Dividend Imputation (Franking Credits)

Australia is one of the few countries that have a system of dividend imputation. It is really quite a simple idea, but it seems to be widely misunderstood in its effect. The most common misunderstanding is that some shareholders benefit more than others. This is incorrect.

Dividend imputation arose out of the situation where it was recognised that dividend income was taxed twice:

1. Dividends are paid out of company profits. Company profits are taxed in the hands of the company.
2. The company then pays dividends out of after-tax profits and those dividends are subject to tax in the hands of the shareholder.

Dividend imputation was introduced to effectively tax dividends only once at the marginal tax rate of the shareholder.

Before we go on, there are a few riders to this:

a. Non-citizens, who do not pay tax in Australia, cannot take advantage of the dividend imputation system (some have ways of reaping some advantage from imputed credits, but that is outside the scope of this article).
b. Dividends from profits on which tax has not been paid do not carry imputed credits. These are called “unfranked” dividends.
c. Dividend imputation is implemented by attaching imputed tax credits (or franking credits) to dividends. If a taxpayer cannot use the imputed tax credits to reduce their tax, or if the shareholder does not have a taxable income, the imputed tax credit that is unused is paid to them by the ATO after they have filed their tax return or they have submitted a claim in the absence of a tax return being required. This is important for understanding the following discussion.

Note: Some of this discussion is not precisely correct in some quite technical respects. I have tried to keep the explanation as simple as I can, so some of my wording may be a bit loose in a technical sense. Also there are various special situations that I have not mentioned in order to try to keep the discussion simple and focused. In particular, I have tried to keep the tax calculations simple by ignoring the Medicare levy and some other aspects. In one situation I used marginal tax rates as though they applied to the whole taxable income of the shareholder. This is, of course, incorrect, but it needed to be done that way to bring out the effect of taxation on the dividends and imputed credits. Moreover, it is correct to apply the marginal tax rate to a dividend for a shareholder who is a taxpayer: the marginal tax rate applies to the investment income, even if not to all of their taxable income.

The way dividend imputation works is very simple:

The shareholders receive a dividend statement that shows three amounts:

1. The amount of the dividend that is “franked”, which means that carries an imputed tax credit of 30% (currently - the company tax rate has varied over time).
2. The amount of the dividend that is “unfranked”, which means that it does not carry an imputed tax credit. (Some profits are earned overseas and not taxed in Australia or were offset by previous losses, so tax has not been paid on them).
3. The amount of the imputed tax credit that was generated by payment of the franked dividend amount.

Dividend imputation then works like this:

- All three amounts are shown in the shareholder’s tax return as income.
- The tax payable on the shareholder’s total income is calculated.
- The total imputed tax credit amount is deducted from the tax payable.

The important principle to grasp here is that the tax that was paid by the company is added to the shareholder’s taxable income so that the franked dividend is now shown as it would have been if the company was not taxed. This might be thought of notionally as being the pre-tax profit that the company has distributed to the shareholder. This notional pre-tax profit is then taxed in the shareholders’ hands at their marginal tax rates. Their tax payable is then reduced by the imputed tax credit (the tax that the company has already paid on that notional pre-tax profit).

The end result is that the profits generating the franked dividends are effectively only taxed once.

A simple example may help to understand what has just been explained.

Income other than dividends	$189,000
Franked Dividend income	7,000
Unfranked dividends	1,000
Imputed credits on franked dividends	3,000
Total taxable income	200,000
Tax at marginal rate of 45%*	90,000
Less Imputed credits on franked dividends	-3,000
Tax payable	87,000

* Ignores Medicare levy, tax-free threshold and tax scales for simplicity.

So, the tax of $3,000 that was already paid by the company on the franked dividend has been declared as income by the shareholder so that their income is the dividend, plus the tax already paid ($7,000 + $3,000 = $10,000). This amount of $10,000 is the pre-tax company profit from which the dividend is paid. The shareholder’s tax is then calculated on that pre-tax profit at their marginal rate. Then the shareholder’s tax payable is reduced by the imputed tax credit, which is the tax that has already been paid by the company on the profit that generated the dividend.

Thus, the taxpayer notionally receives the pre-tax profit amount, is taxed on it, but receives a tax credit for the tax already levied at the company level. The end result is that the dividend is only taxed once – at the shareholder’s marginal tax rate.

Now we can look at the very common misconception that some shareholders benefit more from imputed credits than do other shareholders. The main reasons for this misconception are:

1. A lack of understanding of dividend imputation. Hopefully, I have helped dispel that problem in the preceding discussion. See also Michael Kemp's article in Free Newsletter 114.
2. A lack of understanding about how tax that includes franking credits is calculated. The above discussion should also have addressed that issue.
3. Overlooking that tax saved is just equally as valuable as imputed credits that are refunded by the ATO.

