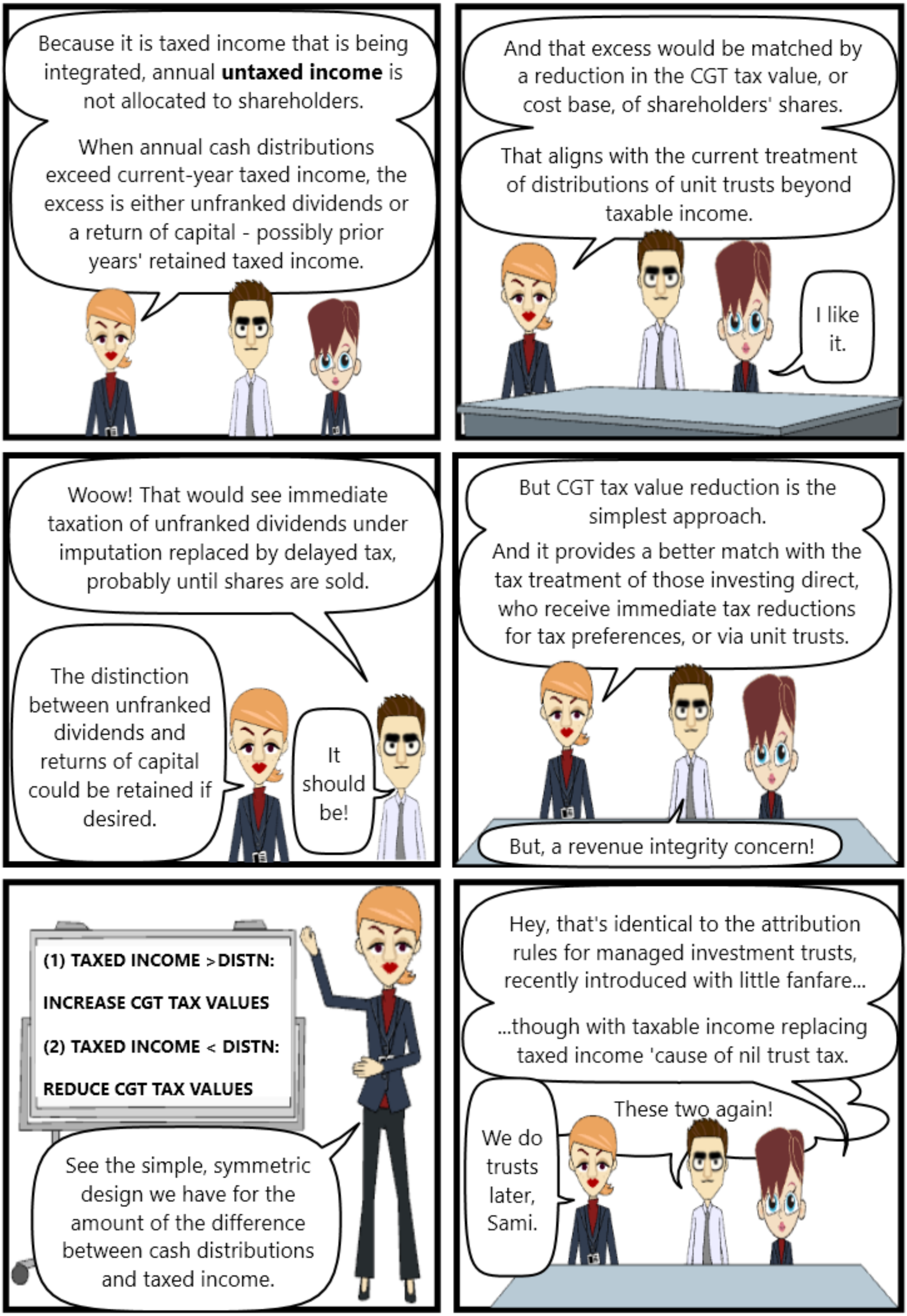


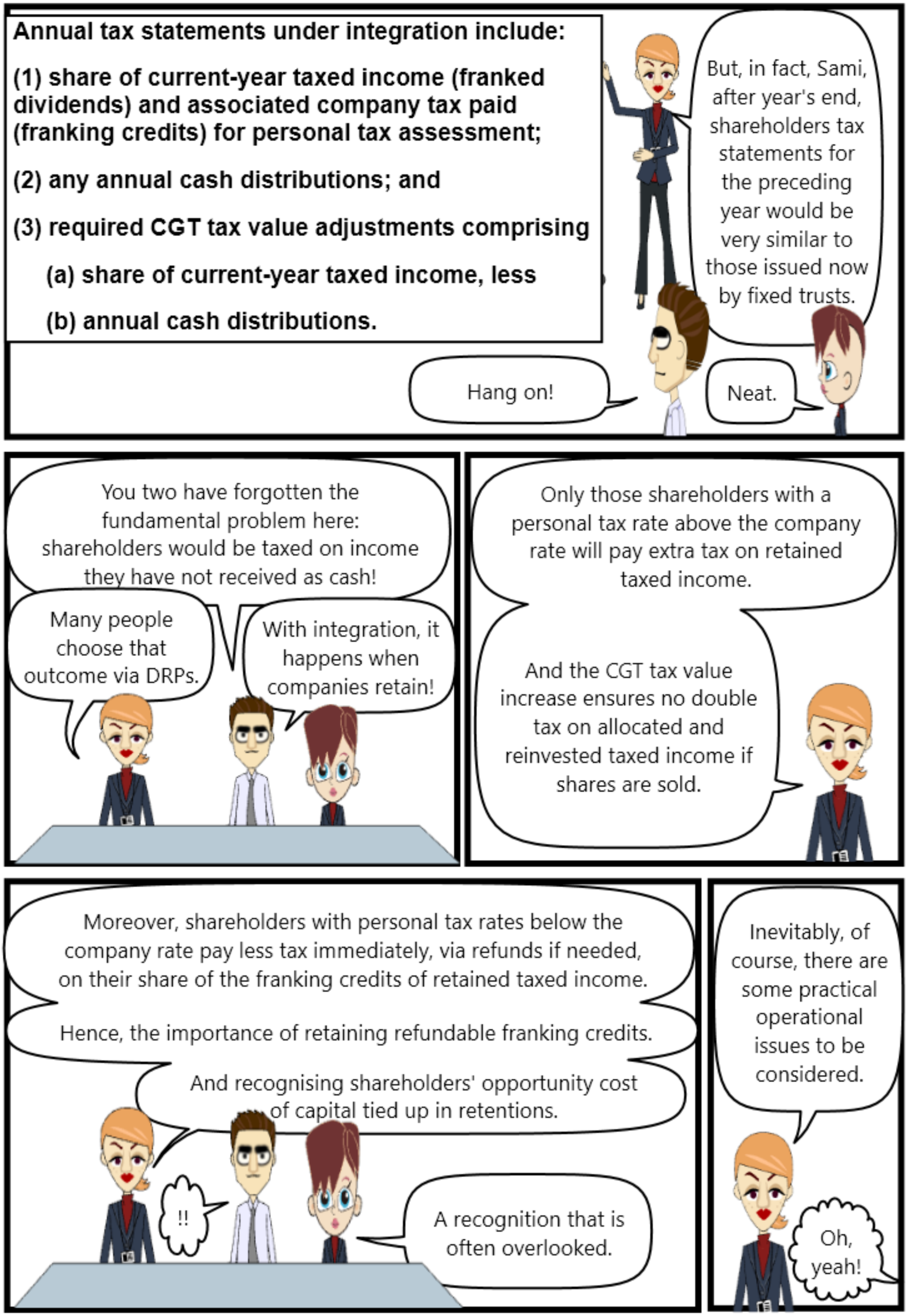
* Mayo (2011), pp177-181.



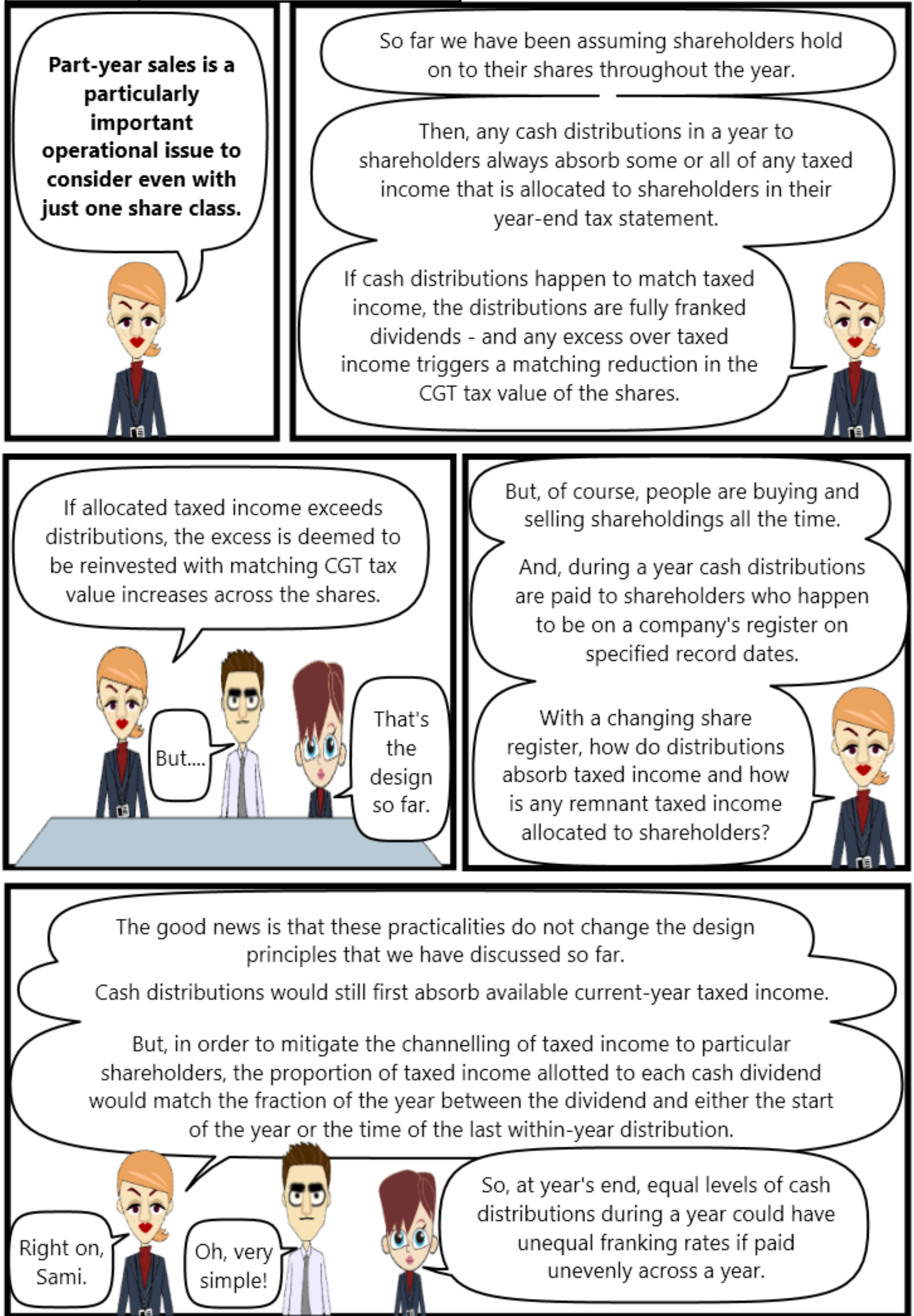
* Mayo (2011), pp186-187.

