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How the government loses 48 per cent of company tax: Dividend imputation and franking credits.

Supplementary information on dividend imputation

Submission
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TAI

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Our philosophy

As we begin the 21st century, new dilemmas confront our society and our planet. Unprecedented levels of consumption co-exist with extreme poverty. Through new technology we are more connected than we have ever been, yet civic engagement is declining. Environmental neglect continues despite heightened ecological awareness. A better balance is urgently needed.

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Our purpose—'Research that matters'

The Institute aims to foster informed debate about our culture, our economy and our environment and bring greater accountability to the democratic process. Our goal is to gather, interpret and communicate evidence in order to both diagnose the problems we face and propose new solutions to tackle them.

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Introduction

On 16 October 2014 the Senate Community Affairs References Committee inquiry into the extent of income inequality in Australia asked The Australia Institute for some background briefing on how the role of dividend imputation in Australia was relevant to the committee's deliberations. The present brief attempts to address that request.

What is 'dividend imputation'?

The design of Australia's company and personal taxation systems aims to prevent the so-called 'double taxation' of dividends. The double taxation of dividends occurred before imputation as a result of the interaction of the company and the personal income tax systems. A company that earns a profit is liable to pay company tax. It may then pay a dividend to its shareholders who, in turn, are also liable to pay tax. There was some concern that the final after-tax income of the shareholder might be a small proportion of the original company profit.

The dividend imputation system was designed to address those concerns and so makes refunds to individual taxpayers to reflect the tax paid by the company and imputed to the individual. A numerical example helps here.

Take a company which makes a profit of $100. Assuming it has no deductions etc it will pay company tax at 30 per cent (or $30) leaving it with an after-tax return of $70. That $70 might be retained by the company or it may be paid out to shareholders as dividends. If the $70 is paid as dividends, then those dividends are again assessable in the hands of the dividend recipient. A dividend recipient may be an individual shareholder or a trust, partnership, super fund or another company. For simplicity assume the dividend recipient is an individual.

Now the $70 dividend is assessable income in the hands of the recipient but under the imputation system credit is given for the tax already paid by the company. We now outline how that is done.

Every $70 received as a dividend by an Australian individual taxpayer is 'grossed up' and taken to be the original $100 in working out the personal tax liability. However, the company tax paid, the $30, is credited against the individual's tax liability. Hence if the shareholder is on a 45 per cent marginal tax rate (ignoring the Medicare levy and temporary levy) the tax on the 'grossed up' dividend of $100 is assessed at $45. A 'franking credit' of $30 representing the company tax already paid is recognised and a net liability of $15 is payable by this individual to the tax office. That leaves $55 (=70+30-45) in the hands of the shareholder with the tax office receiving $45, $30 from the company and $15 from the individual. The net effect in this example is as if the company paid no tax and the individual is taxed on the full amount at the appropriate marginal tax rate.

If the franking credit exceeds the actual assessed tax liability (for example, if the dividend is paid to a low income earner not liable to pay tax, then that taxpayer receives a cash payment for the difference (subject to residency, etc.). The cash payment is important in the case of other entities taxed at low rates, such as super funds.

We referred earlier to the amount credited against the individual's tax liability as a 'franking credit'. Companies that pay tax maintain a franking credit account and can declare a franked dividend, so long as the franking credit account maintains a positive balance.

In addition to individuals, franking credits can also be claimed by trusts, partnerships and super funds. Companies too can earn imputation credits on any franked dividends they

receive from other companies. Our examination of the tax office figures suggest that 47.5 per cent of the company tax is given away as franking credits.

In 2011-12 the Australian government collected $66,584 million in company tax. Tax office statistics show that for the same year $31,650 million in franking credits were returned to the taxpayers who received dividends from Australian companies.[1] Table 1 shows the value of franking credits over the forward estimates based on the assumption that the ratio of franking credits to company tax remains at the 2011-12 rate.

Table 1: Company tax and franking credits

	2013-14	2014-15	2015-16	2016-17	2017-18
	$m (est)	**$m (est)**	**$m (est)**	**$m (proj)**	**$m (proj)**
Company tax	68,000	71,600	75,400	80,000	84,700
Franking credits	32,323	34,034	35,841	38,027	40,261

Source: Australian taxation office (2014) Taxation statistics, 2011-12, at https://data.gov.au/dataset/taxation-statistics-2011-12

Overall some $180.5 billion will be given back in franking credits over the forward estimates (2014-15 to 2017-18).

It is worth noting that if a company pays company tax but does not pay a dividend to its shareholders, there is no further action on the part of the tax office. For many high-tax individuals it can be worthwhile leaving income which is not needed in the hands of a company, especially one controlled by the taxpayer. The individual is thereby allowed to take advantage of deferring tax liabilities. In years gone by Australia used to operate an additional tax on undistributed profits so as to counter that type of avoidance.

The fact that companies do not pay out all of their after-tax profit as dividends means that they can build up substantial unused credits in their franking accounts. At the end of 2011-12 Australian companies had franking account balances of $245.7 billion.[2] The government could be called upon to spend this, or part of this, at any time if companies decide to increase dividends, for example, as part of a special dividend designed to return capital to shareholders. To put the franking account balances into perspective, Australia's net government debt was $197.9 billion at the end of June 2014.[3]

Distributional considerations

Given the value of the imputation system in Australia we need to understand who receives dividends. That allows us to consider who would win or lose if there were to be any changes to the present imputation arrangements.

