

BRAD

Chapter 3



UPGRADING IMPUTATION TO INTEGRATION OF TAXABLE INCOME

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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.

Integration would address that flaw in imputation design.



Sounds similar to Sami's points on TV about closely held companies seeking zero tax over time under imputation.

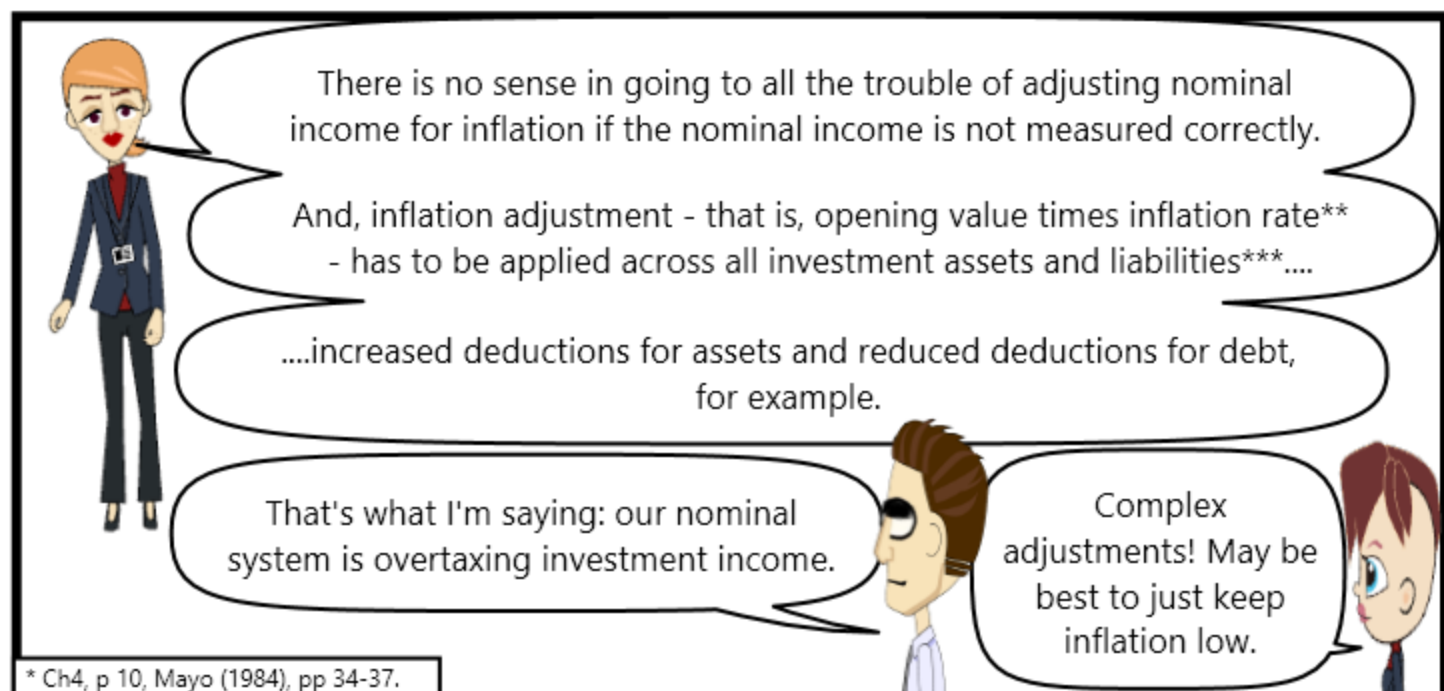
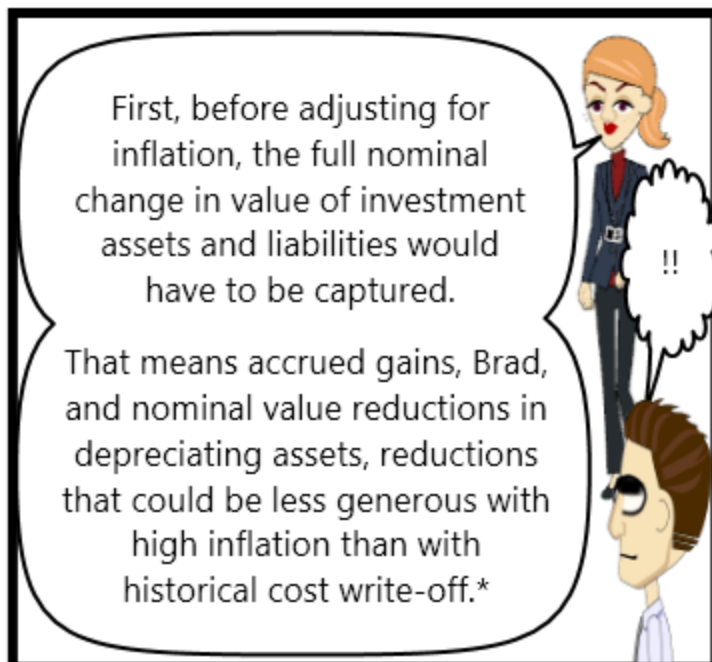
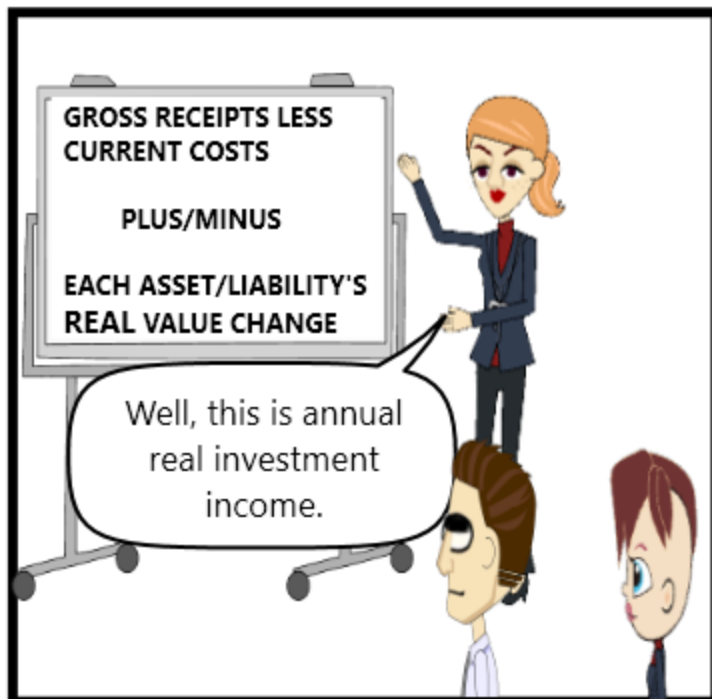
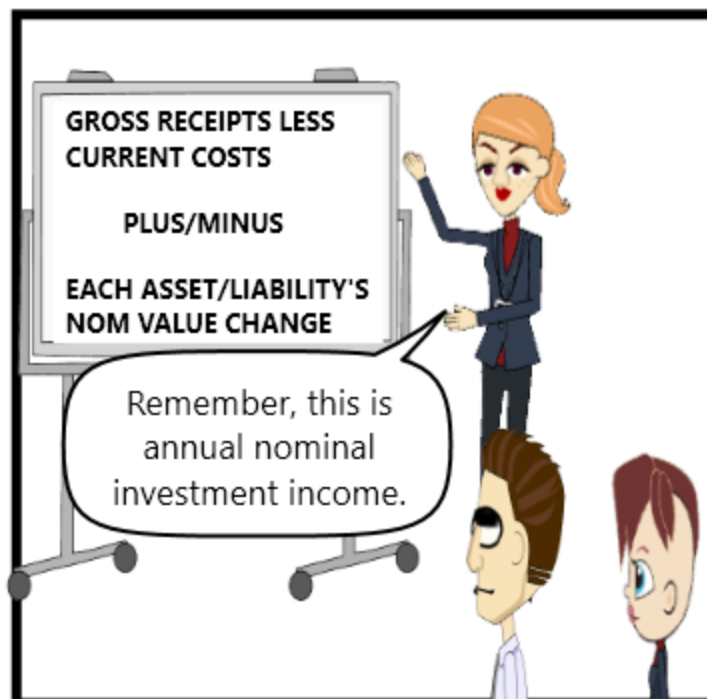
I understand that one of the key reasons Scandinavian countries introduced dual income taxation was because taxing nominal, rather than real, investment income overtaxed increases in real wealth.