** Mayo (2011), pp 215-223.

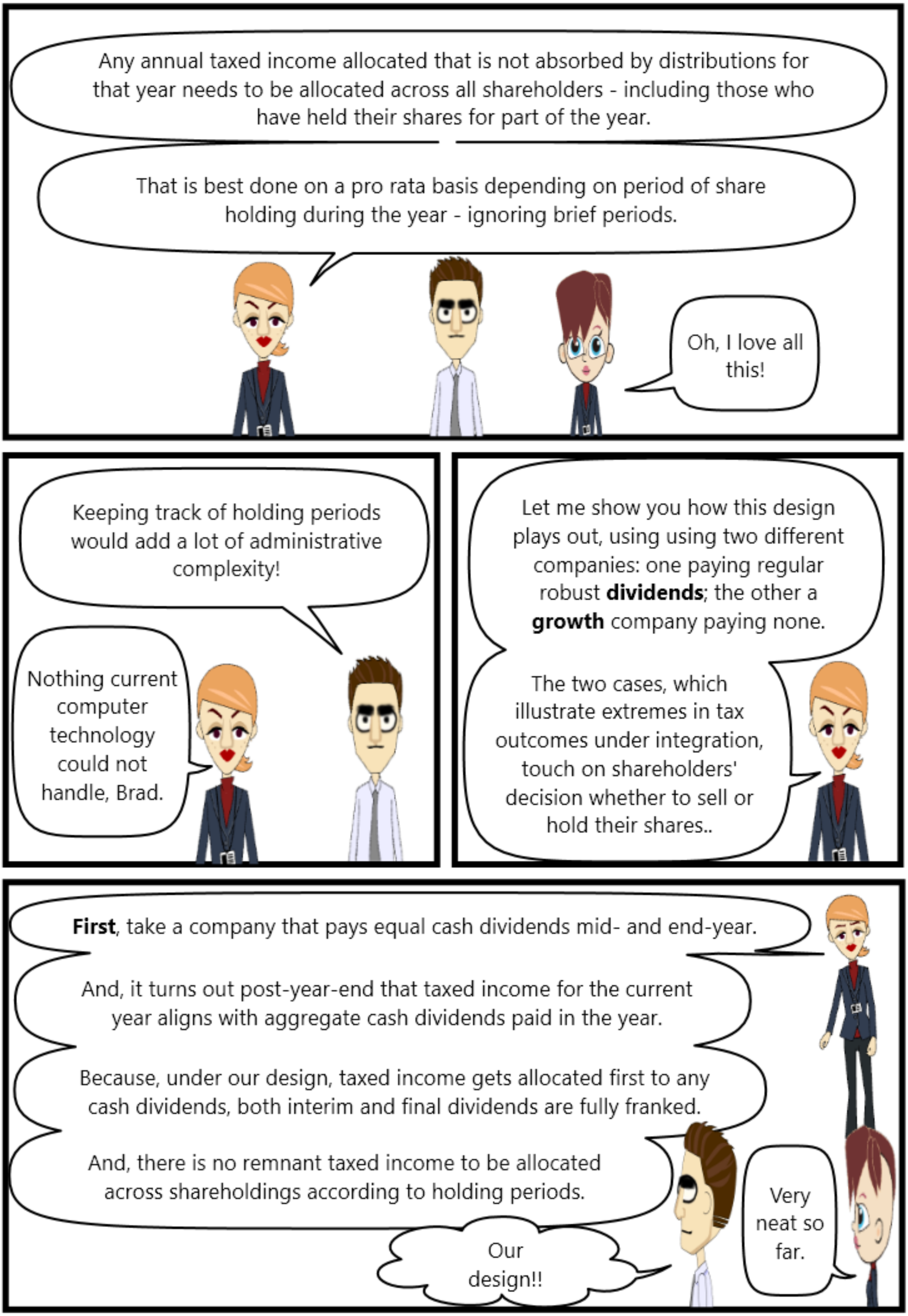

Because it is taxed income that is being integrated, annual **untaxed income** is not allocated to shareholders.
When annual cash distributions exceed current-year taxed income, the excess is either unfranked dividends or a return of capital - possibly prior years' retained taxed income.
And that excess would be matched by a reduction in the CGT tax value, or cost base, of shareholders' shares.
That aligns with the current treatment of distributions of unit trusts beyond taxable income.
I like it.
Woow! That would see immediate taxation of unfranked dividends under imputation replaced by delayed tax, probably until shares are sold.
The distinction between unfranked dividends and returns of capital could be retained if desired.
It should be!
But CGT tax value reduction is the simplest approach.
And it provides a better match with the tax treatment of those investing direct, who receive immediate tax reductions for tax preferences, or via unit trusts.
But, a revenue integrity concern!
(1) TAXED INCOME >DISTN:
INCREASE CGT TAX VALUES
(2) TAXED INCOME < DISTN:
REDUCE CGT TAX VALUES
See the simple, symmetric design we have for the amount of the difference between cash distributions and taxed income.
Hey, that's identical to the attribution rules for managed investment trusts, recently introduced with little fanfare...
...though with taxable income replacing taxed income 'cause of nil trust tax.
These two again!
We do trusts later, Sami.

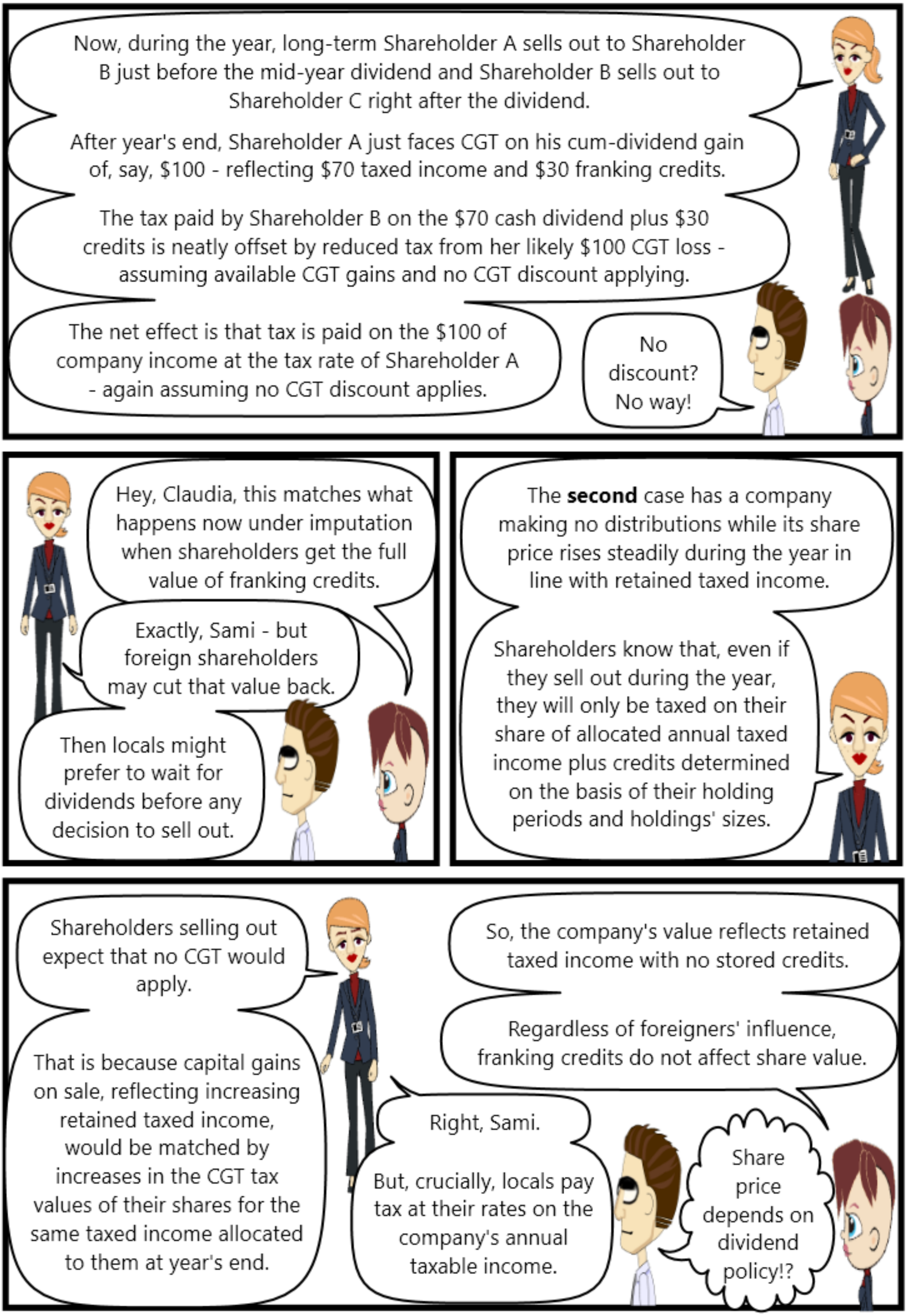

Annual tax statements under integration include:
(1) share of current-year taxed income (franked dividends) and associated company tax paid (franking credits) for personal tax assessment;
(2) any annual cash distributions; and
(3) required CGT tax value adjustments comprising
(a) share of current-year taxed income, less
(b) annual cash distributions.
But, in fact, Sami, after year's end, shareholders tax statements for the preceding year would be very similar to those issued now by fixed trusts.
Hang on!
Neat.
You two have forgotten the fundamental problem here: shareholders would be taxed on income they have not received as cash!
Many people choose that outcome via DRPs.
With integration, it happens when companies retain!
Only those shareholders with a personal tax rate above the company rate will pay extra tax on retained taxed income.
And the CGT tax value increase ensures no double tax on allocated and reinvested taxed income if shares are sold.
Moreover, shareholders with personal tax rates below the company rate pay less tax immediately, via refunds if needed, on their share of the franking credits of retained taxed income.
Hence, the importance of retaining refundable franking credits.
And recognising shareholders' opportunity cost of capital tied up in retentions.
!!
A recognition that is often overlooked.
Inevitably, of course, there are some practical operational issues to be considered.
Oh, yeah!

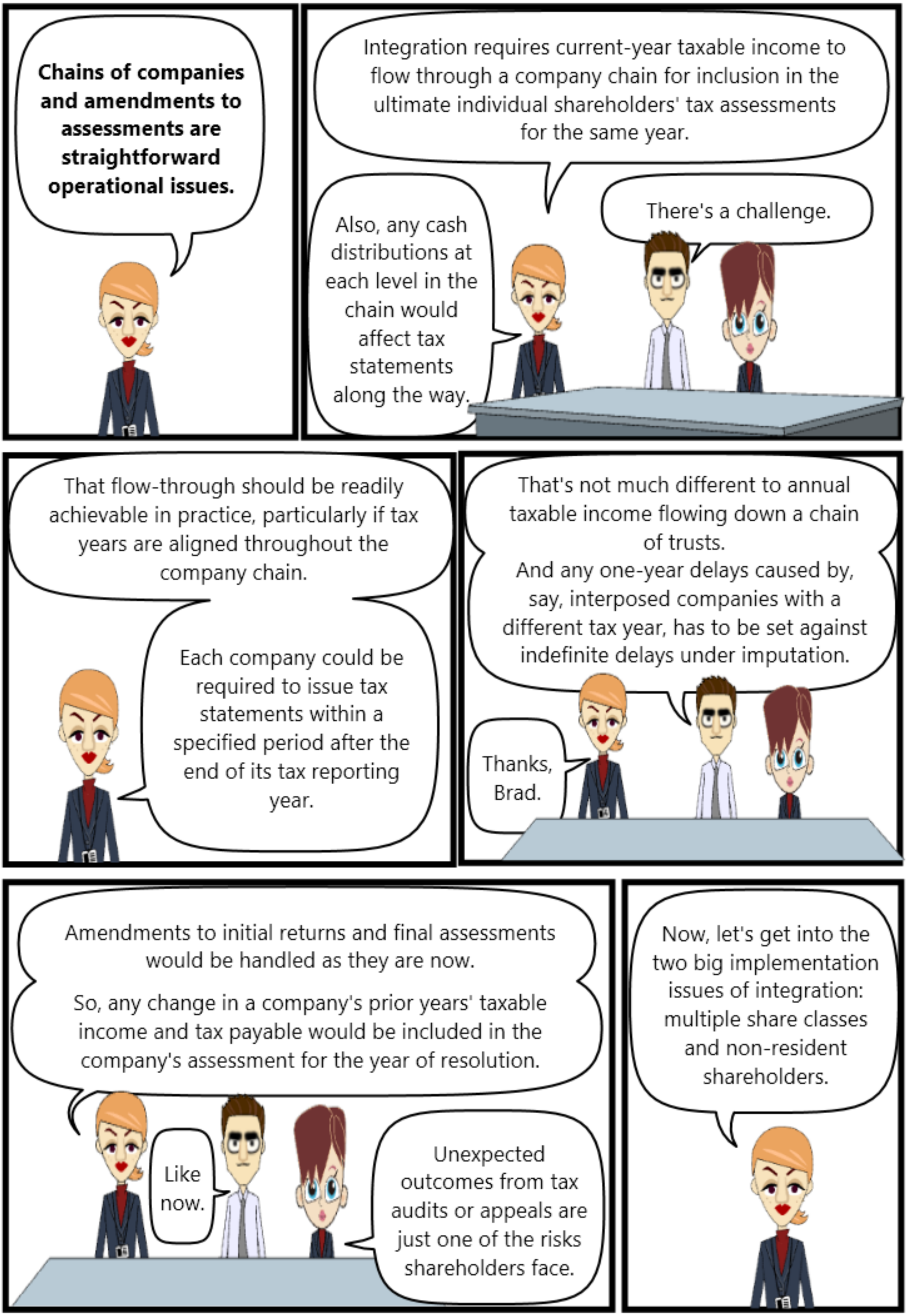
Practical operational issues*........

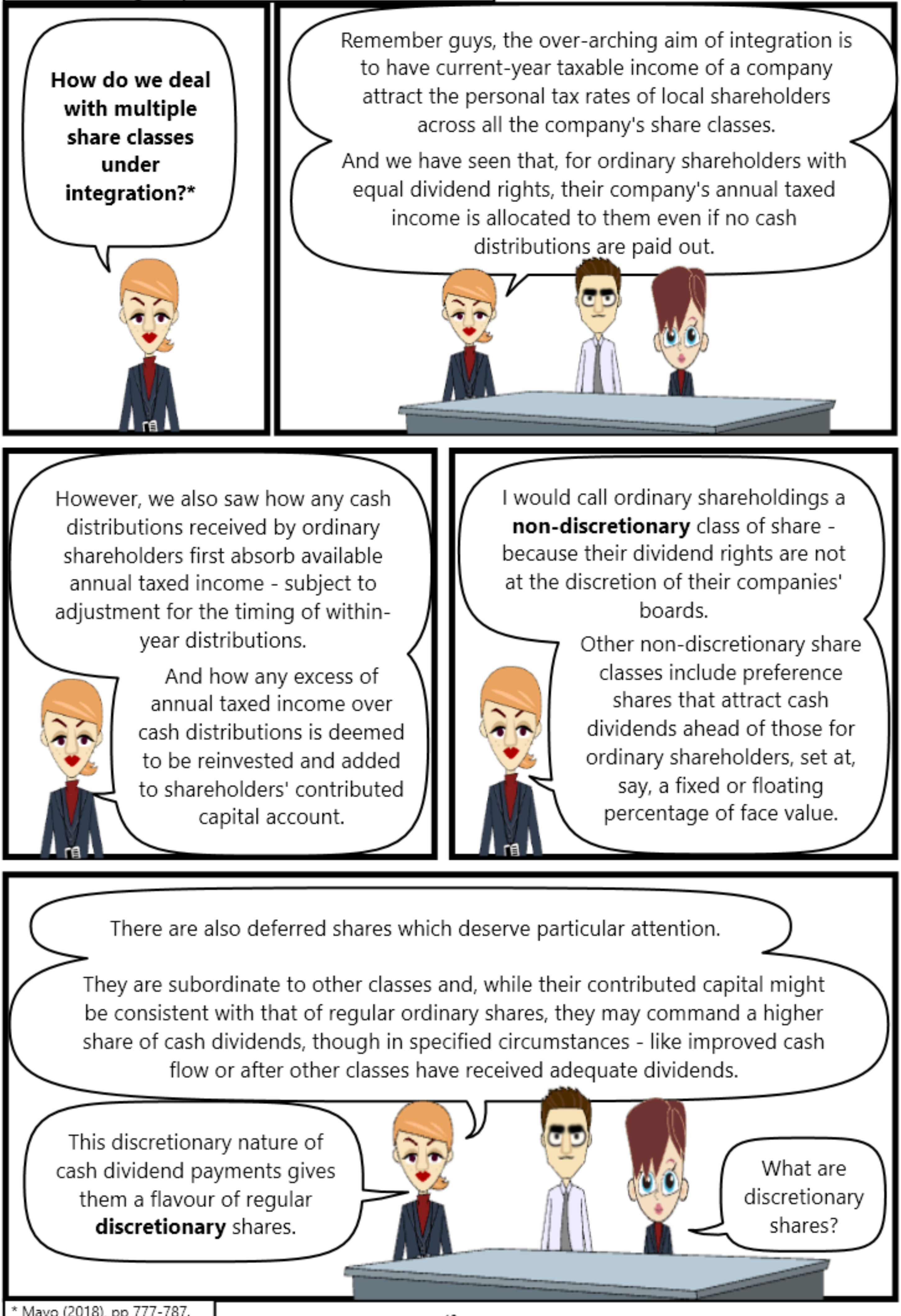


* Mayo (2018), pp 772-777.

