

# Changes in the imputation system

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The benchmark rules and the anti-streaming rules ensure that the intended wastage of imputation benefits is not undermined.

(Paragraph 7.103 of the Explanatory Memorandum to the Exposure Draft of New Business Tax System (Entity Taxation) Bill 2000.)

Paragraph 7.102 of the Explanatory Memorandum states that 'wastage' of the benefit of imputation credits 'is a design feature of the imputation system'. It is also stated that 'Wastage of imputation benefits also includes the failure to use franking credits attributable to profits that are never distributed'.

It is a fundamental principle of the imputation system that corporate tax entities should not be able to direct franked and unfranked distributions to members in a way that maximises the benefits to members. Otherwise, the cost to revenue would be higher than originally intended. (Para 7.61).

It is clear from the above that one outcome of the legislation will be to frustrate, to some extent, the attempts of directors of companies (and trustees of trusts that are 'corporate taxable entities') to maximise the value of imputation credits in the hands of shareholders and beneficiaries of non-fixed trusts.

Another feature of the legislation is the severe penalties that apply if there is a failure to comply with the rules, even in cases where it is difficult to perceive any mischief. For example, if an entity has incurred losses over a period of years and has not made a distribution and has not made a specific or standing franking allocation, it cannot, without incurring penalties, commence to pay a fully franked dividend when it becomes profitable. In such a case fully franked dividends could only be paid by phasing them in over a two year period.

As explained below, such a delay could be avoided if the company, within the first six months of its operations, declares a specified percentage to be its benchmark franking percentage for the franking period. If the determination stated that the franking percentage for all distributions by the company was 100%, the company could commence to pay fully franked dividends immediately after it commenced to pay tax. A penalty would, however, arise if the company paid a dividend franked to a percentage less than 80%.

## Recording franking credits

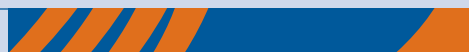
One of the three major changes under the new provisions is that a corporate tax entity's franking account will record the tax paid by the company, rather than the after-tax profits. Under the present system, if a company derives \$100 taxable profits and pays tax (at a 30% rate) of \$30, it would credit its franking account with \$70, being the after-tax profit available for distribution as a fully franked dividend. Under the new system, the relevant credit to the franking account would be the tax paid, ie \$30, rather than the \$70 after-tax profits.

## Franking limits

A second major change to the present rules is that, under the current system, companies must frank dividends to the maximum extent possible. Under the new rules an entity may determine its franking rate within certain limits.

## Company shareholders

Under the present system resident companies that receive a franked dividend from another company include in assessable income the cash component of the dividend and not the franking credits attributable to the dividend. In the usual case, the dividend would be virtually tax-free by virtue of the rebate



under s 46. Under the proposed system, resident corporate tax entities that receive a franked distribution from another corporate tax entity must gross up the distribution by the amount of the attached franking credit and a credit equal to the amount of the gross up is available to offset the tax payable on the dividend, or other income received.

## Limits in allocating franking credits

An entity cannot allocate a greater franking credit to a distribution than the tax paid by the corporate tax entity on the underlying profits.

Assume that a corporate tax entity derives \$100 taxable profits, on which it pays tax (at 30%) of \$30. The maximum franking credit that can be allocated to a distribution of the \$70 after-tax profit is \$30. The percentage to which a distribution is franked is called the franking percentage. It is expressed as a percentage of the frankable part of a distribution, rather than the whole of the distribution. The franking percentage of a distribution is calculated as follows:

$$\frac{\text{Franking credit allocated to the frankable distribution}}{\text{Maximum credit that could be allocated to the distribution}} \times 100$$

In the above example, if the franking credit allocated to a distribution of \$70 was \$30 (equal to the maximum credit that could be allocated to the distribution) the distribution would be franked to 100%.

If an entity allocates a franking credit to a distribution at a franking percentage in excess of 100%, the distribution will be treated in the member's hands as if it were franked to 100% and no more, but the entity will incur a franking debit based on the actual allocation.

## The benchmark rules

Benchmark rule 1 provides that the franking percentage for a frankable distribution made by a corporate tax entity in a six month period (referred to as a franking period) must not differ from the entity's benchmark franking percentage for the period. This rule prevents a corporate tax entity making distributions to its members within a particular franking period that are franked to different extents, unless the Commissioner is satisfied that there is a legitimate (non-tax driven) reason for doing so.

The benchmark rules are designed to prevent 'dividend streaming'. Dividend streaming occurs where unfranked distributions are paid to members who have no need for franking credits, so as to preserve the credits for those who benefit most from the credits.