Hence, the attraction of a single low rate over progressive personal rates.

Let's look at that in more detail.



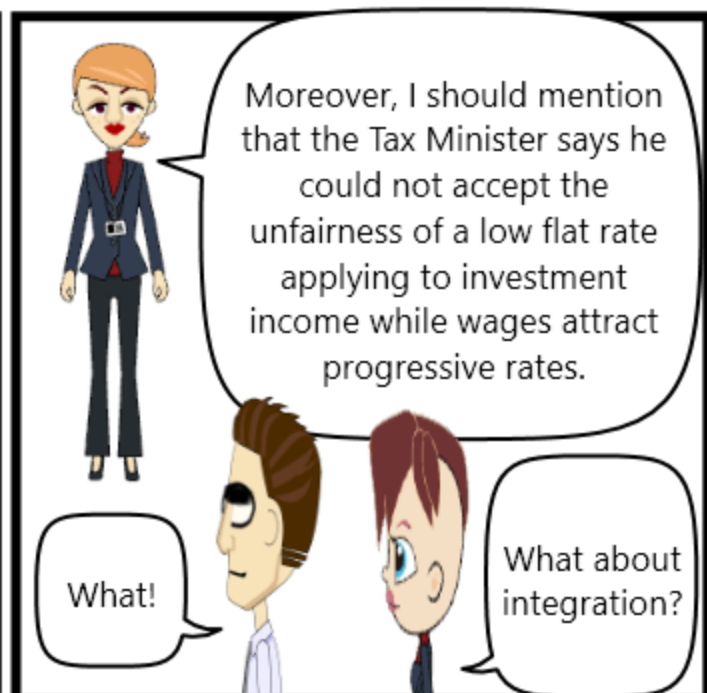
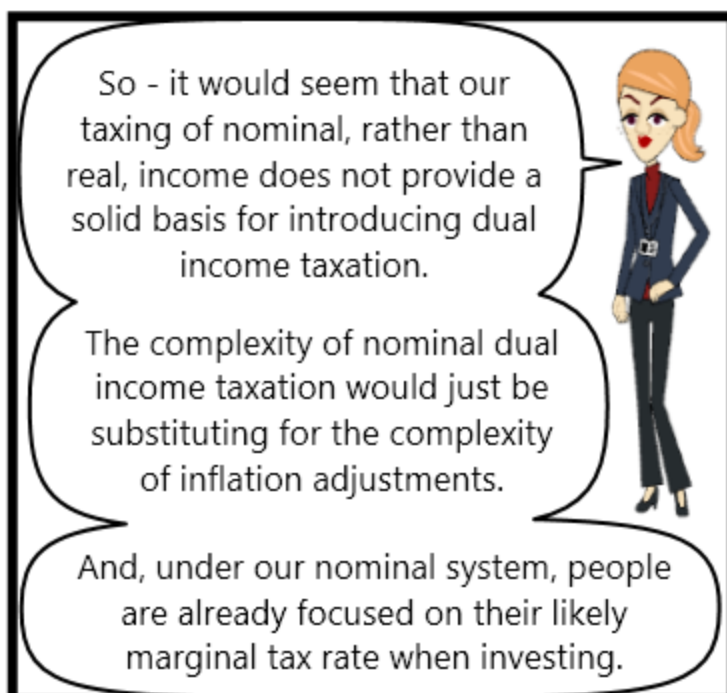
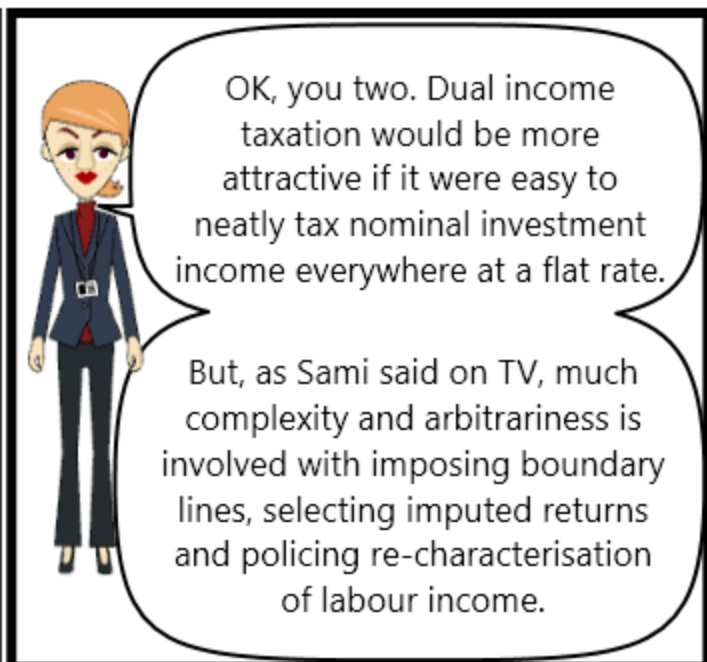
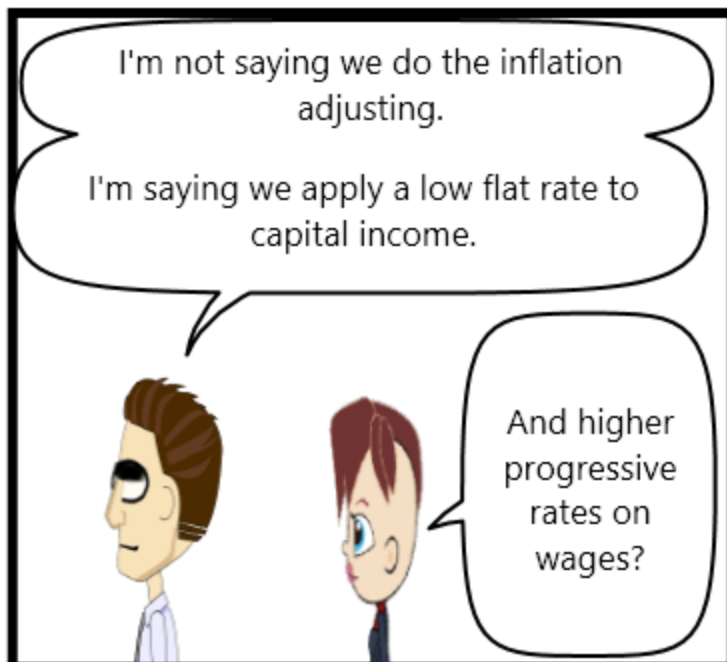
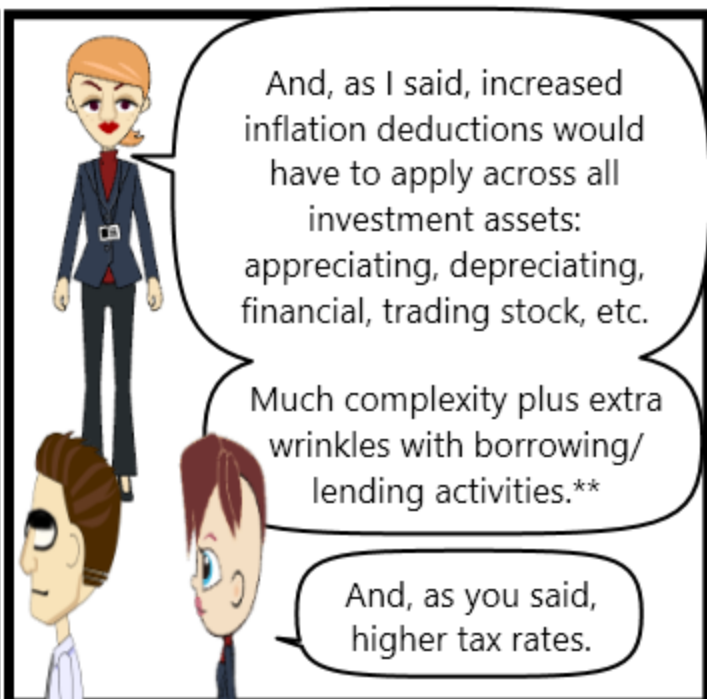
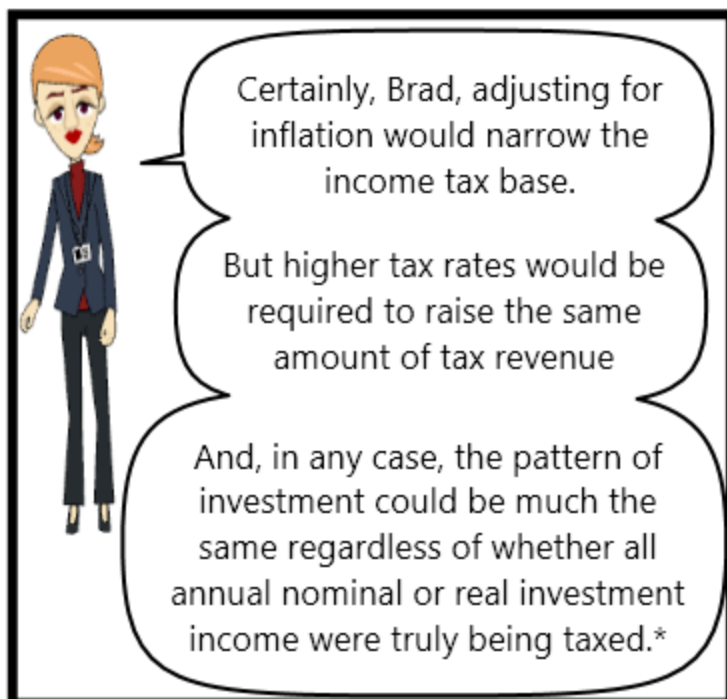
I'd like that, Claudia.