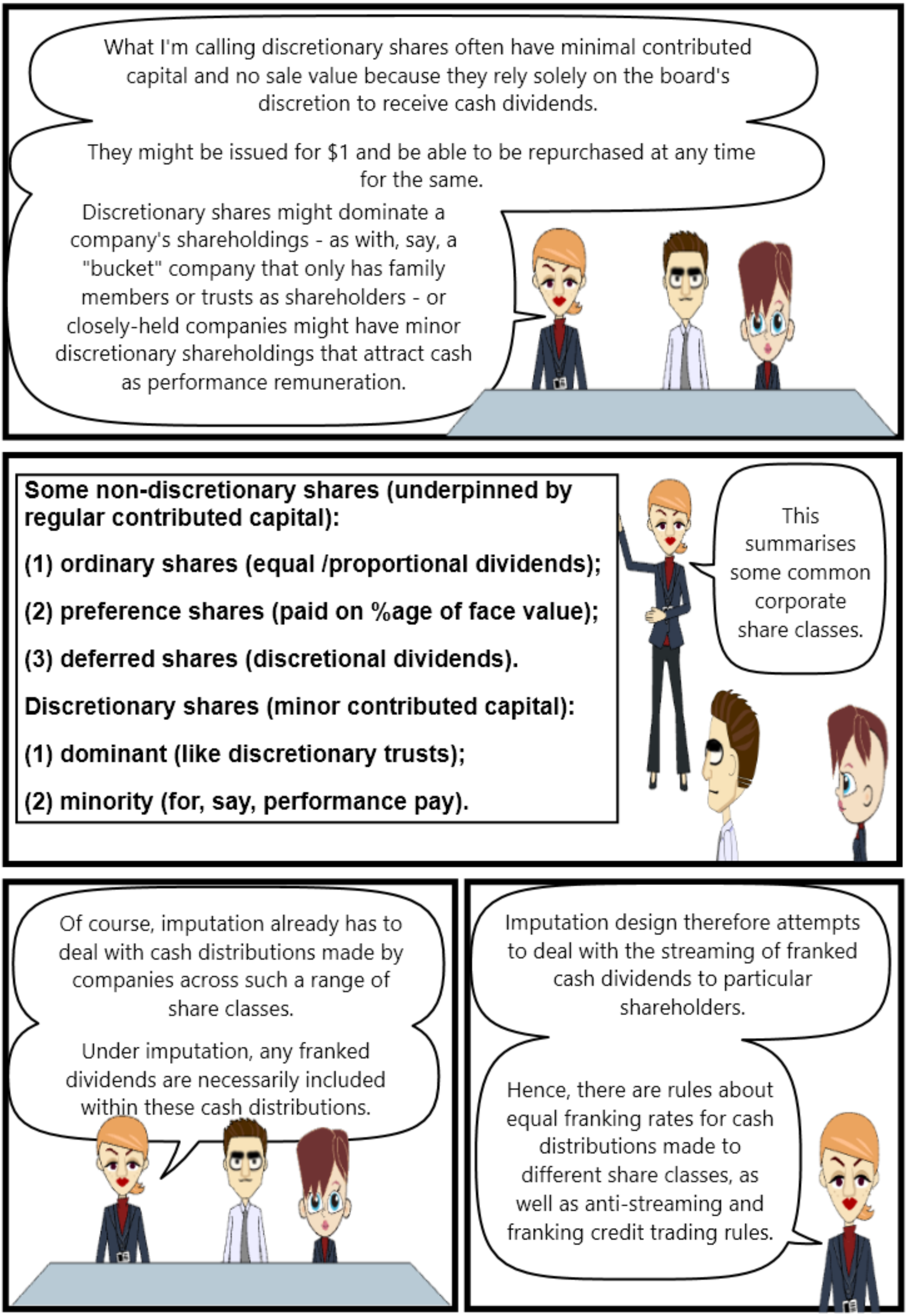

Any annual taxed income allocated that is not absorbed by distributions for that year needs to be allocated across all shareholders - including those who have held their shares for part of the year.
That is best done on a pro rata basis depending on period of share holding during the year - ignoring brief periods.
Oh, I love all this!
Keeping track of holding periods would add a lot of administrative complexity!
Nothing current computer technology could not handle, Brad.
Let me show you how this design plays out, using using two different companies: one paying regular robust **dividends**; the other a **growth** company paying none.
The two cases, which illustrate extremes in tax outcomes under integration, touch on shareholders' decision whether to sell or hold their shares..
First, take a company that pays equal cash dividends mid- and end-year.
And, it turns out post-year-end that taxed income for the current year aligns with aggregate cash dividends paid in the year.
Because, under our design, taxed income gets allocated first to any cash dividends, both interim and final dividends are fully franked.
And, there is no remnant taxed income to be allocated across shareholdings according to holding periods.
Our design!!
Very neat so far.

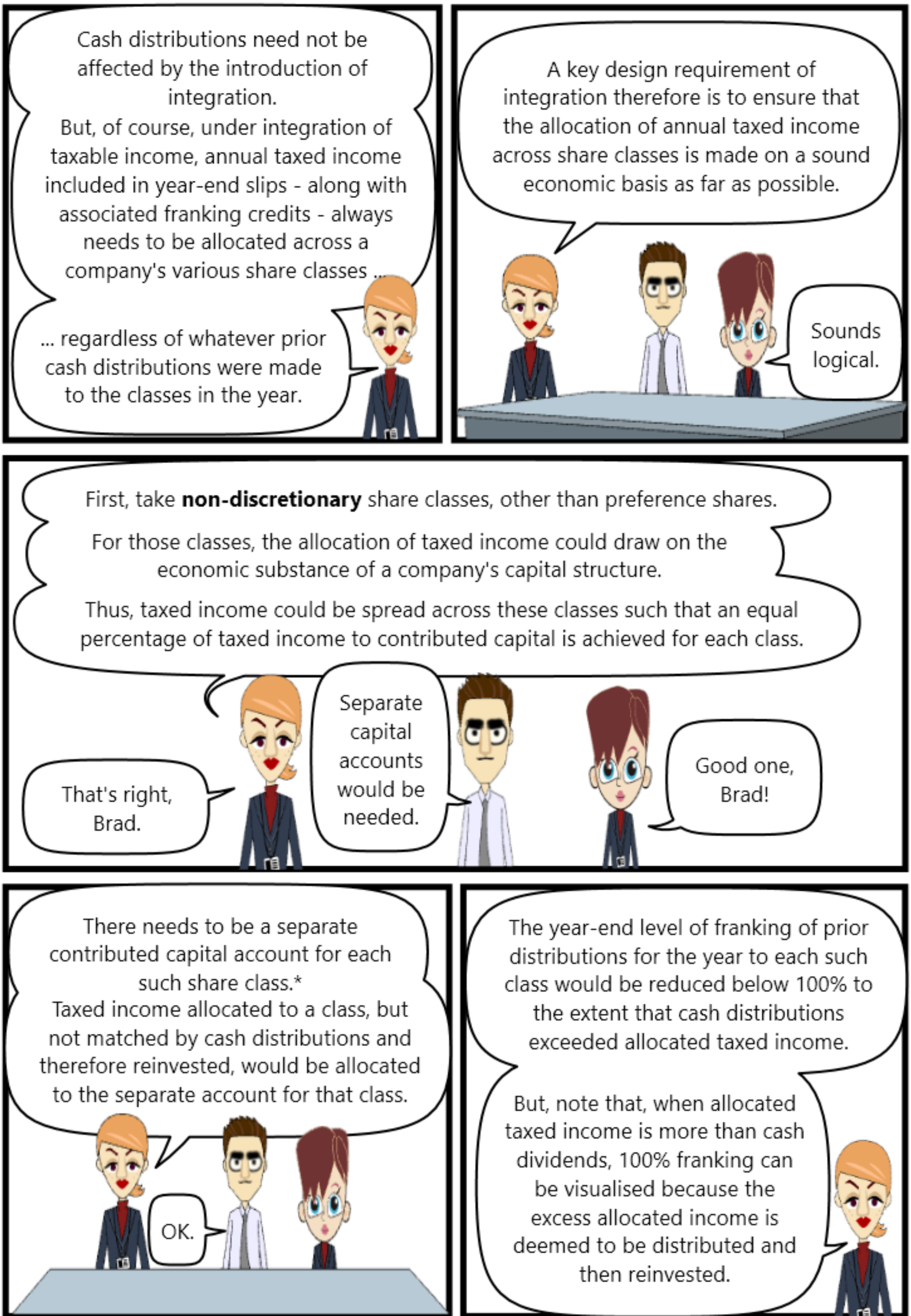

Now, during the year, long-term Shareholder A sells out to Shareholder B just before the mid-year dividend and Shareholder B sells out to Shareholder C right after the dividend.
After year's end, Shareholder A just faces CGT on his cum-dividend gain of, say, $100 - reflecting $70 taxed income and $30 franking credits.
The tax paid by Shareholder B on the $70 cash dividend plus $30 credits is neatly offset by reduced tax from her likely $100 CGT loss - assuming available CGT gains and no CGT discount applying.
The net effect is that tax is paid on the $100 of company income at the tax rate of Shareholder A - again assuming no CGT discount applies.
No discount? No way!
Hey, Claudia, this matches what happens now under imputation when shareholders get the full value of franking credits.
Exactly, Sami - but foreign shareholders may cut that value back.
Then locals might prefer to wait for dividends before any decision to sell out.
The **second** case has a company making no distributions while its share price rises steadily during the year in line with retained taxed income.
Shareholders know that, even if they sell out during the year, they will only be taxed on their share of allocated annual taxed income plus credits determined on the basis of their holding periods and holdings' sizes.
Shareholders selling out expect that no CGT would apply.
That is because capital gains on sale, reflecting increasing retained taxed income, would be matched by increases in the CGT tax values of their shares for the same taxed income allocated to them at year's end.
So, the company's value reflects retained taxed income with no stored credits.
Regardless of foreigners' influence, franking credits do not affect share value.
Right, Sami.
But, crucially, locals pay tax at their rates on the company's annual taxable income.
Share price depends on dividend policy!?


Chains of companies and amendments to assessments are straightforward operational issues.
Integration requires current-year taxable income to flow through a company chain for inclusion in the ultimate individual shareholders' tax assessments for the same year.
Also, any cash distributions at each level in the chain would affect tax statements along the way.
There's a challenge.
That flow-through should be readily achievable in practice, particularly if tax years are aligned throughout the company chain.
Each company could be required to issue tax statements within a specified period after the end of its tax reporting year.
That's not much different to annual taxable income flowing down a chain of trusts.
And any one-year delays caused by, say, interposed companies with a different tax year, has to be set against indefinite delays under imputation.
Thanks, Brad.
Amendments to initial returns and final assessments would be handled as they are now.
So, any change in a company's prior years' taxable income and tax payable would be included in the company's assessment for the year of resolution.
Like now.
Unexpected outcomes from tax audits or appeals are just one of the risks shareholders face.
Now, let's get into the two big implementation issues of integration: multiple share classes and non-resident shareholders.