The Explanatory Memorandum states that:

Due to the limited opportunities for streaming by widely held companies with only one class of shares, the benchmark rules only apply to a company if:

- it is closely held; or
- it is widely held and has more than one class of shares.

A company has one class of shares if all the shares on issue have the same, or substantially the same, rights.

Benchmark rule 1 does not apply if the allocation of a franking credit is made to a distribution by a non-fixed trust dealt with under the slice rule, ie the rule that ensures that, on redemption of units in a unit trust, the beneficiary receives an appropriate share of contributed capital, available profits, and prior taxed profits. In such a case, the trust is taken to have allocated a franking credit to that part of the distribution that is from taxed profit at a franking percentage of 100% (and zero to the untaxed component).

An entity establishes its

benchmark franking percentage for a franking period by making a benchmark declaration (in writing), or by franking a distribution during the period. If it does neither, a default rate may apply. A benchmark declaration may be made at any time before the end of the franking period, unless a frankable distribution has already been made within that franking period. The declaration may be varied or revoked up until a time a frankable distribution is made. Once a frankable distribution has been made, any purported making, variation or revocation of the benchmark declaration is ineffective. If no distribution is made by the entity in the franking period, the declaration may be made, varied or revoked before, but not after, the end of the franking period.

As discussed below, benchmark rule 2 limits the extent to which a benchmark franking percentage for a franking period may differ from the franking percentage for a previous year. Because of the operation of this second rule, a corporate tax entity may wish to make a declaration during a franking period in which no distribution is made. If an entity fails to validly declare a benchmark franking percentage for a franking period and makes no frankable distribution during the period, it is taken to have the same benchmark franking percentage as it had in the preceding franking period. If there is no benchmark franking percentage for the preceding franking period, there is no benchmark franking percentage for the period.

If a corporate tax entity does not declare a benchmark franking percentage for a franking period, the benchmark franking percentage for the period is:

- the franking percentage for a frankable distribution made in the period and nominated in writing by the entity before the end of the period, ie it can simply frank a distribution made during the

- period; or
- if no distribution is nominated as above, the franking percentage for the first frankable distribution that is made.

The default benchmark franking percentage does not apply if the entity would breach benchmark rule 2 if the benchmark franking percentage for that period were that franking percentage, or if the Commissioner sets a different benchmark franking percentage for the period in exercise of the Commissioner's powers to permit a departure from benchmark rule 1 or 2.

A breach of benchmark rule 1 will not invalidate the allocation made to the distribution, but it will result in a penalty. If the franking percentage for the distribution exceeds the benchmark franking percentage, the entity will incur over-franking tax equivalent to the franking credit allocated in excess of the amount determined under the benchmark. If the franking percentage of the distribution is less than the benchmark franking percentage, the entity incurs a franking debit equivalent to the extra franking credit that should have been allocated according to the benchmark rate. The Explanatory Memorandum states that:

The penalty for under-franking by the entity is that the extra franking credit that ought to have been allocated to the distribution is wasted.

(It might be argued that, in a case where there is no suggestion of dividend streaming, the recipient of the distribution should be entitled to the extra franking credit.)

Benchmark rule 2 is that the benchmark franking percentage for a corporate tax entity for a franking period cannot differ by more than 20 percentage points from the benchmark franking percentage for the entity for the immediately preceding franking period. If the

benchmark declared by the entity is more than 20 percentage points higher than the earlier benchmark, the entity's benchmark franking percentage for the period is taken to be 20 percentage points higher than the earlier benchmark. If the benchmark declared by the entity is more than 20 percentage points lower than the earlier benchmark, the entity's benchmark franking percentage for the period is taken to be 20 percentage points lower than the earlier benchmark. These provisions are subject to the power of the Commissioner to set a different benchmark franking percentage in exercise of the discretionary power conferred.

An entity is allowed to change its benchmark franking percentage by an absolute amount of 20 percentage points, as distinct from a relative variation of 20%. This means that a corporate tax entity may increase its previous period's benchmark franking percentage of 20% to 40%, notwithstanding that, in relative terms, this constitutes a 100% increase.

The Explanatory Memorandum contains the following example of the operation of Benchmark Rule 2.

Brooks Ltd, a corporate tax entity, is a company with an income year ending on 30 June. It will have franking periods of 1 July to 31 December (the first franking period) and 1 January to 30 June (the second franking period).

On 1 July 2001, Brooks Ltd declares a benchmark franking percentage of 40% for the first franking period. The company makes distributions within that period and does not vary or revoke that declaration.

On 1 January 2002, Brooks Ltd declares a benchmark franking percentage of 70% for the second franking period. Since the declared benchmark franking percentage differs by more than 20 percentage points from the declared benchmark franking percentage for the immediately preceding franking period, benchmark rule 2 will limit that variation to 20

percentage points. Therefore, the benchmark franking percentage for the later period will be taken to be 60%.