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

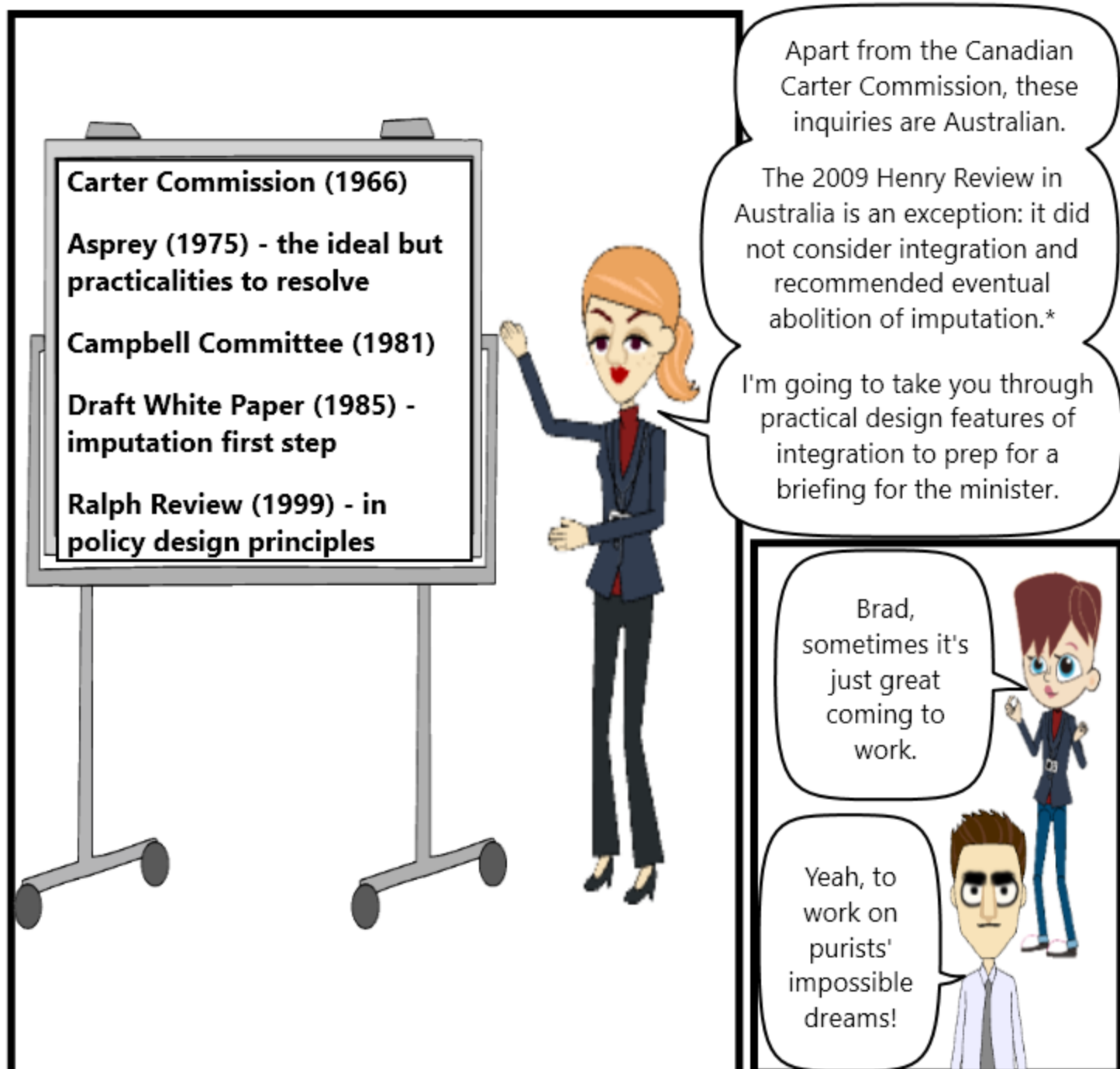
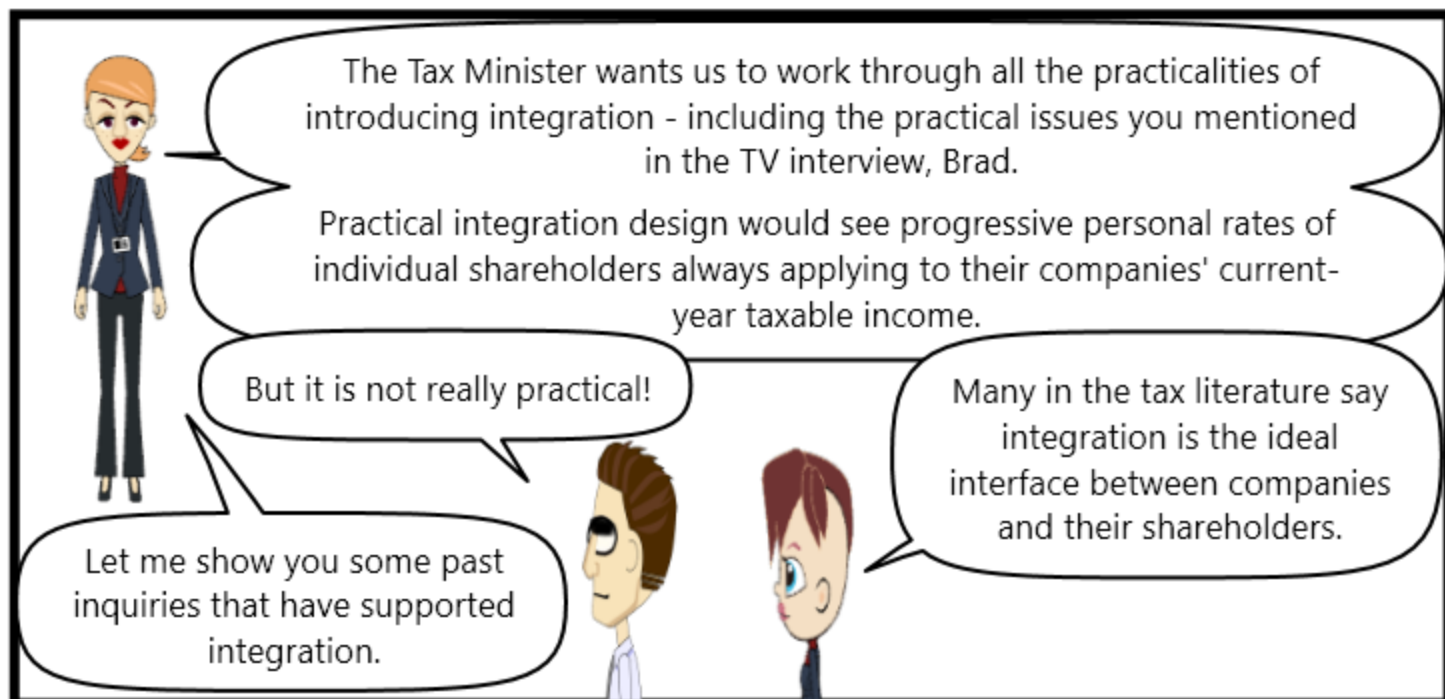
** Swan (1978), p4. Mayo (1984), pp 39-42.