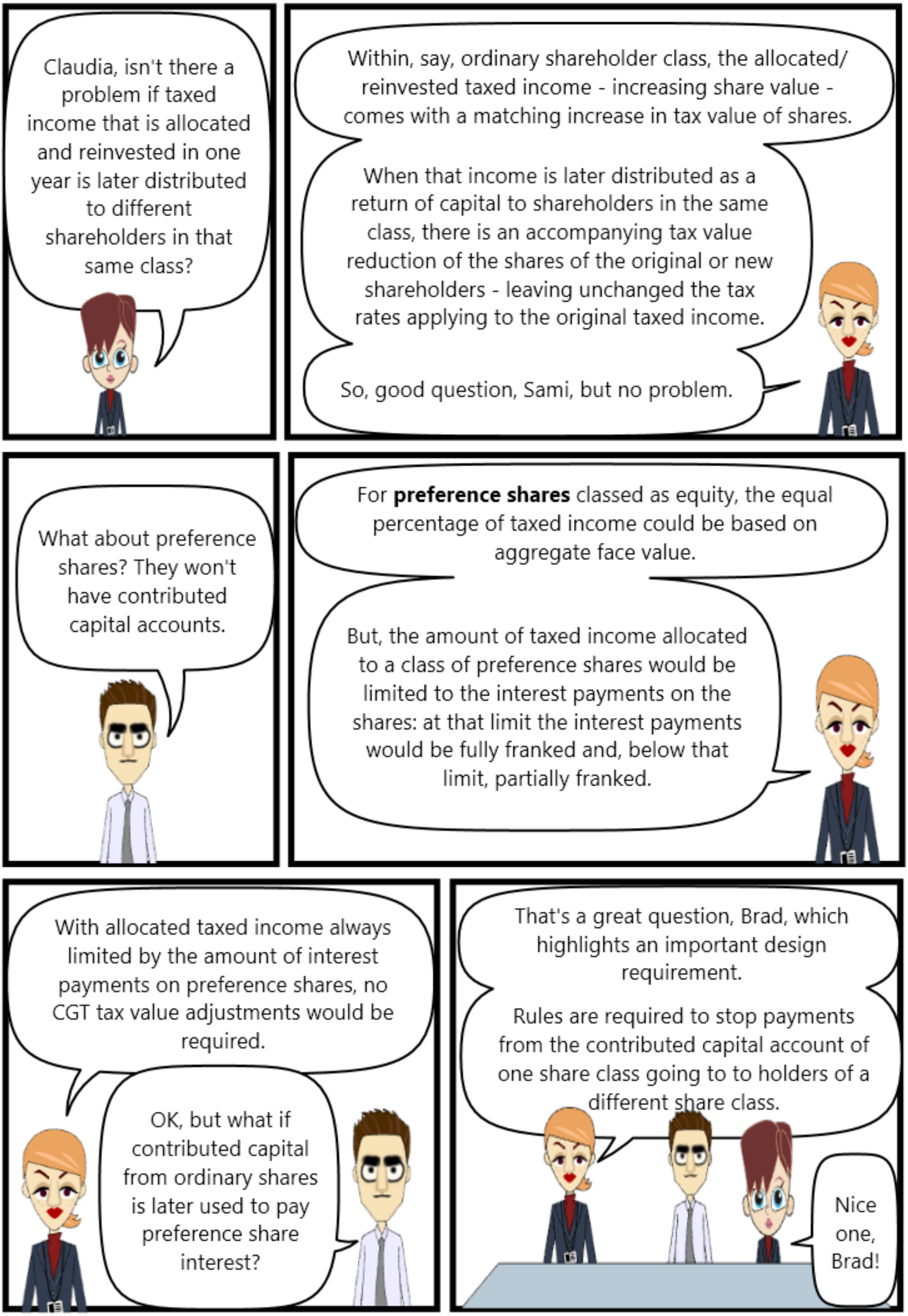


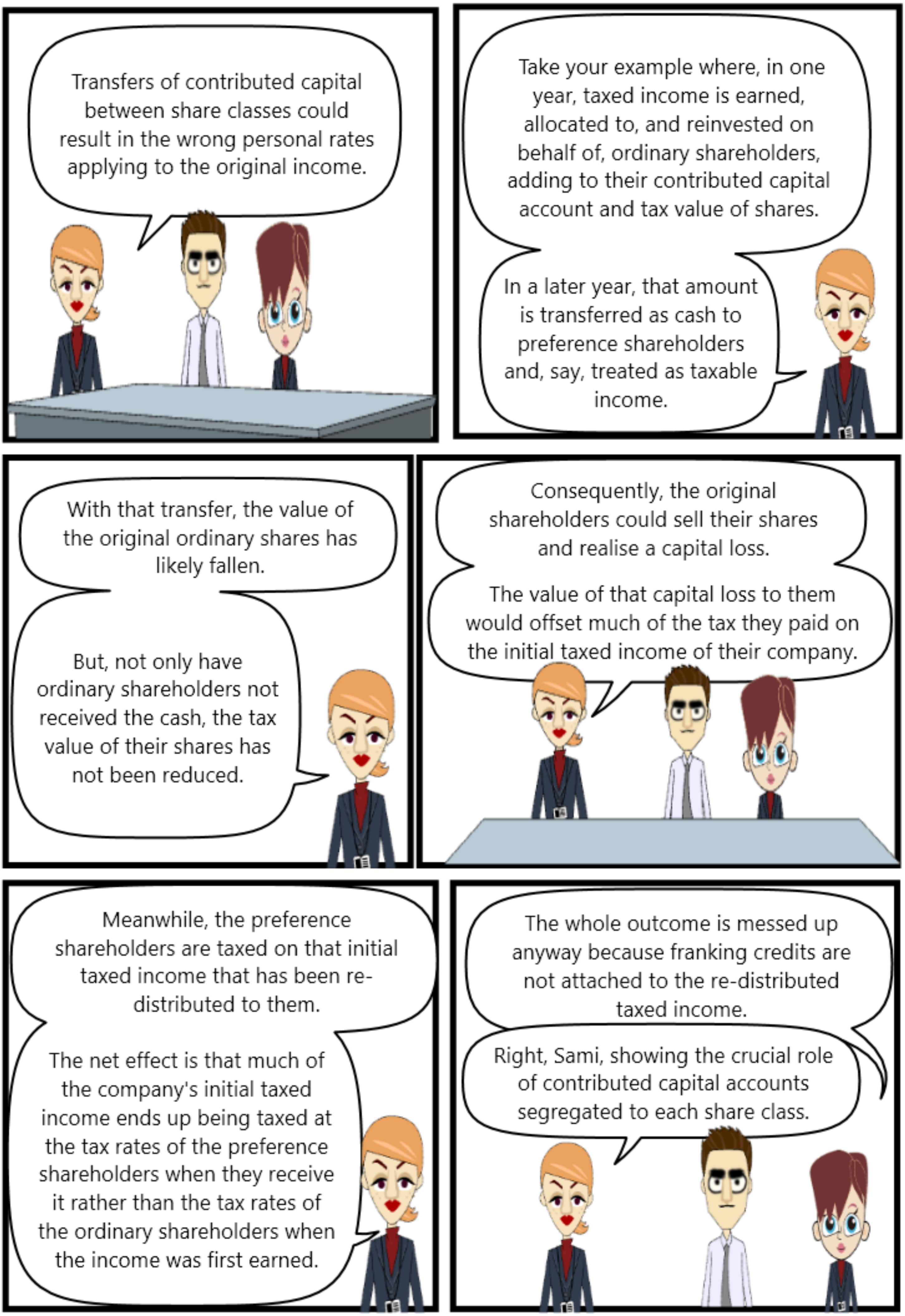
* Mayo (2018), pp 777-787.

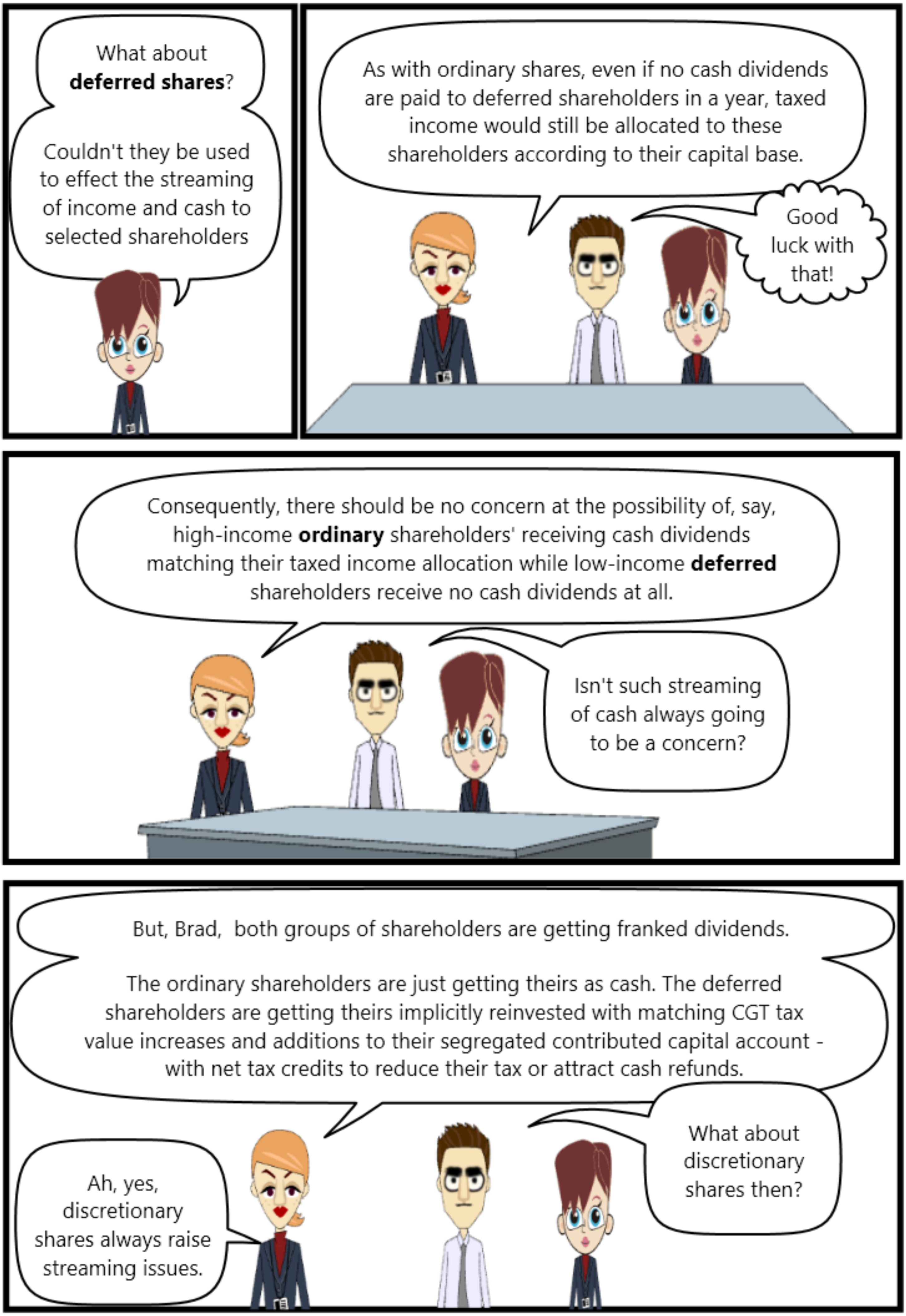

What I'm calling discretionary shares often have minimal contributed capital and no sale value because they rely solely on the board's discretion to receive cash dividends.
They might be issued for $1 and be able to be repurchased at any time for the same.
Discretionary shares might dominate a company's shareholdings - as with, say, a "bucket" company that only has family members or trusts as shareholders - or closely-held companies might have minor discretionary shareholdings that attract cash as performance remuneration.
Some non-discretionary shares (underpinned by regular contributed capital):
(1) ordinary shares (equal /proportional dividends);
(2) preference shares (paid on %age of face value);
(3) deferred shares (discretional dividends).
Discretionary shares (minor contributed capital):
(1) dominant (like discretionary trusts);
(2) minority (for, say, performance pay).
This summarises some common corporate share classes.
Of course, imputation already has to deal with cash distributions made by companies across such a range of share classes.
Under imputation, any franked dividends are necessarily included within these cash distributions.
Imputation design therefore attempts to deal with the streaming of franked cash dividends to particular shareholders.
Hence, there are rules about equal franking rates for cash distributions made to different share classes, as well as anti-streaming and franking credit trading rules.

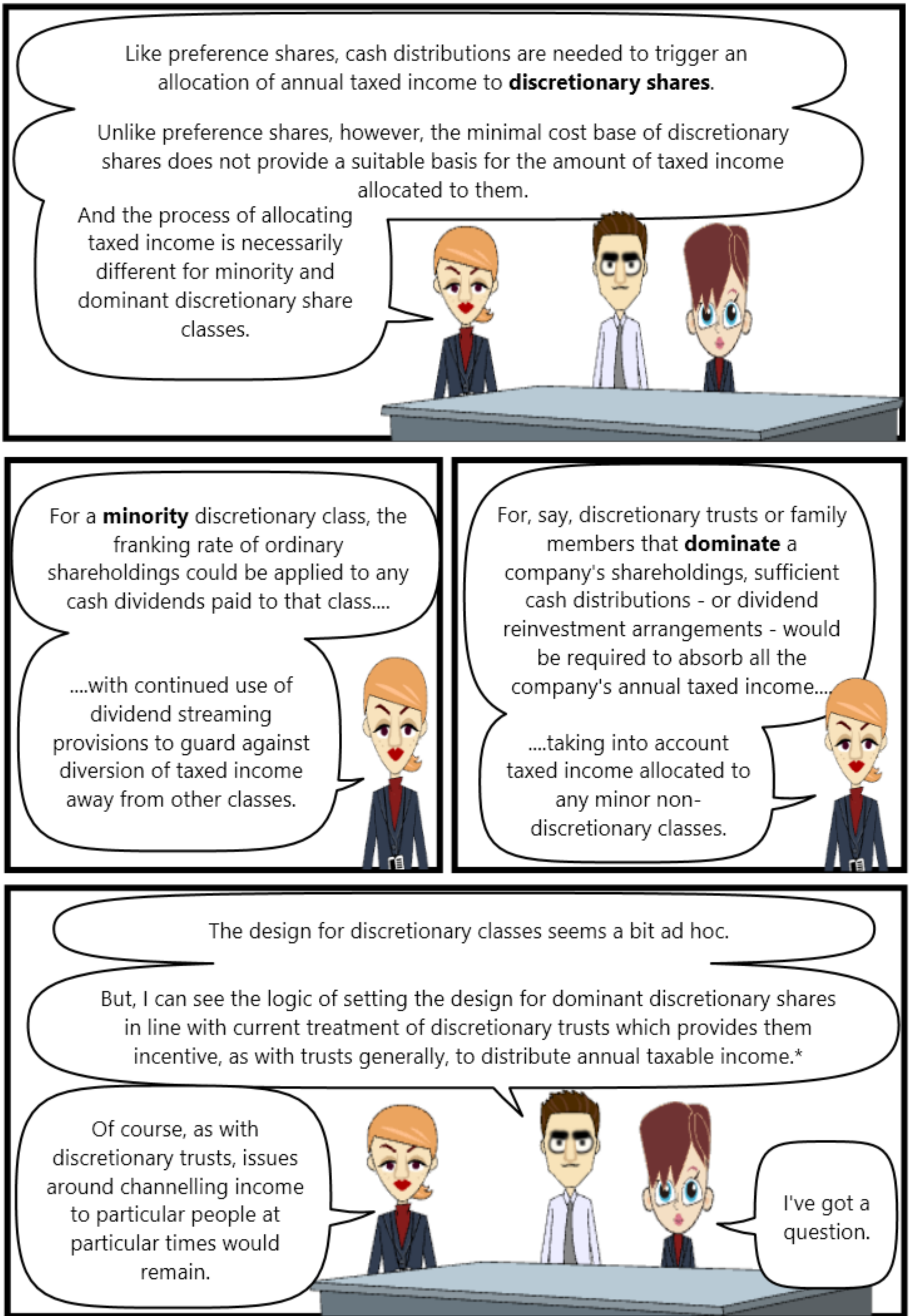


* See Ralph Review, pp 441-442.