This last point needs some explanation to get around one of the common cognitive errors that are discussed in my book *Think Like the Great Investors*: mental accounting. Basically, what is happening is that many investors are not conscious that a cost that is reduced is a benefit that has any relationship to money that is paid to them. In this case, one has to do with the calculation of tax - something they do not (try to) understand and leave to their tax accountant (the tax is then taken from their account by direct debit by the ATO). However, a cost avoided, leaves us more money to spend, does it not? For most investors, this is in another mental world to a cheque from the ATO for imputed credits, which they perceive as a windfall gain and something they can spend. The two transactions are in totally separate categories of their life, occur at different times and are different in nature. This is a great example of mental accounting. Mental accounting is dangerous to our wealth, because it can cause us to make sub-optimal decisions.

This table shows four different investors and how dividend imputation affects them:

	Taxpayer Max rate	**Taxpayer Low rate**	**SMSF Accum.**	**SMSF Pension**
Marginal tax rate	45%	19%	15%	Nil
Dividend	$70.00	$70.00	$70.00	$70.00
Franking Credit	$30.00	$30.00	$30.00	$30.00
Taxable Income	**$100.00**	**$100.00**	**$100.00**	**$100.00**
Tax (ignore M'care levy)	$45.00	$19.00	$15.00	$0.00
Tax credit	$30.00	$30.00	$30.00	$30.00
Net tax	$15.00	-$11.00	-$15.00	-$30.00
Franking credit refund*	$0.00	$11.00	$15.00	$30.00
Tax saved by franking	$30.00	$19.00	$15.00	$0.00
Total benefit of franking	**$30.00**	**$30.00**	**$30.00**	**$30.00**
* in the case of the taxpayer with a marginal tax rate of 19%, The franking credit refund is notional in this limited situation, but is a real benefit because it will reduce tax on other income.				

In the table, I have considered four shareholders:

- A taxpayer on the highest marginal tax rate of 47%
- A taxpayer on the low marginal tax rate of 15%
- A self-managed superannuation fund in accumulation mode (its marginal tax rate is 15%)

- A self-managed superannuation fund in pension mode (currently pays no tax)

If you thought that the self-managed superannuation fund in pension mode, that has all of the imputed credits paid to it by the ATO in a cheque, is the best able to take advantage of franking credits you are wrong and need to study this table!

The table shows that all four shareholders benefit equally from franking credits.

The key is the bottom line of the table – all four shareholders benefit equally ($30.00 in the example). The table shows how each shareholder benefits:

- The shareholder on the highest marginal rate saves $30 in tax. The $30 of tax that is avoided is **$30 that the shareholder has to spend** that they would not have had if they had paid the $30 tax.
- The shareholder on the low rate saves $19 in tax and gets a cheque for unused imputed tax credits of $11. That totals **$30 that the shareholder has to spend**.
- The Self-managed superannuation fund in accumulation mode is in the same position as the shareholder on a low tax rate. The fund has **$30** more available to ultimately pay as a pension i.e. **to spend by the beneficiary**.
- The self-managed superannuation fund in pension mode receives a cheque from the ATO for $30. The fund has **$30** more available to be taken as a pension i.e. **to spend by the beneficiary**.

So, each of the shareholders has **$30 more to spend** as a result of dividend imputation compared to the situation if the dividends they received were not franked – the situation we had before the introduction of dividend imputation.

Dividend imputation has been a benefit to shareholders by increasing their disposable income. Further, it does this equally, no matter what their tax situation.

Next time anyone tells you some shareholders are better off under dividend imputation, do your bit in helping them to avoid the mental accounting bias that has led them to that erroneous conclusion.

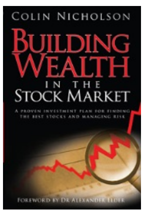
To read more of my work

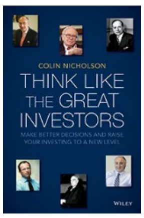
Previous Articles

All my previous articles for the free website are now on the *Educational Articles* page on the Free Resources menu. They are now listed alphabetically by title with a brief description of their contents.

Books

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





Building Wealth in the Stock Market – A proven investment plan for finding the best stocks and managing risk

Think like the Great Investors – Make better decisions and raise your investing to a new level

Members Website

Follow my thinking on my own investments, disclosure of my portfolio as I go, weekly market scans, weekly market charts and analysis plus many more articles about investing and analysis

I am one of the very few investors who publishes their investment results each year, which I have done since 2000 – see the Investment Returns page on the About Colin menu on the website