*** 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.

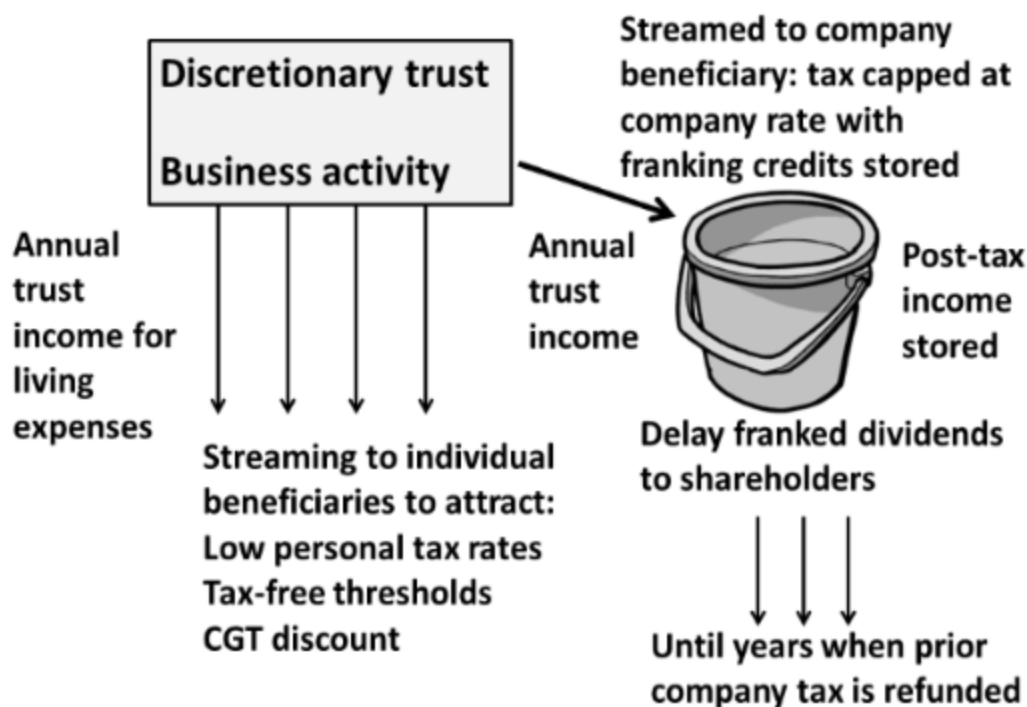


I have a simple illustration of that, Sami, using a company and trust structure.

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



In contrast, integration would have the annual taxed income of the bucket company immediately **allocated** to shareholders.

Complex laws would no longer be needed that seek to ensure companies' income is not accessed by shareholders, say, via loans, without being subject to personal tax rates.

Thus, integration would obviate the need for some complex anti-avoidance measures and would directly address serious tax revenue loss and major inequities arising from imputation's allowing taxed company income to be retained indefinitely.

These effects are exacerbated by the big gap between the company and top personal tax rates, as well as refundable imputation credits.

There would be many people most disgruntled with any proposal to remove the current tax advantages of imputation.

Like high income people now able to cap the tax on much of their income at the company rate for many years either by investing in large growth companies or controlling their own family company.

Enter our strong Tax Minister, who could use other arguments for integration beyond fairness and tax revenue savings.

Including those using family bucket companies looking for nil tax over time.

With integration there would also no tax incentive to incorporate.

Remaining biases between companies' local debt versus equity funding - favouring equity* - would be removed.

More soundly-based investments would be engendered, boosting productivity and long-term growth.

Most importantly, our company tax rate could be reduced as required to attract the long-term inwards foreign equity investor.

Domestically, the overall aim is to have shareholders paying tax on their companies' local current-year taxable income, just like sole traders and trust investors, even when the companies retain taxed income.

Good luck with that!

* See Ch2, pp 12-13.

Now, I'm going to start assuming companies have only one class of share with equal dividend rights and only local shareholders.

Then explain the basic design features* of integration of taxable income.

Under integration, annual - or, current-year - **taxed income** is always allocated to shareholders' tax assessments together with associated tax credits for company tax paid on the income.

That is regardless of whether the income is retained or distributed.

Companies therefore have no tax credits stored in franking accounts.

If annual cash distributions received by shareholders happen to match the annual taxed income allocated to them, the distributions will comprise fully franked dividends.

And shareholders' tax outcomes will be identical to those under full imputation.

But, if some or all annual taxed income is retained so that annual distributions are less than allocated taxed income, that's when things get more interesting.

Here we go!

Great.

When taxed income allocated exceeds cash distributed, the excess (retained taxed income):

- (1) is deemed to be reinvested by shareholders (similar to current dividend reinvestment plans, or DRPs);
- (2) is matched by an increase in the **CGT tax values** of shareholders' existing shares (substituting for new shares received under DRPs); and
- (3) gets added to shareholders' contributed capital account (not classed as retained earnings).

Unlike, DRPs, shareholders would not be choosing whether or not to participate.

Could you explain these features, Claudia?



These design features seek to avoid either double tax or double deductions that might otherwise arise through the interaction of CGT and company income tax arrangements.

I will contrast their effect of under **integration** with current CGT interaction with our **imputation** system.

With both integration and imputation, I'll have a company with share capital of \$1000 acquire that asset we have studied before for \$1000.



You remember the \$1000 asset that produces a 10% pa pre-tax return, or \$100, from \$250 net receipts less \$150 reduction in value.

If the asset attracted 15% tax depreciation, or \$150 in its first year, the company would pay 30% tax on \$100 of taxable income.



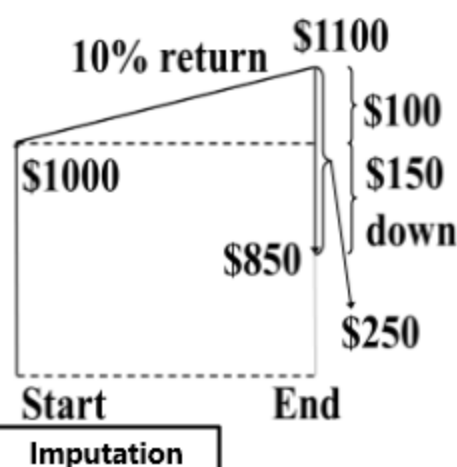
Because tax depreciation matches actual reduction in asset value, the \$100 of taxable income matches economic income, or commercial profit.



Then, if all post-tax cash were distributed, shareholders would receive \$70 of franked dividends and \$150 return of capital as shown in my chart.

Nothing new there.

Sure, Brad, but, if the company retained all post-tax cash, there would be contrasting outcomes under imputation versus integration.



Under **imputation**, the company's value could still increase to pre-tax \$1100, as shown, if shareholders value the retained \$30 of franking credits \$ for \$. Shareholders paying \$1100 would know that, when the \$70 of franked dividends plus \$30 of franking credits are eventually distributed as \$100 of taxable income, they would get a matching \$100 CGT loss if they then sold their shares for \$1000.

The double tax via company tax plus CGT on prior share sales is removed. Net tax on the \$100 of income would come from those who sold their shares for \$1100.*

Oh, please..!!



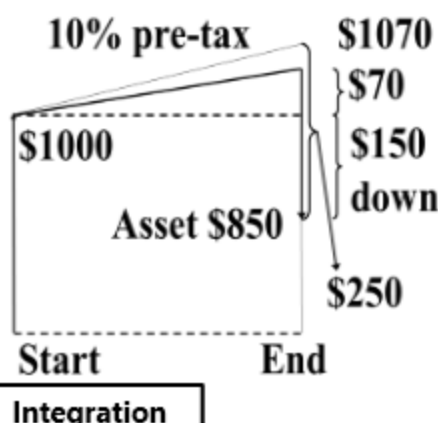
First, foreign shareholders put no value on our franking credits if they are not recognised at home.

They will try to trade their shares with locals who do value the credits.

Second, we halve CGT gains and losses.

I said on TV, half CGT may produce permanent double tax with imputation.*

OK, OK, Brad, The illustration is just to contrast integration, which I want to get back to now.



Under **integration**, the company's \$1000 asset still produces \$100 pre-tax income from \$250 net receipts less \$150 reduction in value.