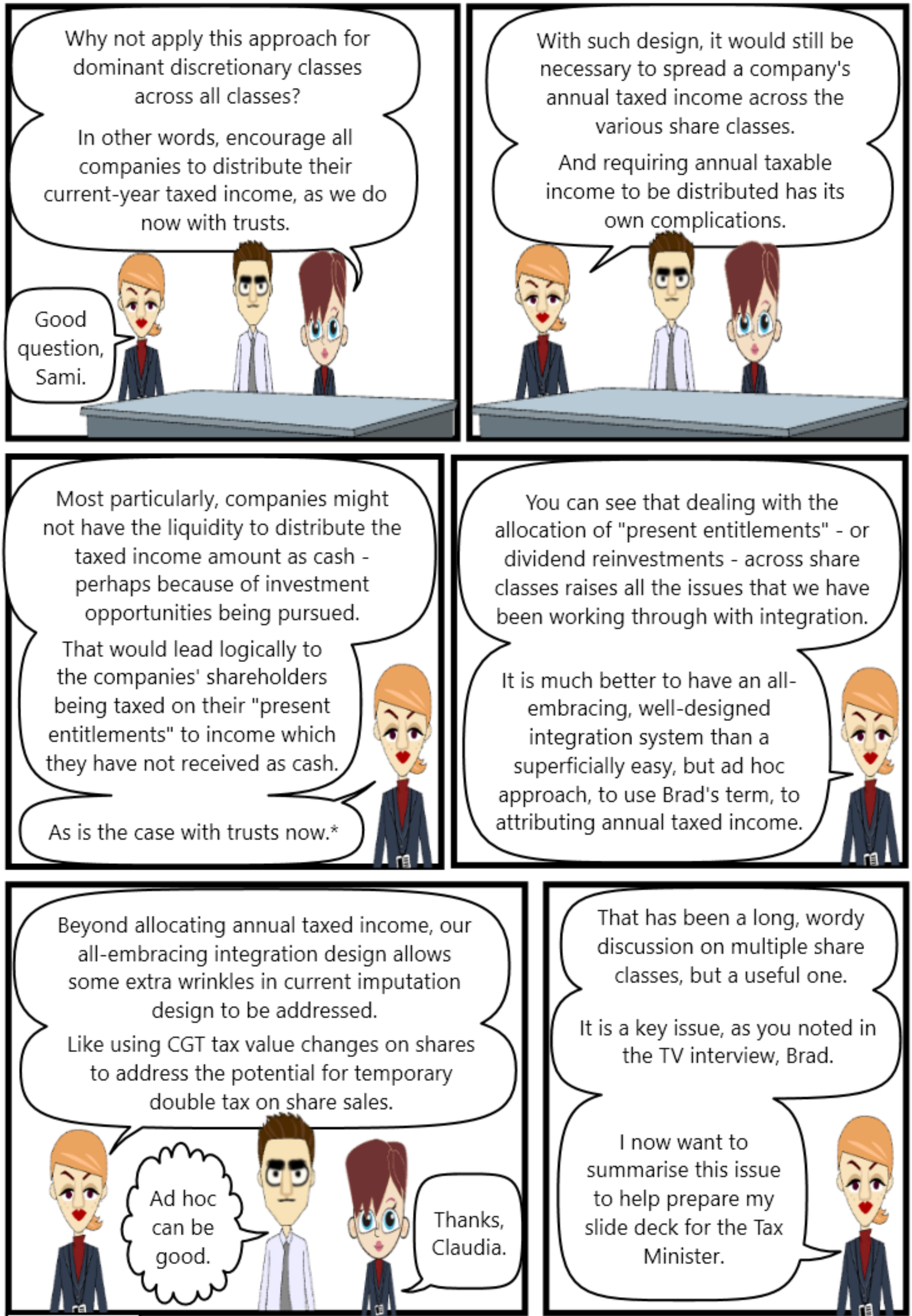

Claudia, isn't there a problem if taxed income that is allocated and reinvested in one year is later distributed to different shareholders in that same class?
Within, say, ordinary shareholder class, the allocated/ reinvested taxed income - increasing share value - comes with a matching increase in tax value of shares.
When that income is later distributed as a return of capital to shareholders in the same class, there is an accompanying tax value reduction of the shares of the original or new shareholders - leaving unchanged the tax rates applying to the original taxed income.
So, good question, Sami, but no problem.
What about preference shares? They won't have contributed capital accounts.
For **preference shares** classed as equity, the equal percentage of taxed income could be based on aggregate face value.
But, the amount of taxed income allocated to a class of preference shares would be limited to the interest payments on the shares: at that limit the interest payments would be fully franked and, below that limit, partially franked.
With allocated taxed income always limited by the amount of interest payments on preference shares, no CGT tax value adjustments would be required.
OK, but what if contributed capital from ordinary shares is later used to pay preference share interest?
That's a great question, Brad, which highlights an important design requirement.
Rules are required to stop payments from the contributed capital account of one share class going to to holders of a different share class.
Nice one, Brad!


Transfers of contributed capital between share classes could result in the wrong personal rates applying to the original income.
Take your example where, in one year, taxed income is earned, allocated to, and reinvested on behalf of, ordinary shareholders, adding to their contributed capital account and tax value of shares.
In a later year, that amount is transferred as cash to preference shareholders and, say, treated as taxable income.
With that transfer, the value of the original ordinary shares has likely fallen.
But, not only have ordinary shareholders not received the cash, the tax value of their shares has not been reduced.
Consequently, the original shareholders could sell their shares and realise a capital loss.
The value of that capital loss to them would offset much of the tax they paid on the initial taxed income of their company.
Meanwhile, the preference shareholders are taxed on that initial taxed income that has been re-distributed to them.
The net effect is that much of the company's initial taxed income ends up being taxed at the tax rates of the preference shareholders when they receive it rather than the tax rates of the ordinary shareholders when the income was first earned.
The whole outcome is messed up anyway because franking credits are not attached to the re-distributed taxed income.
Right, Sami, showing the crucial role of contributed capital accounts segregated to each share class.


What about **deferred shares**?
Couldn't they be used to effect the streaming of income and cash to selected shareholders
As with ordinary shares, even if no cash dividends are paid to deferred shareholders in a year, taxed income would still be allocated to these shareholders according to their capital base.
Good luck with that!
Consequently, there should be no concern at the possibility of, say, high-income **ordinary** shareholders' receiving cash dividends matching their taxed income allocation while low-income **deferred** shareholders receive no cash dividends at all.
Isn't such streaming of cash always going to be a concern?
But, Brad, both groups of shareholders are getting franked dividends.
The ordinary shareholders are just getting theirs as cash. The deferred shareholders are getting theirs implicitly reinvested with matching CGT tax value increases and additions to their segregated contributed capital account - with net tax credits to reduce their tax or attract cash refunds.
What about discretionary shares then?
Ah, yes, discretionary shares always raise streaming issues.


Like preference shares, cash distributions are needed to trigger an allocation of annual taxed income to **discretionary shares**.
Unlike preference shares, however, the minimal cost base of discretionary shares does not provide a suitable basis for the amount of taxed income allocated to them.
And the process of allocating taxed income is necessarily different for minority and dominant discretionary share classes.
For a **minority** discretionary class, the franking rate of ordinary shareholdings could be applied to any cash dividends paid to that class....
....with continued use of dividend streaming provisions to guard against diversion of taxed income away from other classes.
For, say, discretionary trusts or family members that **dominate** a company's shareholdings, sufficient cash distributions - or dividend reinvestment arrangements - would be required to absorb all the company's annual taxed income....
....taking into account taxed income allocated to any minor non-discretionary classes.
The design for discretionary classes seems a bit ad hoc.
But, I can see the logic of setting the design for dominant discretionary shares in line with current treatment of discretionary trusts which provides them incentive, as with trusts generally, to distribute annual taxable income.*
Of course, as with discretionary trusts, issues around channelling income to particular people at particular times would remain.
I've got a question.

* See Ch6, p 4.


Why not apply this approach for dominant discretionary classes across all classes?
In other words, encourage all companies to distribute their current-year taxed income, as we do now with trusts.
Good question, Sami.
With such design, it would still be necessary to spread a company's annual taxed income across the various share classes.
And requiring annual taxable income to be distributed has its own complications.
Most particularly, companies might not have the liquidity to distribute the taxed income amount as cash - perhaps because of investment opportunities being pursued.
That would lead logically to the companies' shareholders being taxed on their "present entitlements" to income which they have not received as cash.
As is the case with trusts now.*
You can see that dealing with the allocation of "present entitlements" - or dividend reinvestments - across share classes raises all the issues that we have been working through with integration.
It is much better to have an all-embracing, well-designed integration system than a superficially easy, but ad hoc approach, to use Brad's term, to attributing annual taxed income.
Beyond allocating annual taxed income, our all-embracing integration design allows some extra wrinkles in current imputation design to be addressed.
Like using CGT tax value changes on shares to address the potential for temporary double tax on share sales.
Ad hoc can be good.
Thanks, Claudia.
That has been a long, wordy discussion on multiple share classes, but a useful one.
It is a key issue, as you noted in the TV interview, Brad.
I now want to summarise this issue to help prepare my slide deck for the Tax Minister.

* See Ch6, p 4.

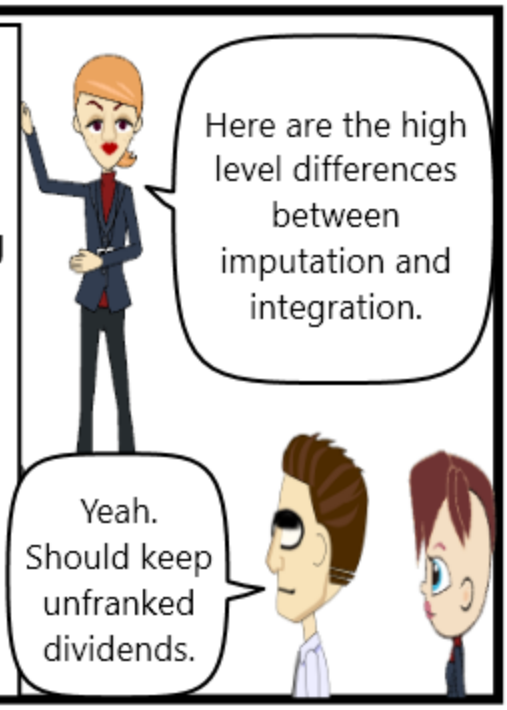
MULTIPLE SHARE CLASSES

Currently under imputation -

(a) taxed income linked to cash dividends when ever they are made; and (b) rules for equal franking across share classes apply.

Under integration -

1. (a) cash distributions as normal; (b) current-year taxed income spread across share classes mostly independent of cash distributions; and (c) streaming concerns focused more on distributions of untaxed income (with CGT tax value reductions) than franking credits.

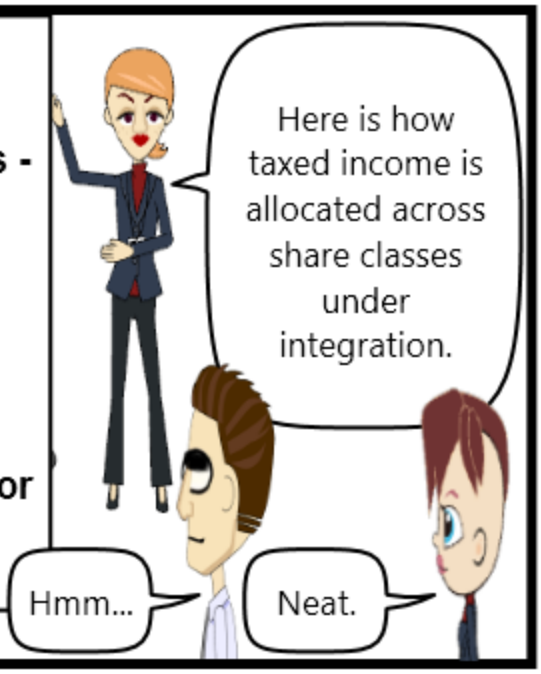


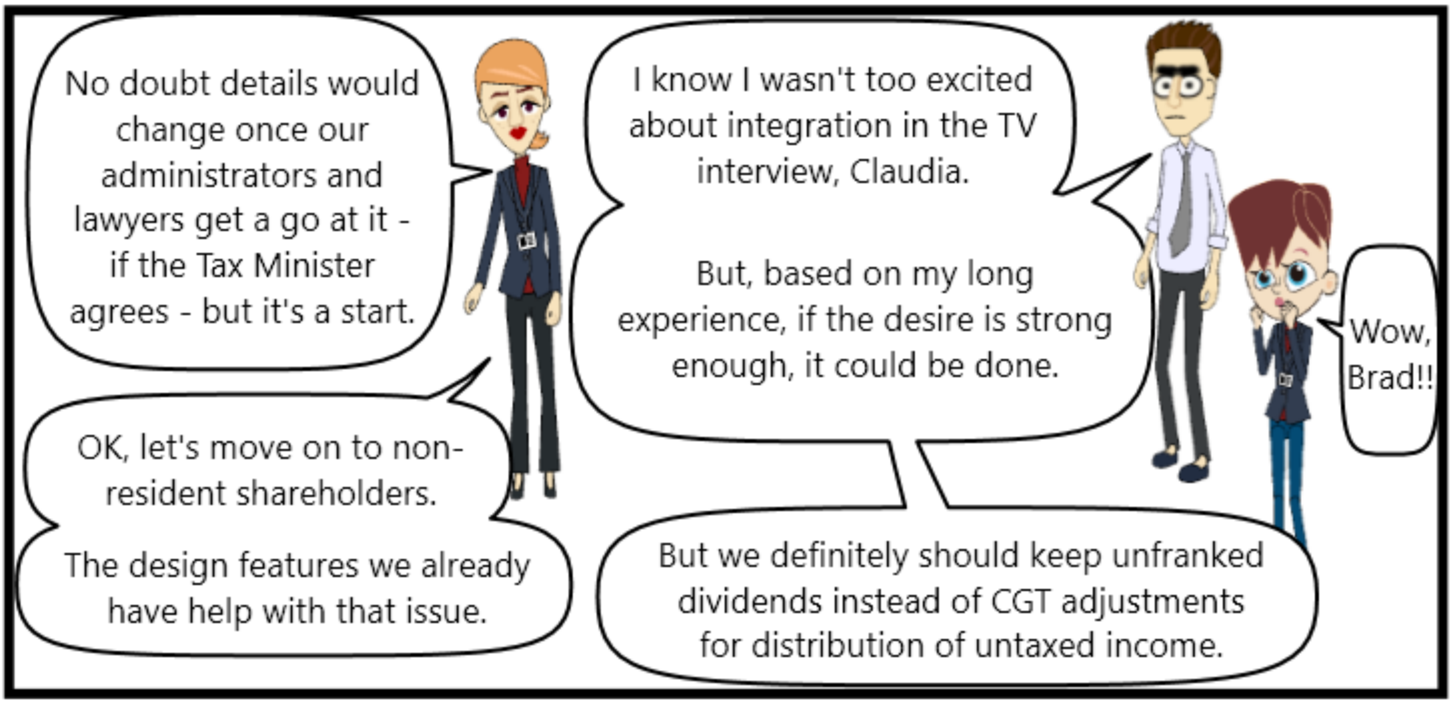
2. For non-discretionary share classes:

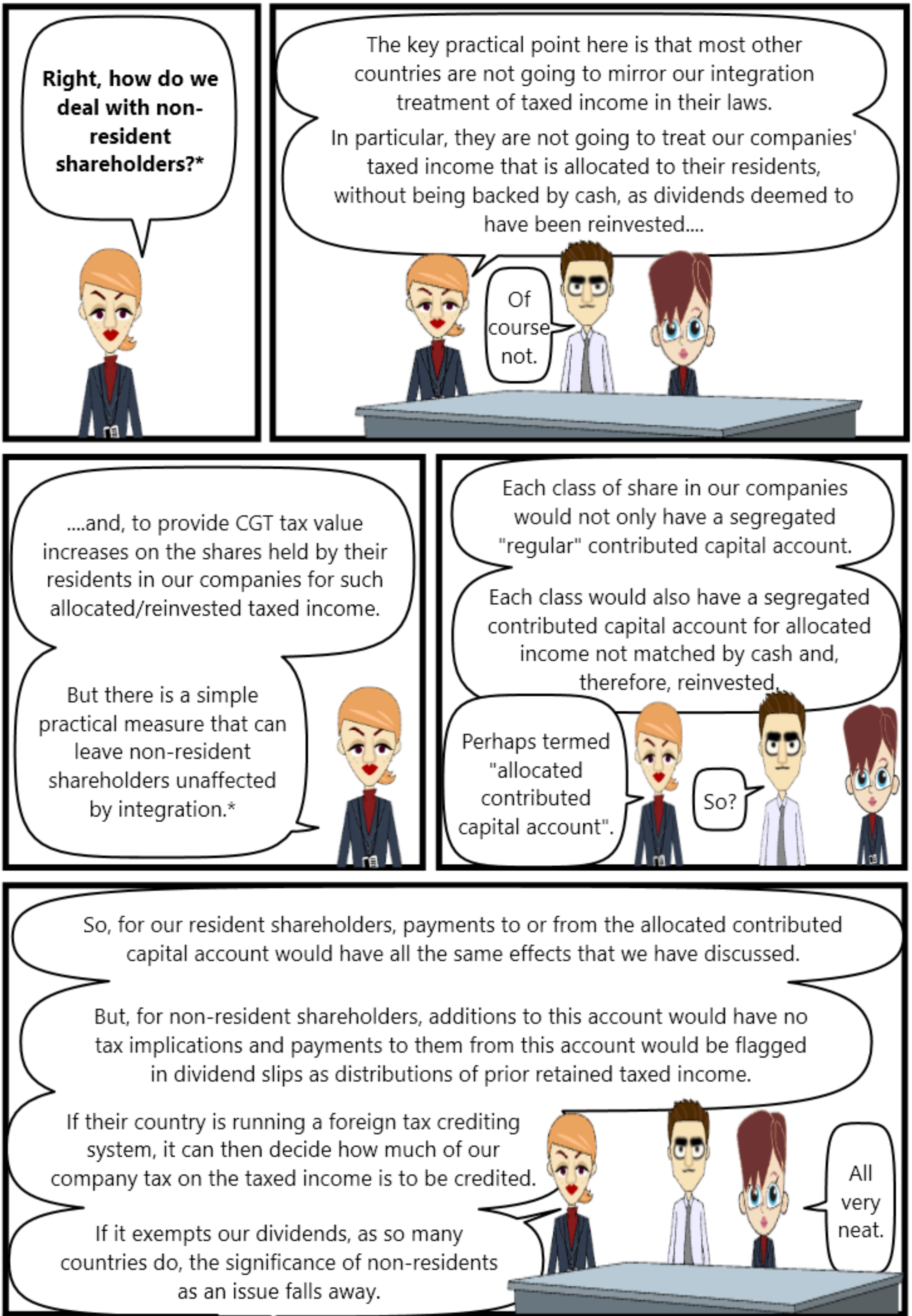
taxed income allocated to achieve an equal percentage of specified capital base in each class - that is, segregated contributed capital for normal share classes, and aggregate face value for preference shares.

3. For discretionary share classes:

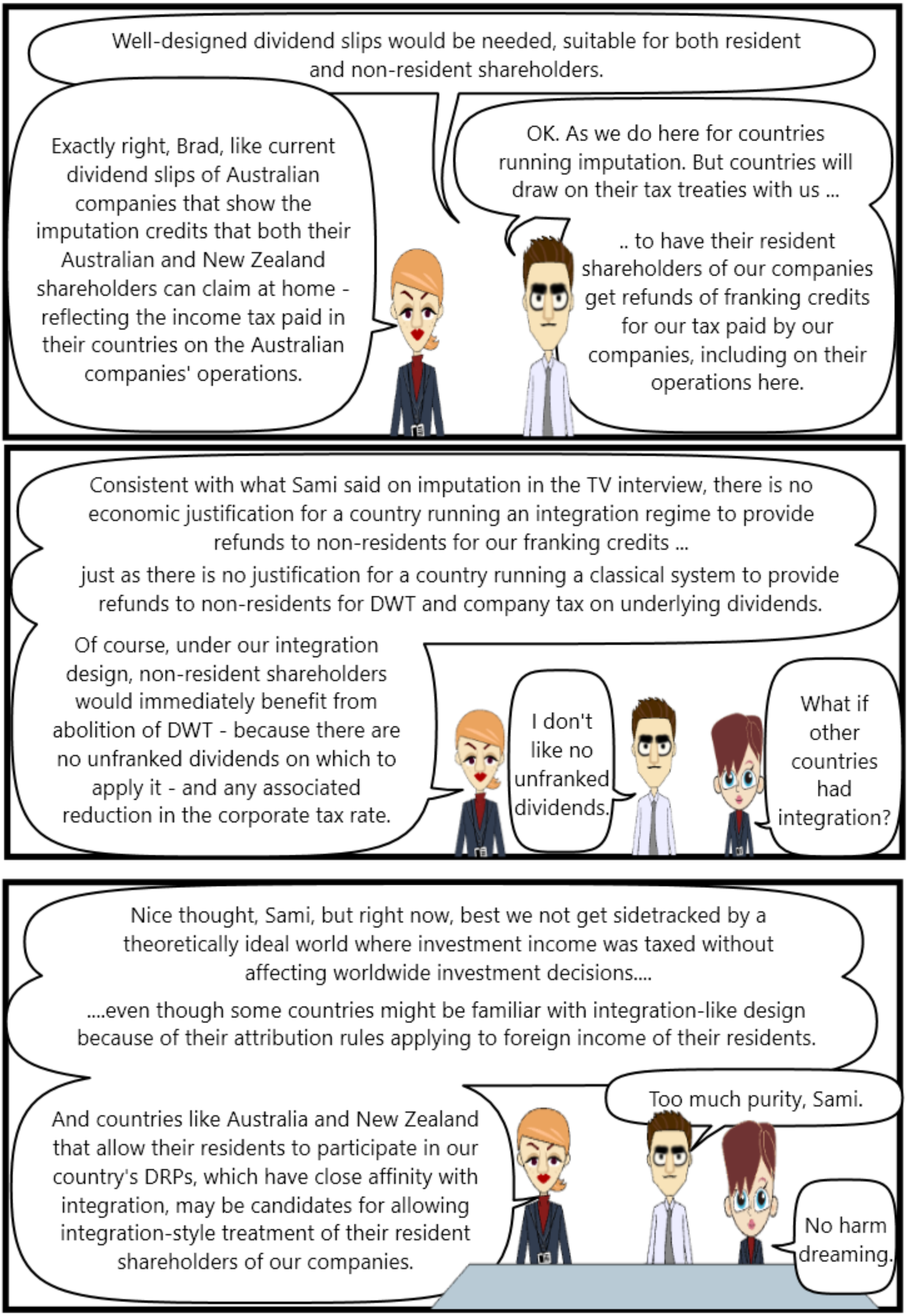
(a) for minority classes, same franking rate as normal shares when cash is distributed; and (b) for dominant classes, sufficient cash distributions required to absorb annual taxed income.







* Mayo (2018), pp 787-792.


Well-designed dividend slips would be needed, suitable for both resident and non-resident shareholders.
Exactly right, Brad, like current dividend slips of Australian companies that show the imputation credits that both their Australian and New Zealand shareholders can claim at home - reflecting the income tax paid in their countries on the Australian companies' operations.
OK. As we do here for countries running imputation. But countries will draw on their tax treaties with us ...
.. to have their resident shareholders of our companies get refunds of franking credits for our tax paid by our companies, including on their operations here.
Consistent with what Sami said on imputation in the TV interview, there is no economic justification for a country running an integration regime to provide refunds to non-residents for our franking credits ...
just as there is no justification for a country running a classical system to provide refunds to non-residents for DWT and company tax on underlying dividends.
Of course, under our integration design, non-resident shareholders would immediately benefit from abolition of DWT - because there are no unfranked dividends on which to apply it - and any associated reduction in the corporate tax rate.
I don't like no unfranked dividends.
What if other countries had integration?
Nice thought, Sami, but right now, best we not get sidetracked by a theoretically ideal world where investment income was taxed without affecting worldwide investment decisions....
....even though some countries might be familiar with integration-like design because of their attribution rules applying to foreign income of their residents.
And countries like Australia and New Zealand that allow their residents to participate in our country's DRPs, which have close affinity with integration, may be candidates for allowing integration-style treatment of their resident shareholders of our companies.
Too much purity, Sami.
No harm dreaming.

NON-RESIDENT SHAREHOLDERS

Key integration design features:

(a) for each non-discretionary share class, a segregated "attributed contributed capital account" for attributed/reinvested taxed income not matched by cash distributions;

(b) distributions from this account flagged in dividend slips to non-resident shareholders as payments of prior retained taxed income - allowing non-residents' countries to provide credit for our underlying company tax on these distributions;

(c) appropriately redesigned dividend slip.

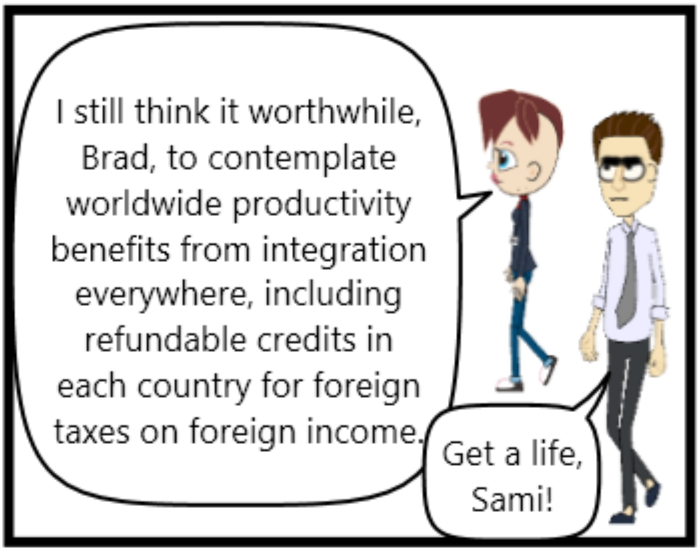
Non-resident shareholders benefit from no DWT (no unfranked dividends) and any reduction in our company tax rate felt in full by non-residents in countries exempting foreign dividends.

On their dividend slips, non-residents see any regular cash distributions comprising:

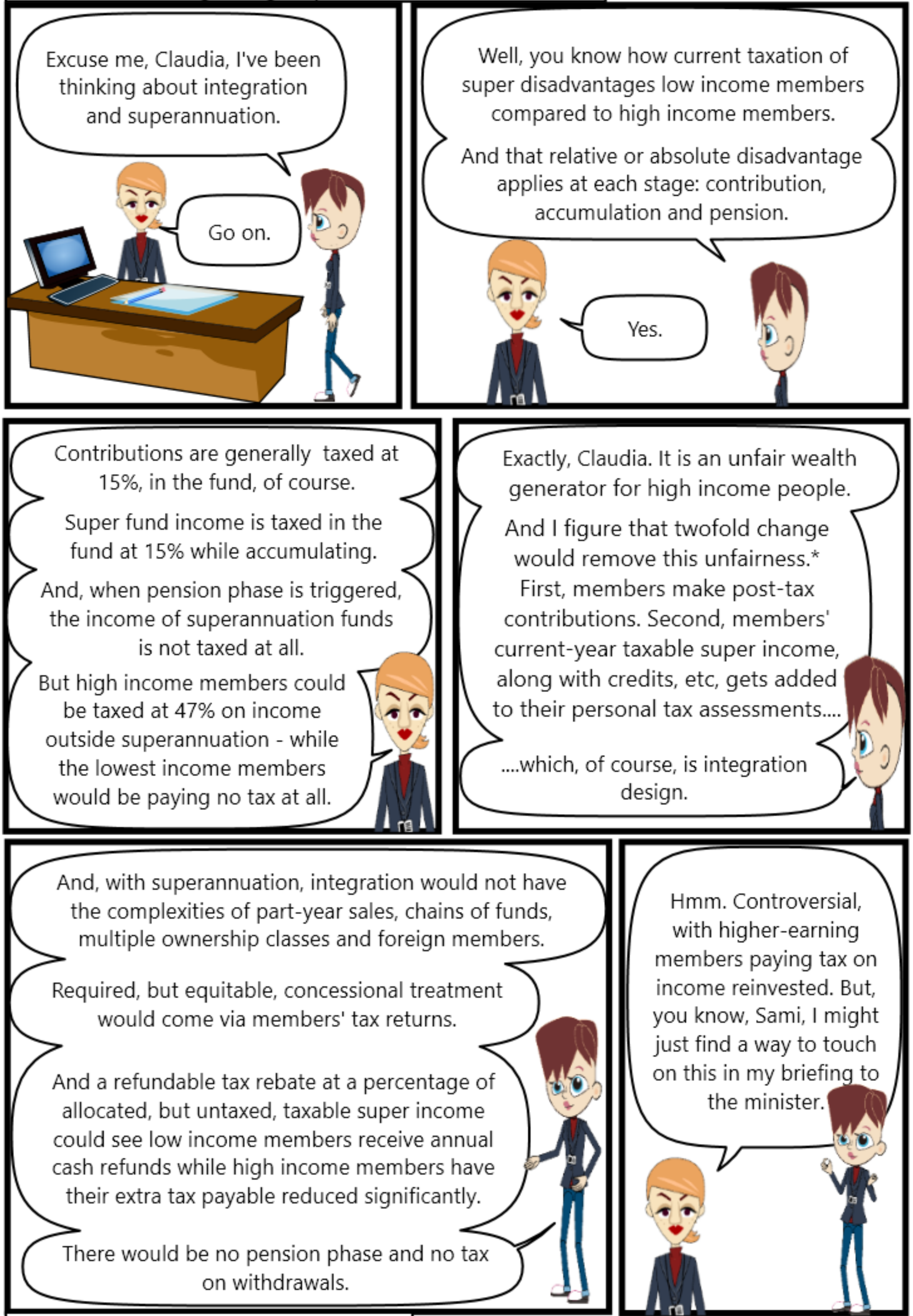
(i) any amount of current-year taxed income (as franked dividends plus franking credits) as under imputation - with current-year taxed income attributed to them above this amount having been added to attributed contributed capital account;

(ii) any payments from that capital account, flagged as prior retained taxed income; and

(ii) untaxed income (formerly unfranked dividends under imputation).