### Allocating franking credits

Apart from the declarations required for benchmark rule 1, a corporate taxable entity must allocate franking credits to frankable distributions.

A corporation may make a 'specific allocation determination', which is a determination in writing that a specified frankable distribution is to have a franking credit allocated to it. The determination must state the franking percentage for the distribution. The franking percentage is the amount of a franking credit allocated to a distribution as a percentage of the maximum credit that can be allocated to the distribution. The determination must be made either when the distribution is made or before the distribution is made. If a specific allocation determination is made and is in force at the time a distribution specified in the determination is made, the distribution has a franking credit allocated to it in accordance with the determination. A determination may be revoked or varied at any time before the specified distribution is made. If an entity fails to validly allocate franking credits, or allocates no franking credits to a distribution, the distribution will be unfranked.

The allocation determination indicates the level at which franking credits are actually allocated to a distribution. As mentioned above, this is different from the benchmark franking percentage declaration, which sets a standard against which the allocation of franking credits is compared, to determine whether the distribution is over-franked or under-franked.

Instead of making a specific

allocation determination, an entity may make a written determination that allocates franking credits either to distributions generally, or to a particular kind of distribution. This type of determination is called a 'standing allocation determination'. A standing allocation determination must be made at the time, or before, a distribution to which it applies is made. A standing allocation determination will allocate credits to all distributions made while it is in force and while there is no specific allocation determination in respect of a particular distribution. A standing allocation determination may apply indefinitely from the time it is made. A standing allocation determination can be revoked or modified at any time. A standing allocation determination will set a default allocation of franking credits for each distribution to which it relates. The default allocation will apply unless a specific allocation determination is made. In other words, a specific allocation determination will override a standing allocation determination if a particular distribution is covered by both.

## Unfrankable distributions

Most distributions by companies will be frankable. However, certain distributions are unfrankable, including an amount taken to be a dividend under Division 7A of Part III of the Act, ie payments to shareholders and associates of shareholders of a private company that are deemed to be dividends. In the case of a non-fixed trust, a distribution from profits is unfrankable to the extent that it is a distribution from profits that are not 'available profits' for the purposes of those rules.

## Anti-streaming rules

The first anti-streaming rule applies to streaming arrangements

involving linked distributions, where a member of one entity can choose to receive a distribution from another entity that is franked to a greater or lesser extent than distributions made to other members of the first entity.

The second anti-streaming rule applies where a member of an entity can choose that tax-exempt bonus shares are issued to the member, or to another member of the entity, instead of receiving a franked dividend.

The third anti-streaming rule applies to arrangements where an entity streams distributions to provide imputation benefits to members who benefit more from imputation credits than other members.

## Credits for foreign withholding tax

The proposed law will allow Australian corporate tax entities that receive foreign distributions equivalent to frankable distributions to claim credits in their franking accounts for withholding tax paid on those distributions. The amount of the credit will be the lesser of the actual withholding tax paid and 15% of the gross distribution equivalent to a frankable distribution. In certain circumstances a further franking credit may be allowed where there is a chain of companies and withholding tax is paid by a wholly owned non-resident subsidiary on foreign distributions received.

Franking credits will not be allowed for payments which, in substance, represent corporations tax paid in advance. Franking credits will also not be allowed for withholding tax on distributions received by an Australian corporate tax entity through foreign trusts or other entities, unless they are taxed as corporate entities in the foreign country and withholding tax is paid on distributions out of after-tax profits.

## The 45-day rule

The 45-day rule requires a shareholder to hold shares for at least 45 days at risk in order to be eligible for franking benefits for dividends paid on the shares. There is no proposal in the legislation to change the 45-day rule and it would appear that its purpose, namely to counter dividend streaming, would be achieved by the operation of the rules outlined above.

## Distribution statements

The legislation imposes a requirement to provide a distribution statement to a member whenever a frankable distribution is made. The statement containing the specified particulars must be given within three months of the actual distribution.

There are a number of changes to be made to the imputation system that are not included in the Bill before Parliament. The Explanatory Memorandum says that these will be included in a later Bill. These are:

- rules for refunding excess imputation credits
- the tax treatment of dividends received indirectly through certain trusts or partnerships
- franking credit trading rules
- venture capital franking rebates
- the application of the imputation system to life insurance companies
- application and transitional provisions
- consequential amendments and
- machinery provisions.

The new imputation system is to apply from 1 July 2001. Entities will need to make decisions, for example determining a benchmark franking percentage, shortly after 1 July 2001. If such decisions are left until distributions are made, entities may have less flexibility in the extent to which distributions are franked.