But, now, even though the company retains its \$70 of post-tax income, that \$70 of taxed income and associated \$30 of tax credits are allocated to the tax assessments of the company's shareholders.

Because they are taxed at their current rates immediately, it is important that they are not taxed again via CGT if they were to sell their shares - this time for \$1070 because the \$30 of credits have been allocated and, so, not stored.



Hence the need to increase the CGT tax values of shares by the \$70 of retained taxed income - so there is no tax if shares are sold for \$1070. And that \$70 amount needs to be converted into contributed capital so it is not taxed when distributed.

The \$70 then attracts a decrease in CGT tax values of shares when distributed, as do returns of capital now - like distribution of the \$150 that is untaxed in the chart because of tax depreciation - to ensure no unjustified CGT losses on share sales.**

Hmmm. Franking credit trading might take a hit depending how retained income and credits are allocated.



Wow. Good one, Brad!

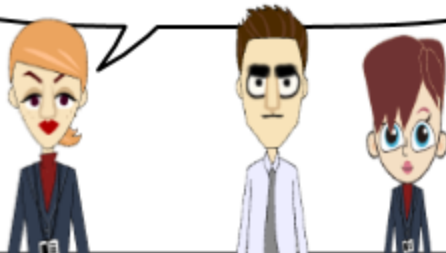
What about untaxed company income, Claudia?

* 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!

Part-year sales is a particularly important operational issue to consider even with just one share class.



So far we have been assuming shareholders hold on to their shares throughout the year.

Then, any cash distributions in a year to shareholders always absorb some or all of any taxed income that is allocated to shareholders in their year-end tax statement.

If cash distributions happen to match taxed income, the distributions are fully franked dividends - and any excess over taxed income triggers a matching reduction in the CGT tax value of the shares.



If allocated taxed income exceeds distributions, the excess is deemed to be reinvested with matching CGT tax value increases across the shares.



But....



That's the design so far.



But, of course, people are buying and selling shareholdings all the time.

And, during a year cash distributions are paid to shareholders who happen to be on a company's register on specified record dates.

With a changing share register, how do distributions absorb taxed income and how is any remnant taxed income allocated to shareholders?



The good news is that these practicalities do not change the design principles that we have discussed so far.

Cash distributions would still first absorb available current-year taxed income.

But, in order to mitigate the channelling of taxed income to particular shareholders, the proportion of taxed income allotted to each cash dividend would match the fraction of the year between the dividend and either the start of the year or the time of the last within-year distribution.

Right on, Sami.



Oh, very simple!



So, at year's end, equal levels of cash distributions during a year could have unequal franking rates if paid unevenly across a year.



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.



How do we deal with multiple share classes under integration?*



Remember guys, the over-arching aim of integration is to have current-year taxable income of a company attract the personal tax rates of local shareholders across all the company's share classes.

And we have seen that, for ordinary shareholders with equal dividend rights, their company's annual taxed income is allocated to them even if no cash distributions are paid out.



However, we also saw how any cash distributions received by ordinary shareholders first absorb available annual taxed income - subject to adjustment for the timing of within-year distributions.

And how any excess of annual taxed income over cash distributions is deemed to be reinvested and added to shareholders' contributed capital account.



I would call ordinary shareholdings a **non-discretionary** class of share - because their dividend rights are not at the discretion of their companies' boards.

Other non-discretionary share classes include preference shares that attract cash dividends ahead of those for ordinary shareholders, set at, say, a fixed or floating percentage of face value.



There are also deferred shares which deserve particular attention.

They are subordinate to other classes and, while their contributed capital might be consistent with that of regular ordinary shares, they may command a higher share of cash dividends, though in specified circumstances - like improved cash flow or after other classes have received adequate dividends.

This discretionary nature of cash dividend payments gives them a flavour of regular **discretionary** shares.



What are discretionary shares?

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 (discretionary 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.



Cash distributions need not be affected by the introduction of integration.

But, of course, under integration of taxable income, annual taxed income included in year-end slips - along with associated franking credits - always needs to be allocated across a company's various share classes ...

... regardless of whatever prior cash distributions were made to the classes in the year.



A key design requirement of integration therefore is to ensure that the allocation of annual taxed income across share classes is made on a sound economic basis as far as possible.



Sounds logical.

First, take **non-discretionary** share classes, other than preference shares.

For those classes, the allocation of taxed income could draw on the economic substance of a company's capital structure.

Thus, taxed income could be spread across these classes such that an equal percentage of taxed income to contributed capital is achieved for each class.



That's right, Brad.

Separate capital accounts would be needed.



Good one, Brad!

There needs to be a separate contributed capital account for each such share class.*

Taxed income allocated to a class, but not matched by cash distributions and therefore reinvested, would be allocated to the separate account for that class.



OK.



The year-end level of franking of prior distributions for the year to each such class would be reduced below 100% to the extent that cash distributions exceeded allocated taxed income.

But, note that, when allocated taxed income is more than cash dividends, 100% franking can be visualised because the excess allocated income is deemed to be distributed and then reinvested.



* 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 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.

Ah, yes,
discretionary
shares always raise
streaming issues.



What about
discretionary
shares then?

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.



Here are the high level differences between imputation and integration.

Yeah. Should keep unfranked dividends.



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.



Here is how taxed income is allocated across share classes under integration.

Hmm...

Neat.



No doubt details would change once our administrators and lawyers get a go at it - if the Tax Minister agrees - but it's a start.

OK, let's move on to non-resident shareholders.

The design features we already have help with that issue.



I know I wasn't too excited about integration in the TV interview, Claudia.

But, based on my long experience, if the desire is strong enough, it could be done.

But we definitely should keep unfranked dividends instead of CGT adjustments for distribution of untaxed income.



Wow, Brad!!

Right, how do we deal with non-resident shareholders?*



The key practical point here is that most other countries are not going to mirror our integration treatment of taxed income in their laws. In particular, they are not going to treat our companies' taxed income that is allocated to their residents, without being backed by cash, as dividends deemed to have been reinvested....

Of course not.



....and, to provide CGT tax value increases on the shares held by their residents in our companies for such allocated/reinvested taxed income.

But there is a simple practical measure that can leave non-resident shareholders unaffected by integration.*



Each class of share in our companies would not only have a segregated "regular" contributed capital account.

Each class would also have a segregated contributed capital account for allocated income not matched by cash and, therefore, reinvested.

Perhaps termed "allocated contributed capital account".

So?



So, for our resident shareholders, payments to or from the allocated contributed capital account would have all the same effects that we have discussed.

But, for non-resident shareholders, additions to this account would have no tax implications and payments to them from this account would be flagged in dividend slips as distributions of prior retained taxed income.

If their country is running a foreign tax crediting system, it can then decide how much of our company tax on the taxed income is to be credited.

If it exempts our dividends, as so many countries do, the significance of non-residents as an issue falls away.



All very neat.

* 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.



Here is a summary of the tax treatment of non-resident shareholders for the Tax Minister - with discretionary classes' distributions at least matching taxed income.

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).



And here is the practical impact on non-resident shareholders.

Highlights the need to retain unfranked dividends, with DWT payable on them by non-residents.



Good involvement, Brad.



OK, guys. Thanks for your input. I'll now finalise the briefing for the Tax Minister.



I still think it worthwhile, Brad, to contemplate worldwide productivity benefits from integration everywhere, including refundable credits in each country for foreign taxes on foreign income.



Get a life, Sami!

Excuse me, Claudia, I've been thinking about integration and superannuation.

Go on.

Well, you know how current taxation of super disadvantages low income members compared to high income members.

And that relative or absolute disadvantage applies at each stage: contribution, accumulation and pension.

Yes.

Contributions are generally taxed at 15%, in the fund, of course.

Super fund income is taxed in the fund at 15% while accumulating.

And, when pension phase is triggered, the income of superannuation funds is not taxed at all.

But high income members could be taxed at 47% on income outside superannuation - while the lowest income members would be paying no tax at all.

Exactly, Claudia. It is an unfair wealth generator for high income people.

And I figure that twofold change would remove this unfairness.*

First, members make post-tax contributions. Second, members' current-year taxable super income, along with credits, etc, gets added to their personal tax assessments....

....which, of course, is integration design.

And, with superannuation, integration would not have the complexities of part-year sales, chains of funds, multiple ownership classes and foreign members.

Required, but equitable, concessional treatment would come via members' tax returns.

And a refundable tax rebate at a percentage of allocated, but untaxed, taxable super income could see low income members receive annual cash refunds while high income members have their extra tax payable reduced significantly.