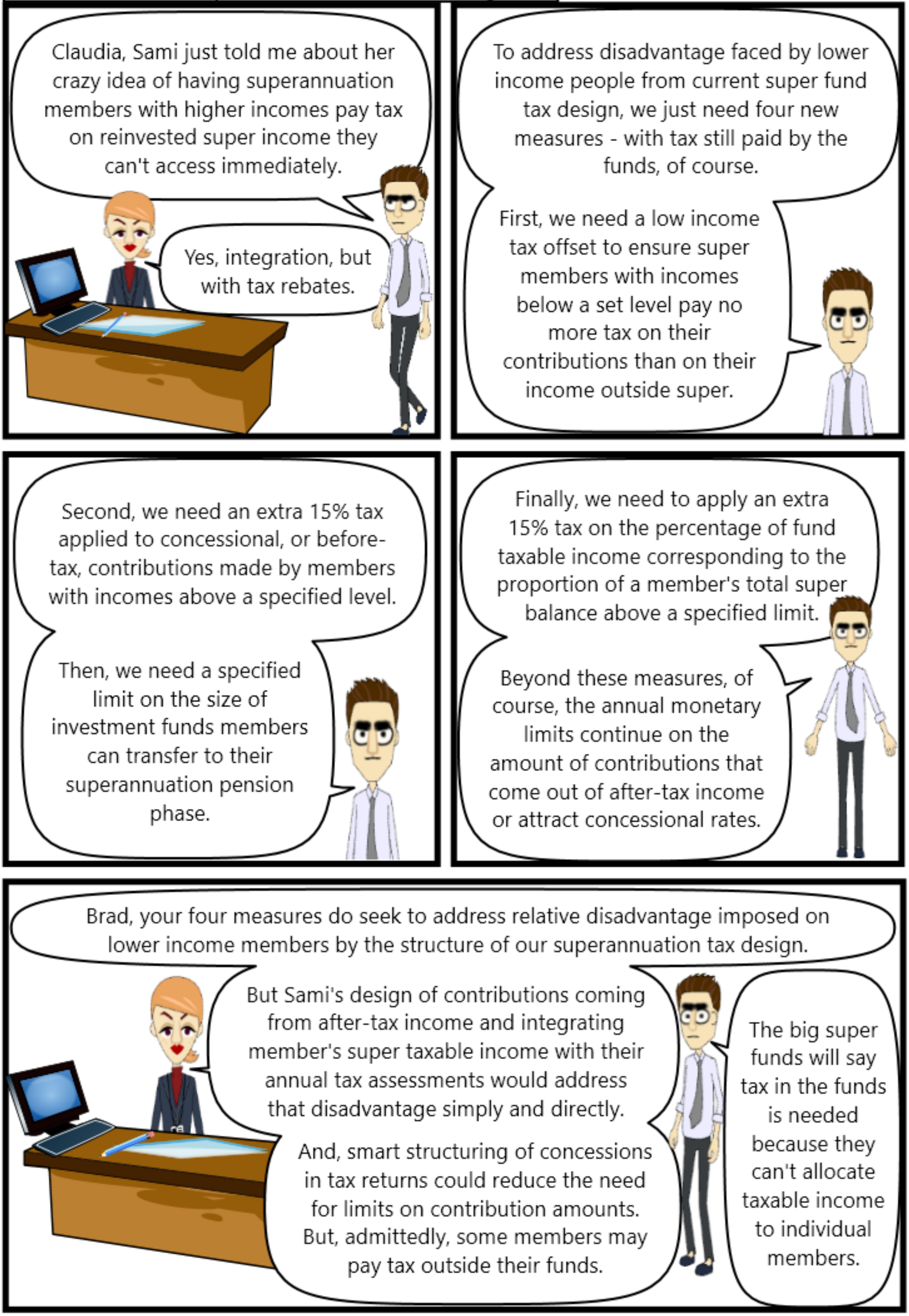


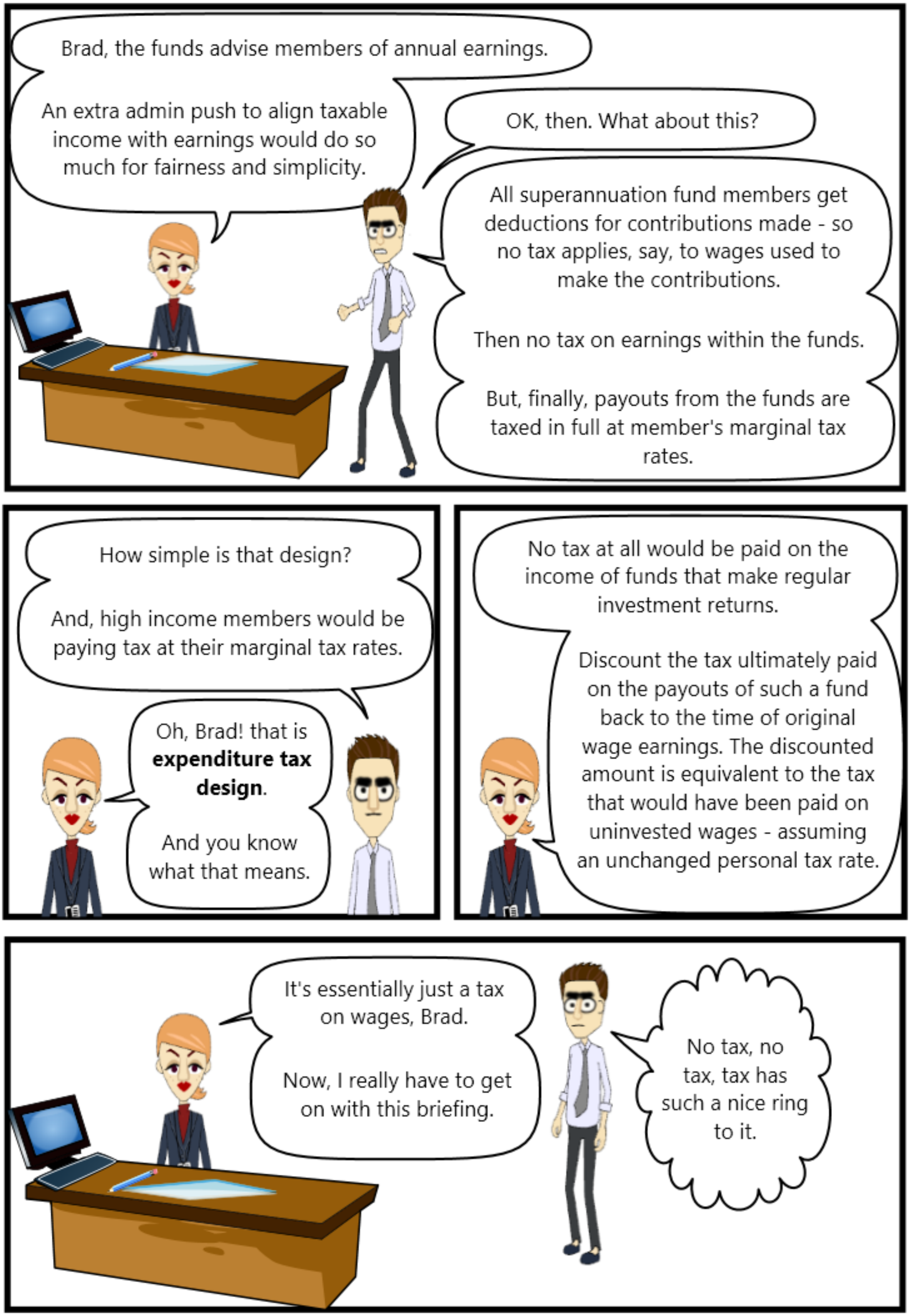
What about integrating superannuation income?



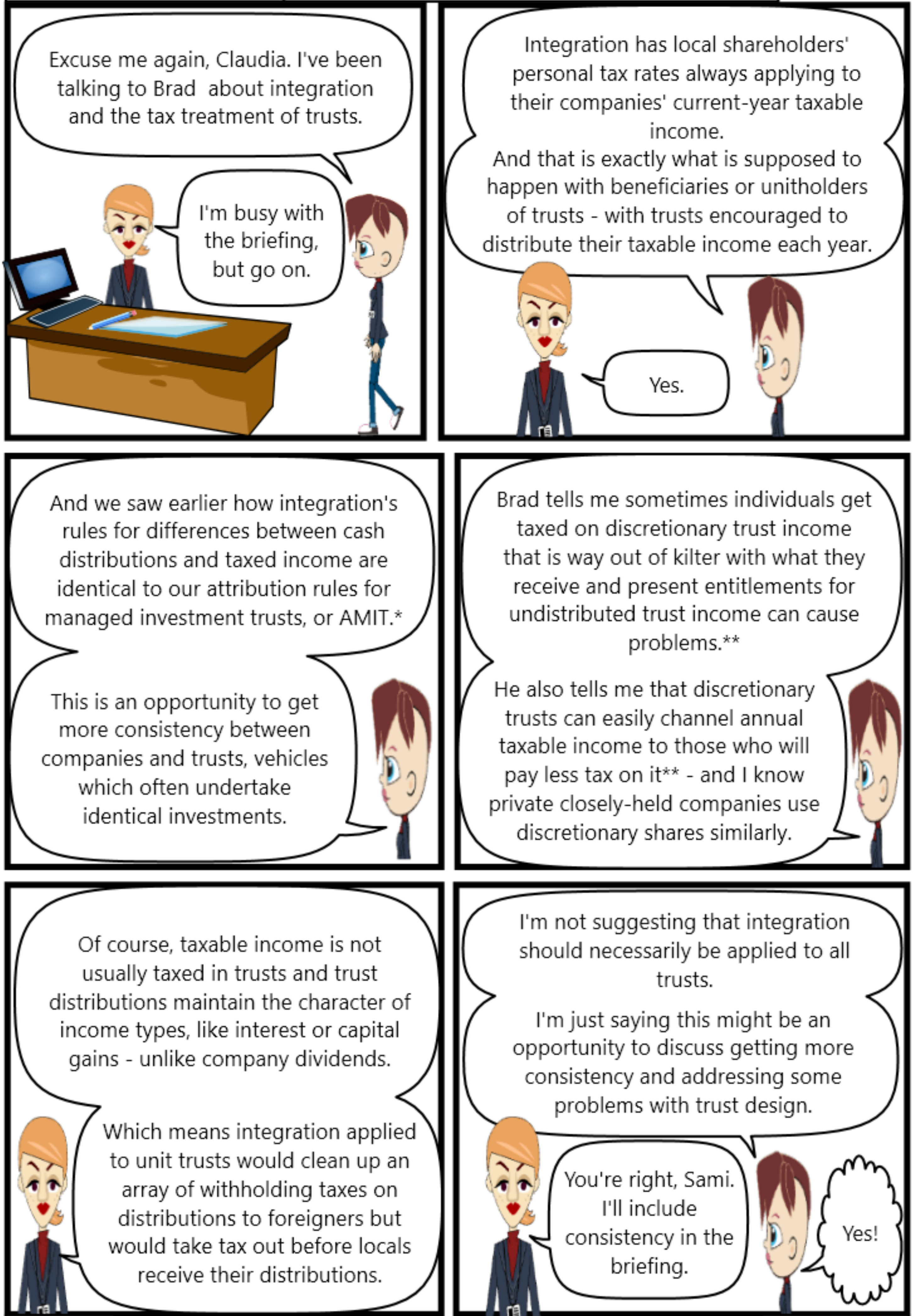
* See Mayo (2020), including for numerical illustrations.