The latest tax office figures relate to 2011-12 and give total income as well as income received as dividends. Those figures are summarised in Table 3.

[1] https://www.ato.gov.au/about-ato/research-and-statistics/in-detail/tax-statistics/taxation-statistics-2011-12/ Note that this figure includes tax credits received by individuals, partnerships, trusts, super funds and companies.

[2] Australian taxation office (2014) Taxation statistics, 2011-12, at https://data.gov.au/dataset/taxation-statistics-2011-12

[3] Australian Government (2014) 'Budget strategy and outlook, Budget paper no 1', Budget 2014-15.

Table 2: Taxpayers and dividend income (2011-12)

	Share of dividends (%)	Share of taxpayers (%)
Non-taxable and below $10,000	2.43	11.36
$10,000 to 50,000	15.19	50.07
$50,000 to 100,000	18.64	28.74
$100,000 to 150,000	11.69	6.13
$150,000 to 250,000	15.20	2.63
$250,000 and above	36.82	1.07
Total	100.00	100.00
Memo item: Taxpayers $1m plus	15.00	0.07

Source: Australian taxation office (2014) Taxation statistics, 2011-12, at https://data.gov.au/dataset/taxation-statistics-2011-12

Table 3 provides some interesting data and our main interest here is the dividend incomes received by the highest income earners. Of those people who lodged a tax return there were around one per cent who earned $250,000 or more but they received 36.82 per cent of all the dividends. The next highest bracket, $150,000 to $250,000, is less than three per cent of the population and received almost 15 per cent of the dividends. If we sum all those with income over $100,000 we have 7.2 per cent of the population receiving 64 per cent of the dividends.

For those earning $1 million or more it is interesting to note that they are just 0.07 per cent of taxpayers, or 8,425 people, but earned 15 per cent of dividends!

While these figures show that the payment of dividends is goes disproportionately towards the rich, it is important to note that many people receive dividends indirectly via trusts, partnerships and super funds for example. It is not possible to determine exactly how those fit into the income distribution. However, ABS figures show that the holding of financial assets is heavily skewed towards the rich.[4]

Other OECD countries

Some other countries give taxpayers some credit or concession when they receive dividend income. Apart from Australia, full dividend imputation applies in Chile, Mexico and New Zealand with partial imputation applying in Canada, Korea and United Kingdom. The 17 other OECD countries, including the US and mainland Europe, do not have dividend imputation.[5]

Table 4 provides recent figures for the company tax rate in some selected countries but it also examines what happens to a dollar of taxable corporate income by the time it is received in the hands of investors on the top marginal tax rate in that country. Where relevant, the company tax rate is that applying on company profits that are distributed to shareholders.[6]

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[4] ABS (2013) *Household wealth and wealth distribution, Australia, 2011-12*, Cat no 6554.0, 21 August.
[5] OECD Tax Database at www.oecd.org/ctp/tax-policy/tax-database.htm#C_CorporateCaptial accessed 16 October 2014.
[6] Some countries also tax profits differently depending on whether or not they have been distributed to shareholders. Australia used to have an additional tax on undistributed profits. The thinking was that while companies would want to retain some profits they should also pass dividends to shareholders who would be taxed at the personal tax rate. Retained earnings should not be a tax avoidance vehicle. That was before the imputation system.

The column headed 'Overall top personal income tax rate plus company tax rate' is the effective tax rate applying to company income by the time it is received in the hands of the individual shareholder. For many countries, full or partial imputation applies and there are other mechanisms used to reduce the combined impact of company and personal tax. For example, many countries have preferential tax rates for dividend income.

Table 3: Total taxation on company income received by individuals

Country	Company tax rate (%)	Overall top personal income tax rate plus company tax rate (%)
France	34.43	59.4
United States	39.1	52.1
United Kingdom	24.0	51.4
Korea	24.2	51.0
Germany	30.175	48.6
Ireland	12.5	48.4
Norway	28.0	48.2
Canada	26.1	47.9
Australia	30.0	45.0
Japan	39.54	45.6
Italy	27.5	42.0
Switzerland	21.17	36.9
New Zealand	28.0	33.0

Source: OECD Tax Database at www.oecd.org/ctp/tax-policy/tax-database.htm#C_CorporateCaptial accessed 16 October 2014

Table 4 clearly shows that it is misleading to compare just the company tax rate across countries. When ranked by company tax rates Australia is equal seventh out of 34 countries with a 30 per cent tax rate and there are 25 countries with lower rates. However, the data are entirely different if we examine the implied personal tax on company income, the overall top personal income tax rate plus company tax rate. On that basis Australia is ranked 15th highest with 19 countries below Australia. Of those 19 countries six are within 5 percentage points of Australia. Countries which are a major source of foreign investment in Australia, such as the UK and US, have much higher taxation on company profits by the time they are taxed in the hands of the taxpayer. The perception that Australia taxes company profits relatively highly disappears when imputation is taken into account.