There would be no pension phase and no tax on withdrawals.

Hmm. Controversial, with higher-earning members paying tax on income reinvested. But, you know, Sami, I might just find a way to touch on this in my briefing to the minister.

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

Claudia, Sami just told me about her crazy idea of having superannuation members with higher incomes pay tax on reinvested super income they can't access immediately.

Yes, integration, but with tax rebates.

To address disadvantage faced by lower income people from current super fund tax design, we just need four new measures - with tax still paid by the funds, of course.

First, we need a low income tax offset to ensure super members with incomes below a set level pay no more tax on their contributions than on their income outside super.

Second, we need an extra 15% tax applied to concessional, or before-tax, contributions made by members with incomes above a specified level.

Then, we need a specified limit on the size of investment funds members can transfer to their superannuation pension phase.

Finally, we need to apply an extra 15% tax on the percentage of fund taxable income corresponding to the proportion of a member's total super balance above a specified limit.

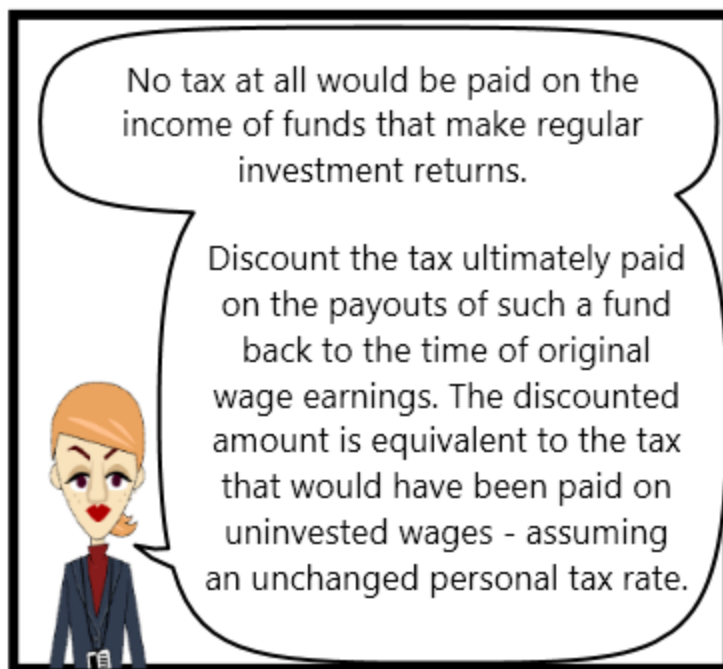
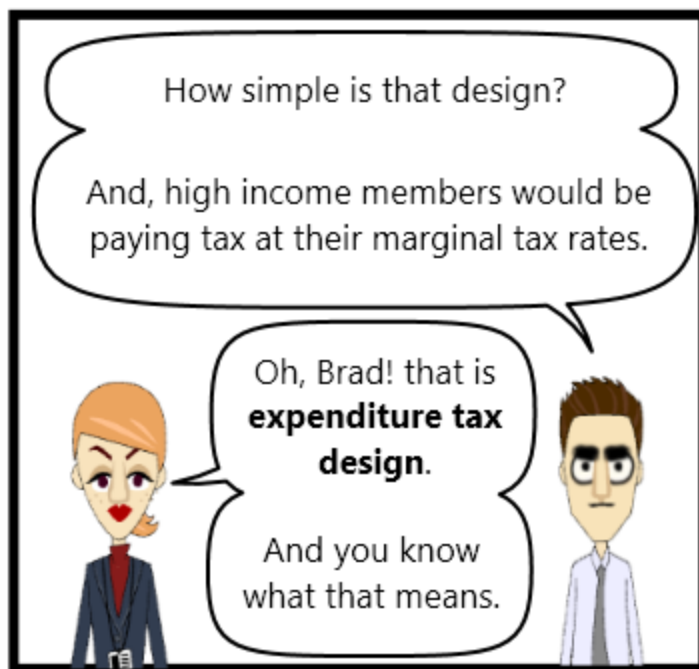
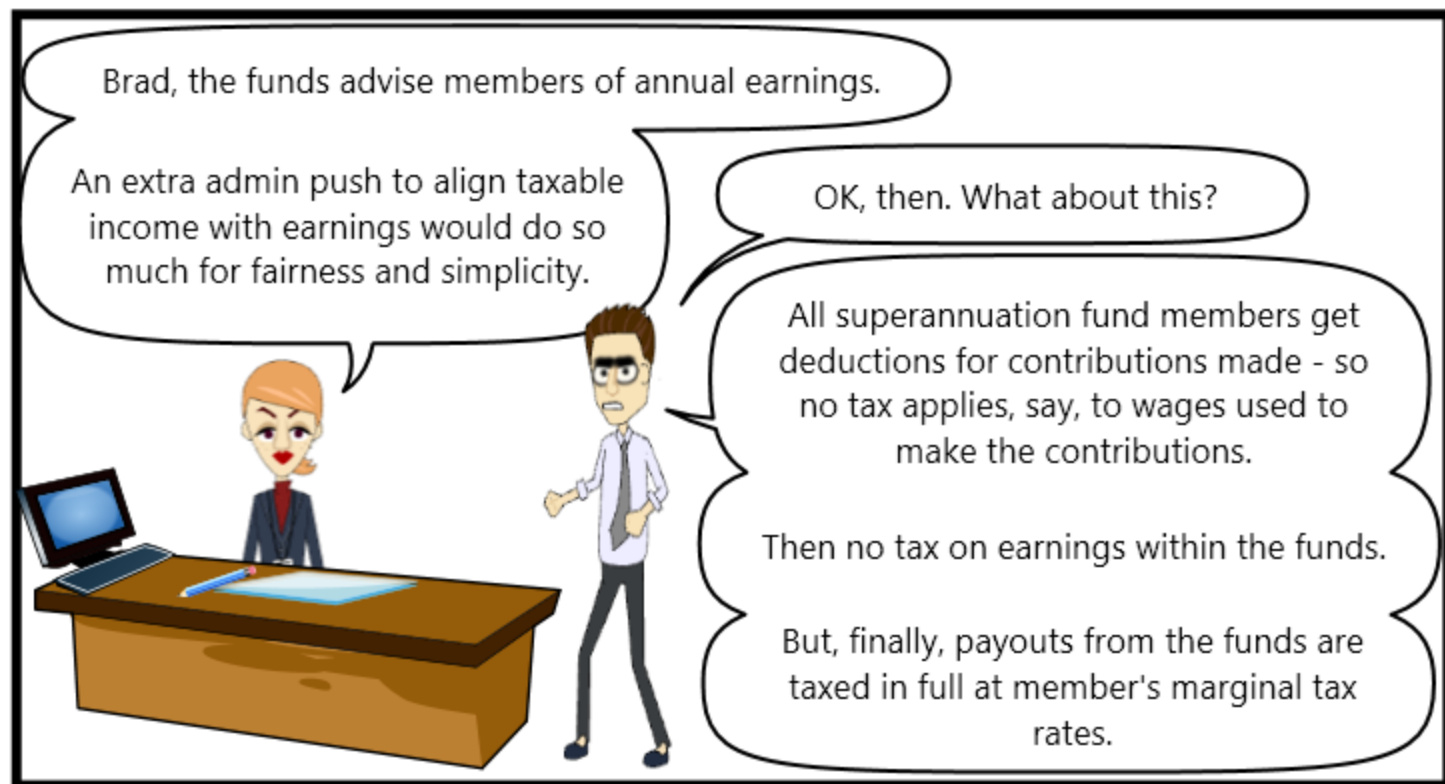
Beyond these measures, of course, the annual monetary limits continue on the amount of contributions that come out of after-tax income or attract concessional rates.