Brad's take on superannuation's tax design



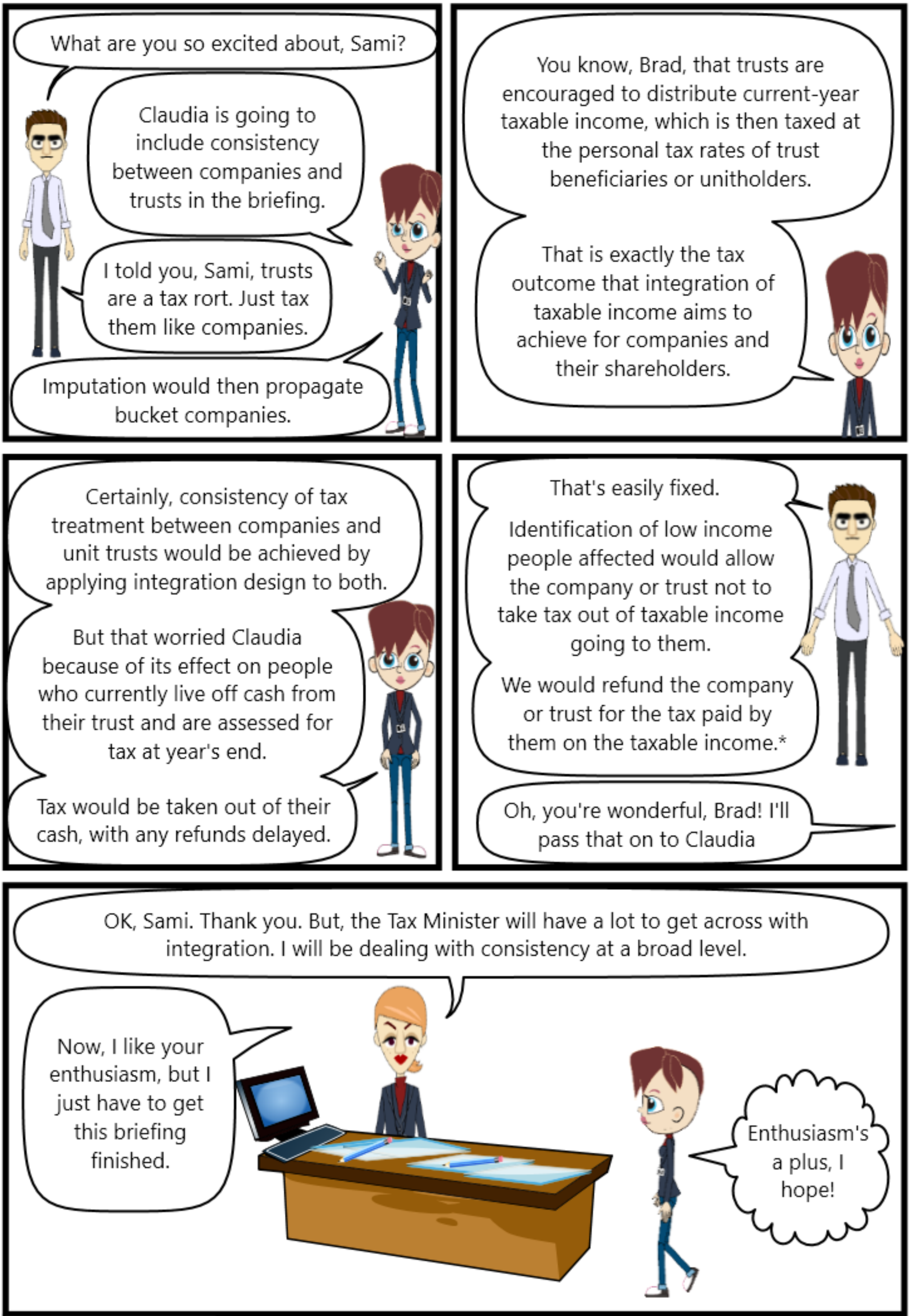

Brad, the funds advise members of annual earnings.
An extra admin push to align taxable income with earnings would do so much for fairness and simplicity.
OK, then. What about this?
All superannuation fund members get deductions for contributions made - so no tax applies, say, to wages used to make the contributions.
Then no tax on earnings within the funds.
But, finally, payouts from the funds are taxed in full at member's marginal tax rates.
How simple is that design?
And, high income members would be paying tax at their marginal tax rates.
Oh, Brad! that is **expenditure tax design**.
And you know what that means.
No tax at all would be paid on the income of funds that make regular investment returns.
Discount the tax ultimately paid on the payouts of such a fund back to the time of original wage earnings. The discounted amount is equivalent to the tax that would have been paid on uninvested wages - assuming an unchanged personal tax rate.
It's essentially just a tax on wages, Brad.
Now, I really have to get on with this briefing.
No tax, no tax, tax has such a nice ring to it.

What about consistency across collective investment vehicles?



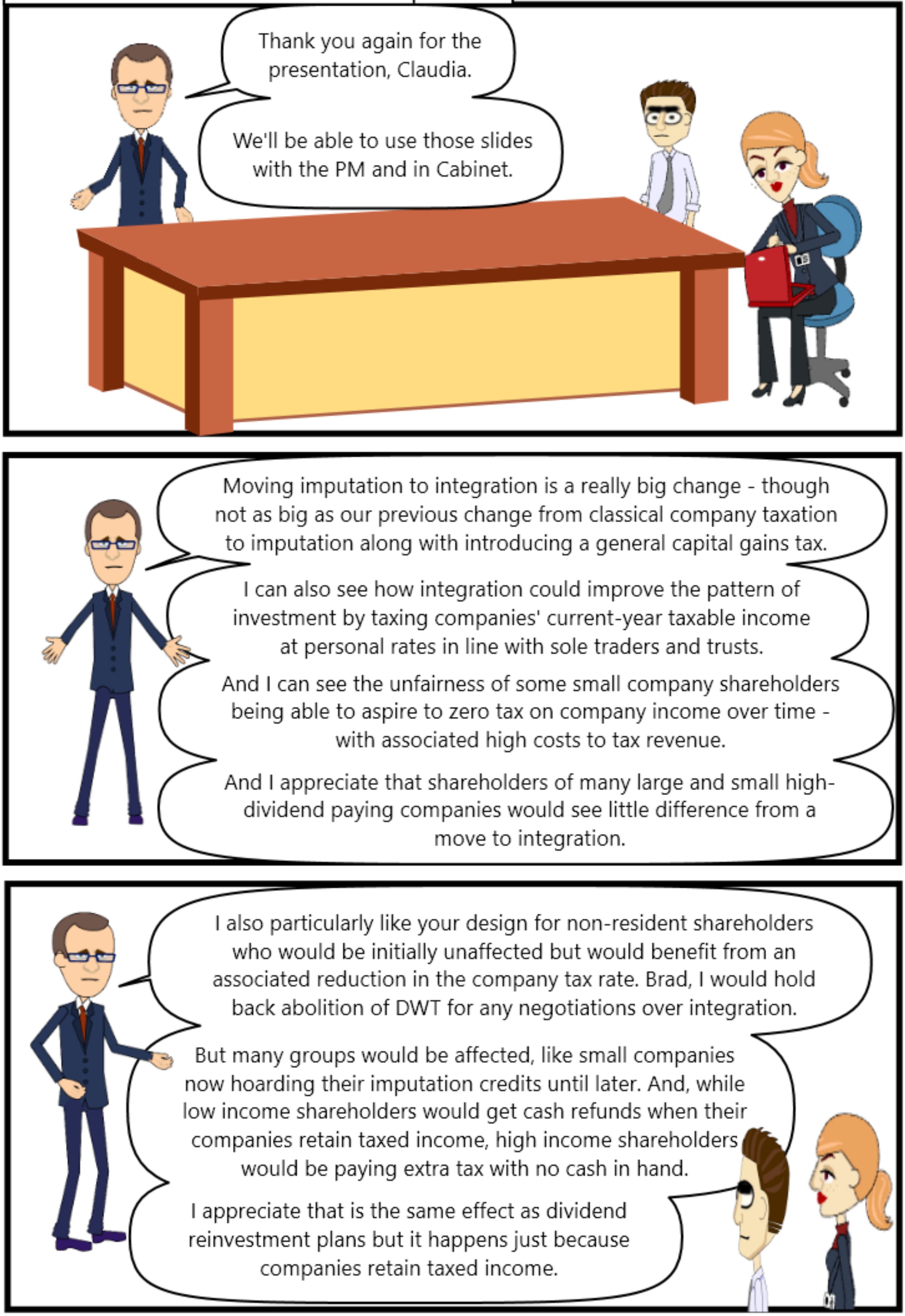
* Ch3, p 13.

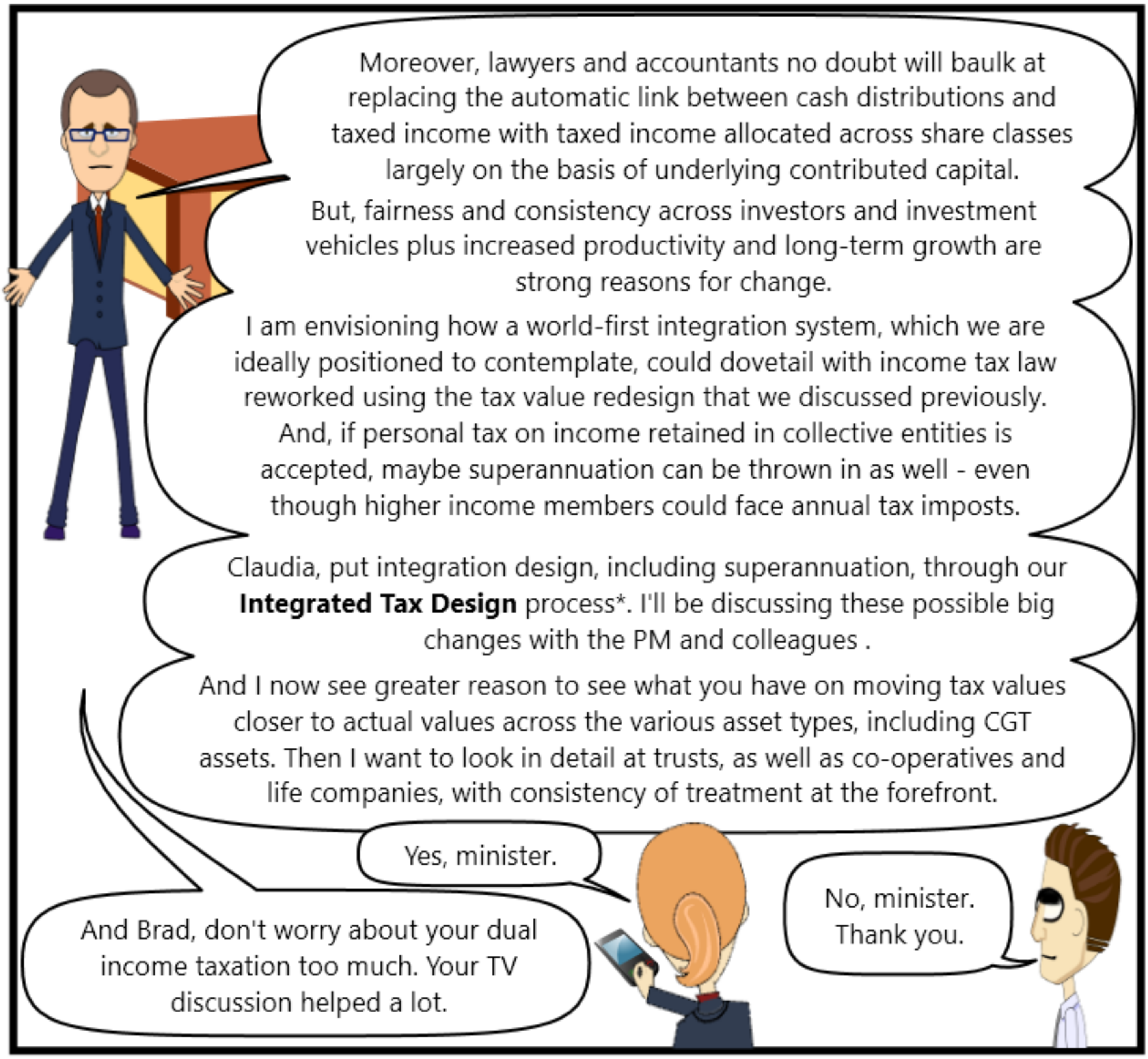
** Ch6, pp 15-30.

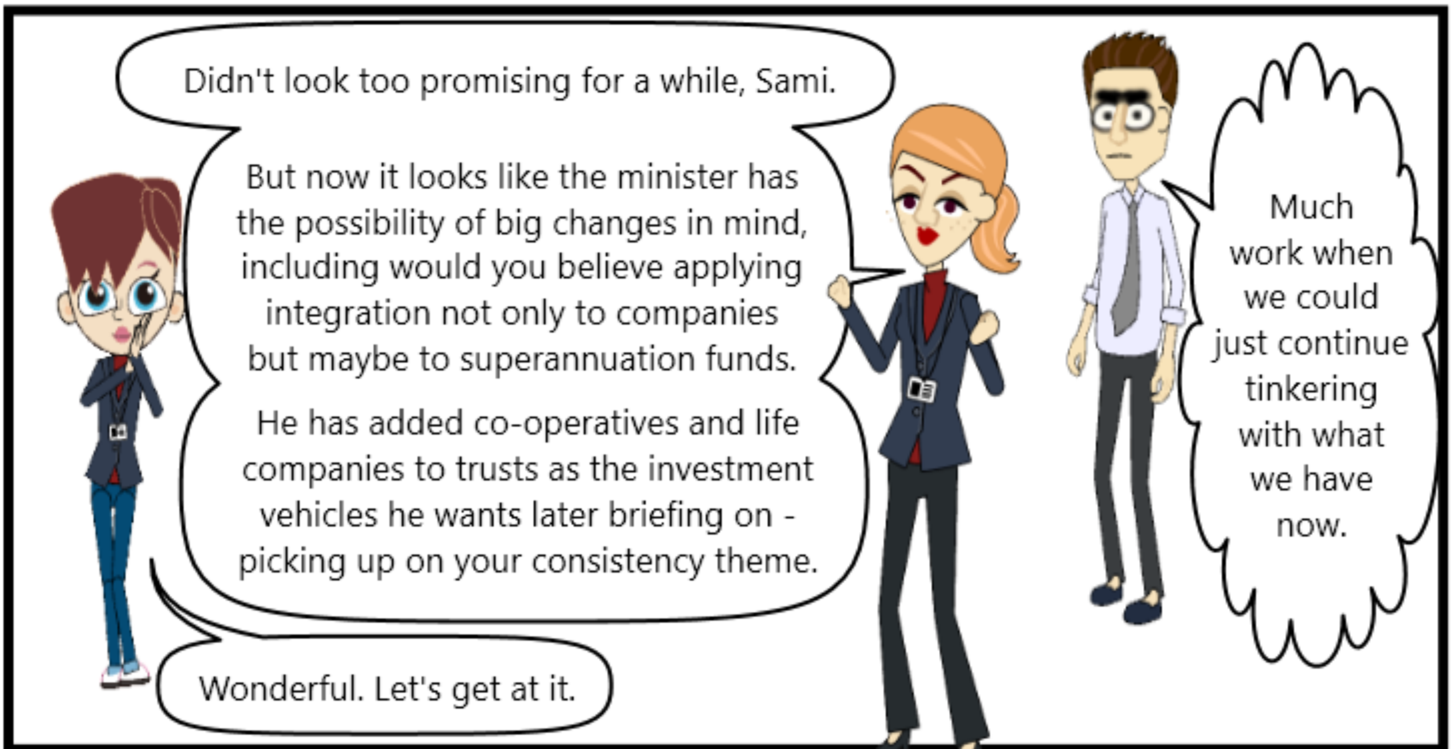


* Ralph Review, pp 421-423.

And how does the Tax Minister respond?







* Ralph Review, pp 95-97.