Dividend Imputation

By Michael Kemp

It's a shame phrases like "dividend imputation", "franking credits" and "tax deferred income" are used. Ascribing a foreign language to simple concepts turns most people cold. If I had my way I'd rename most tax, business and economic principles using simple English.

The purpose of this article is to lift the fog surrounding the who, what, where and why of tax payable on stock dividends.

Double taxation

Individuals, companies or trusts; we all pay our pound of flesh to the Australian Tax Office. Fair enough if we want our government to operate. But prior to 1987 a large group of Australians were paying more than their fair share. Owners of shares had to pay tax on company profits twice. The first hit was at the company level, before dividends were distributed. The second hit was in shareholder's hands, payable at their respective personal income tax rate.

It didn't seem fair. The Hawke/Keating government thought the same. So, in 1987 they introduced dividend imputation which saw the end of taxing company profits twice. Forget the fancy title; understanding how the system works is fairly straight forward.

What is dividend imputation?

In abolishing the double taxation of dividends the government had a choice. Did it eliminate the tax at the company level or the personal level? The system we have today - of dividend imputation - effectively eliminates the tax paid at the company level. To demonstrate how it works an example is in order. Let's look at things from the perspective of a typical shareholder, Joe Citizen.

Consider a company pays a dividend of 70 cents per share. This distribution is made after tax has been paid at the company rate of 30%. So for every dollar the company pays out 30 cents goes to the tax office and 70 cents to shareholders.

To calculate the amount of tax Joe pays we undertake 3 steps:

Firstly we add back to Joe's 70 cent dividend the tax already paid by the company. That is the 30 cents it previously forwarded on to the ATO. This gives us our original figure of $1, the amount the company had before it paid tax and a dividend. This is often referred to as the grossed-up amount.

Secondly we apply Joe's rate of personal income tax to the $1 (let's call his tax rate 46.5%). That gives us the tax payable in Joe's hands - 46.5 cents.

And thirdly - here comes the good news. Since the Tax Office has already received 30 cents Joe only has to pay another 16.5 cents per share to meet his tax obligation.

The additional tax paid by Joe represents the difference between the corporate tax rate and his marginal tax rate. What then of a shareholder whose marginal tax rate is below the 30% corporate tax rate? The news is even better for him. He receives a cheque in the mail. The tax office refunds the difference between his personal tax rate and the corporate tax rate.

Why is this referred to as dividend imputation? Imputed means “representing” or “assigned”. The tax paid by the company is assigned to the shareholder.

What are franking credits?

Franking credits represent the tax paid by a company on the earnings it has distributed as dividends. You will also hear reference to the franking account. This is not an account containing money. It is simply a record of the tax which has already been paid by the company. Franking credits are paid out of the franking account. And because franking credits are only of use to shareholders, most companies are usually quick to pass them on.

It is easy to find out the size of the franking credit attached to any dividend you receive. Companies supply a dividend statement to shareholders, either by email or post. This states, as a separate item, the amount of the franking credit. A dividend, which has a franking credit attached, is referred to as “a franked dividend”.

What determines the level of franking credits?

Dividends are usually 100 per cent franked for companies paying tax on Australian-derived income. But dividends are not always fully franked. For example, when a company generates income overseas, or experiences losses rather than gains, the franking account can be insufficient to pay a fully franked dividend. Under these circumstances the dividend could be partly franked or it might not be franked at all.

Dividends with no franking credits are referred to as unfranked dividends. These dividends cannot be “grossed up” hence the tax payable in the shareholder’s hands is calculated by applying the shareholder’s marginal tax rate to the dividend they receive – with no adjustment.

Where dividends are partly franked they are grossed up only by the franked portion. This is clearly shown on the dividend statement. It will be listed as an actual dollar amount.

Who are franking credits attractive to?

Franking credits are attractive to most shareholders (exceptions are mentioned below). But this hasn’t always been the case. Until 11 years ago, franking credits were wasted on Australian taxpayers in low tax brackets. If the franking credit (the tax the company had already paid) was more than what the shareholder would have paid by applying their personal tax rate to the grossed up dividend then too bad. The ATO kept the difference. In other words, the franking credit was wasted, either wholly or in part.

That all changed on 1 July 2000. Since then the ATO has refunded unused franking credits. This has benefited superannuation funds and those on the lower rungs of the PAYE tax scale.

Fine-tuning the Tax Act

Like all tax codes, ours has developed special exemptions and additions over time – the bells and whistles that convert something which started off being simple into something more complex. Below are a couple of these changes:

1. In 2003 New Zealand companies could choose to offer franking credits on Australian tax paid.

2. Holding period eligibility rules were introduced. They stated that to be eligible to use franking credits certain requirements had to be met. Either you:

> Had to have owned the shares for a minimum continuous period of 45 days
>
> OR:
>
> Had total franking credits for the year of less than $5,000

This meant that short-term traders couldn't claim the franking credits. However, small holders were exempted provided they had not arranged to pass on the benefits to someone else.

Real Estate Investment Trusts (REITs)

Distributions made by REITs require a special mention. They are typically untaxed in the trust's hands (i.e. they don't come with franking credits attached). But they are taxable in the hands of unit holders. Calculating the tax liability is not straight forward. It is determined after adjusting for tax concessions such as depreciation allowances and also tax-deferred income. The proportion of tax-deferred income varies depending upon a REIT's particular circumstances. For a worked example refer to the ASX website at: http://www.asx.com.au/products/tax-deferral-example

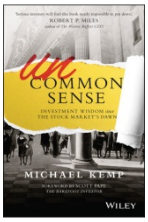
To read more of Michael Kemp's work

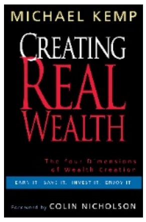
Previous Articles

All Michael's previous articles for the website are now on the *Michael Kemp Articles* page on the Free Resources menu. They are now listed by title with a brief description of their contents.

Books

Michael has written two books, both of which are available for purchase from the ***Buy Books*** menu:





CREATING REAL WEALTH - The four dimensions of wealth creation

UNCOMMON SENSE - Demystify the complex world of investments and make your own investment calls

Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.