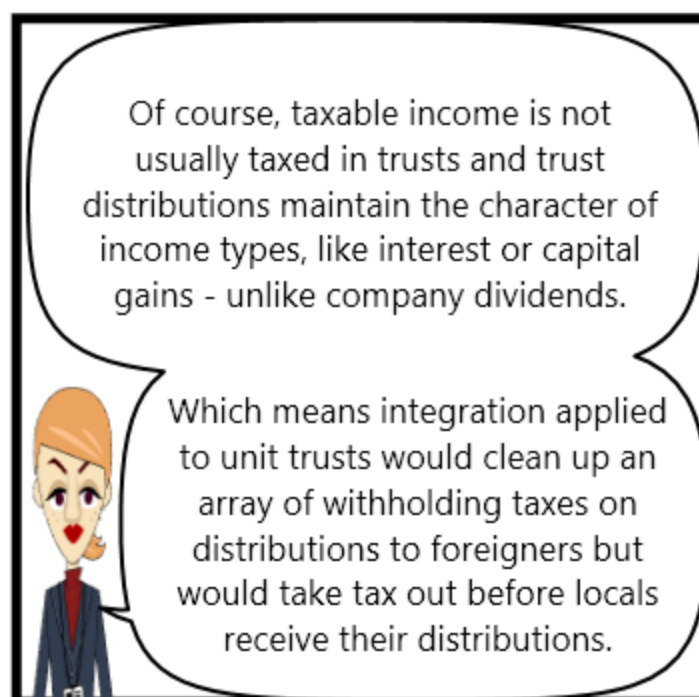
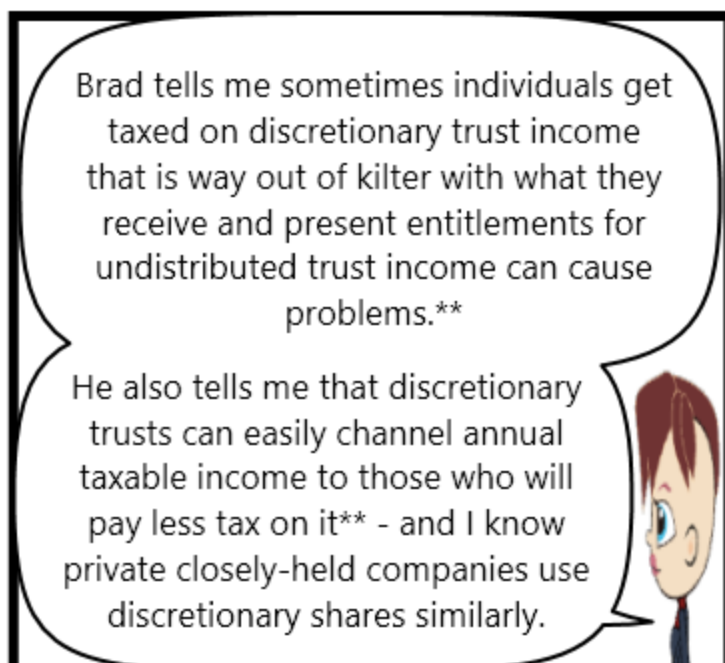
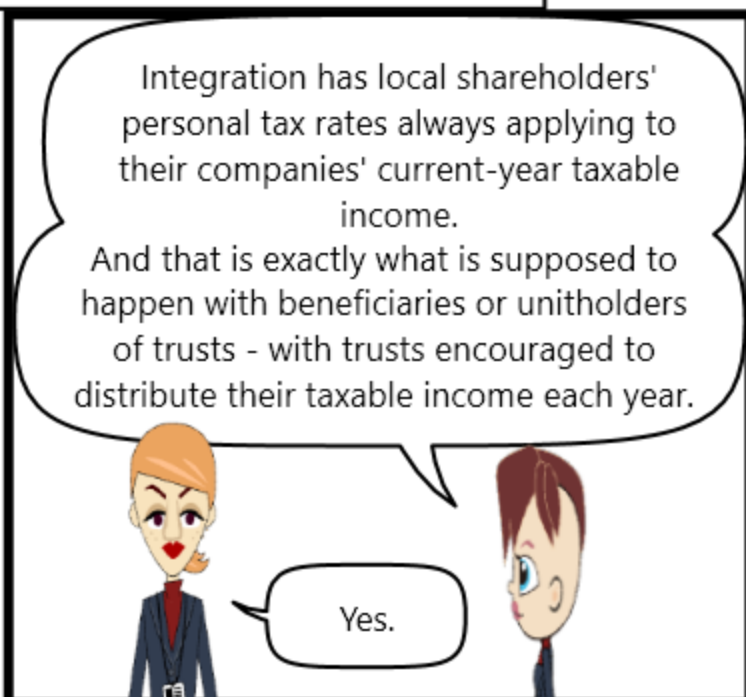
Brad, your four measures do seek to address relative disadvantage imposed on lower income members by the structure of our superannuation tax design.

But Sami's design of contributions coming from after-tax income and integrating member's super taxable income with their annual tax assessments would address that disadvantage simply and directly.

And, smart structuring of concessions in tax returns could reduce the need for limits on contribution amounts. But, admittedly, some members may pay tax outside their funds.

The big super funds will say tax in the funds is needed because they can't allocate taxable income to individual members.





* Ch3, p 13.

** Ch6, pp 15-30.

What are you so excited about, Sami?

Claudia is going to include consistency between companies and trusts in the briefing.

I told you, Sami, trusts are a tax rort. Just tax them like companies.

Imputation would then propagate bucket companies.

You know, Brad, that trusts are encouraged to distribute current-year taxable income, which is then taxed at the personal tax rates of trust beneficiaries or unitholders.

That is exactly the tax outcome that integration of taxable income aims to achieve for companies and their shareholders.

Certainly, consistency of tax treatment between companies and unit trusts would be achieved by applying integration design to both.

But that worried Claudia because of its effect on people who currently live off cash from their trust and are assessed for tax at year's end.

Tax would be taken out of their cash, with any refunds delayed.

That's easily fixed.

Identification of low income people affected would allow the company or trust not to take tax out of taxable income going to them.

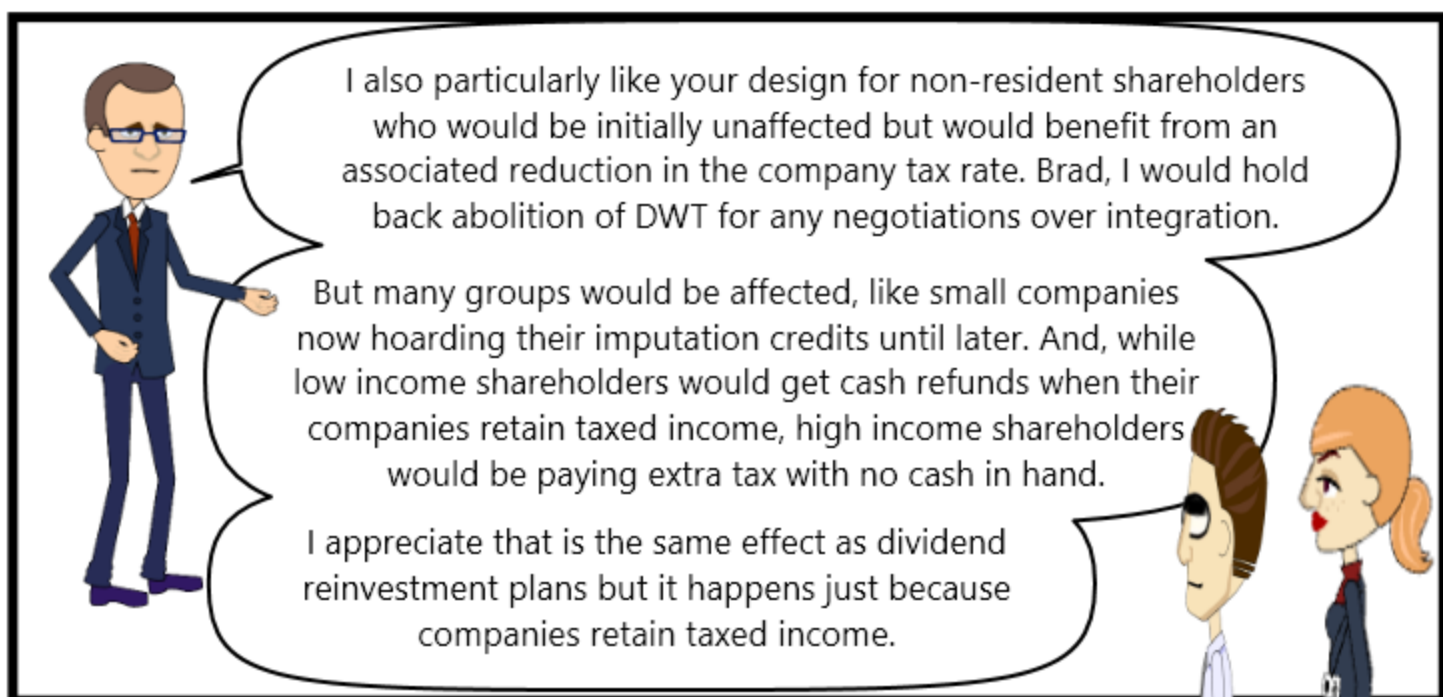
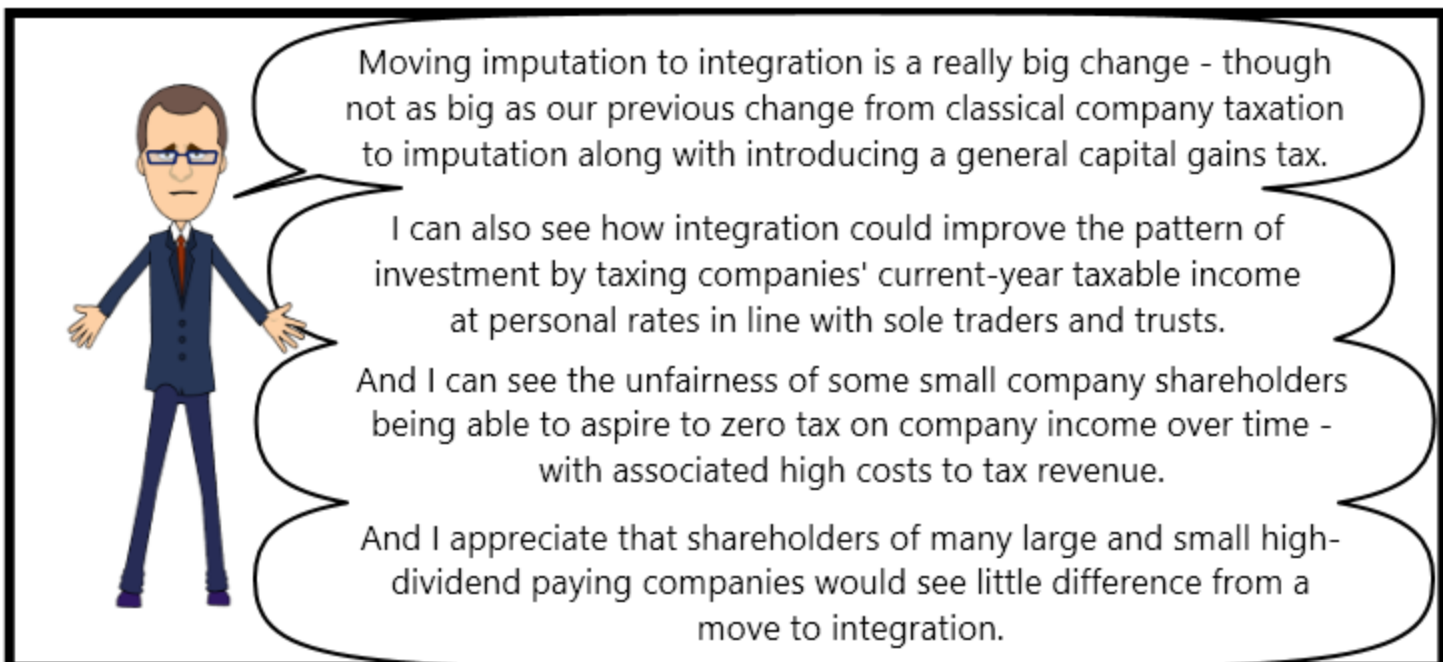
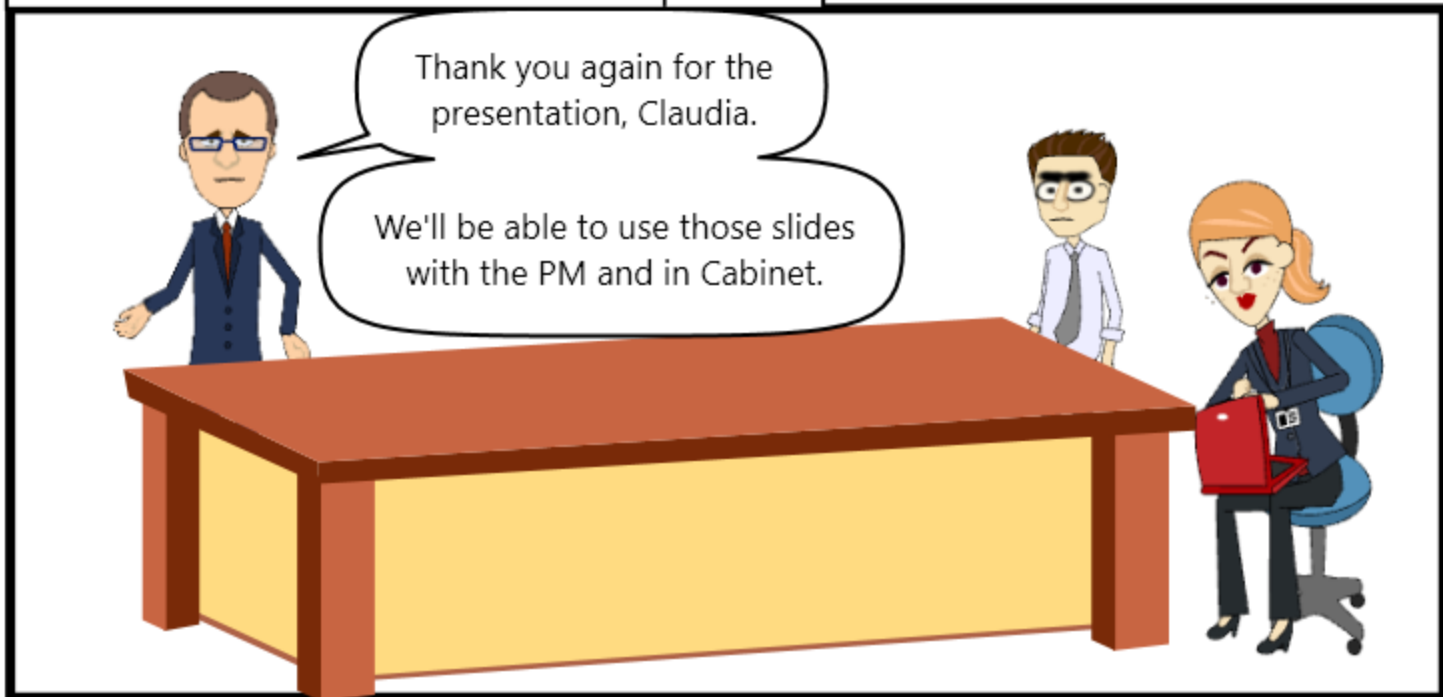
We would refund the company or trust for the tax paid by them on the taxable income.*

Oh, you're wonderful, Brad! I'll pass that on to Claudia

OK, Sami. Thank you. But, the Tax Minister will have a lot to get across with integration. I will be dealing with consistency at a broad level.

Now, I like your enthusiasm, but I just have to get this briefing finished.

Enthusiasm's a plus, I hope!





Moreover, lawyers and accountants no doubt will balk at replacing the automatic link between cash distributions and taxed income with taxed income allocated across share classes largely on the basis of underlying contributed capital.

But, fairness and consistency across investors and investment vehicles plus increased productivity and long-term growth are strong reasons for change.

I am envisioning how a world-first integration system, which we are ideally positioned to contemplate, could dovetail with income tax law reworked using the tax value redesign that we discussed previously.

And, if personal tax on income retained in collective entities is accepted, maybe superannuation can be thrown in as well - even though higher income members could face annual tax imposts.

Claudia, put integration design, including superannuation, through our **Integrated Tax Design** process*. I'll be discussing these possible big changes with the PM and colleagues.

And I now see greater reason to see what you have on moving tax values closer to actual values across the various asset types, including CGT assets. Then I want to look in detail at trusts, as well as co-operatives and life companies, with consistency of treatment at the forefront.

Yes, minister.

And Brad, don't worry about your dual income taxation too much. Your TV discussion helped a lot.

No, minister.
Thank you.

Didn't look too promising for a while, Sami.

But now it looks like the minister has the possibility of big changes in mind, including would you believe applying integration not only to companies but maybe to superannuation funds.

He has added co-operatives and life companies to trusts as the investment vehicles he wants later briefing on - picking up on your consistency theme.

Wonderful. Let's get at it.

Much work when we could just continue tinkering with what we have now.

