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New Business Tax System (Imputation) Bill 2002

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New Business Tax System (Imputation) Bill 2002

New Business Tax System (Over-Franking Tax) Bill 2002

New Business Tax System (Franking Deficit Tax) Bill 2002

Date Introduced: 30 May 2002

House: House of Representatives

Portfolio: Treasury

Commencement: On the day the Acts receives Royal Assent. The measures take effect from 1 July 2002.

Purpose:

The package of Bills comprising the New Business Tax System (Imputation) Bill 2002 (the Imputation Bill), the New Business Tax System (Over-Franking Tax) Bill 2002 (the Over-Franking Tax Bill) and the New Business Tax System (Franking Deficit Tax) Bill 2002 (the Franking Deficit Tax Bill) introduce a new simplified imputation system.

The Imputation Bill includes proposed measures in three Schedules.

- **Schedule 1** inserts **proposed Part 3-6 – The imputation system** into the *Income Tax Assessment Act 1997* (ITAA 1997) which applies to events that occur on or after 1 July 2002 under **proposed section 201-5**.

- **Schedule 2** has consequential amendments to the Dictionary of the ITAA 1997 and takes effect under section 2 of the Imputation Bill when it receives Royal Assent.

- **Schedule 3** includes transitional provisions and provides for Part IIIAA of the *Income Tax Assessment Act 1936* (ITAA 1936) which deals with the current imputation system to cease to apply to events that occur on or after 1 July 2002.

The Over-franking Bill provides a mechanism that ensures that companies frank distributions in accordance with the benchmark rule.

The Franking Deficit Bill ensures that a company makes good the over-imputation of franking credits that it makes to its shareholders when making franked dividends to them.

In the words of the joint Explanatory Memorandum to the three Bills (paragraph 1.18) the changes are mainly to the mechanics of the imputation system and not to its outcome:

> Whilst the new imputation system changes the mechanics of the current system, the new imputation provisions will generally provide the same outcome as the current imputation system.[1]

The Explanatory Memorandum also states that new imputation system will have no revenue impact.[2]

Background

Brief explanation of the imputation system

The imputation system is the mechanism in taxation law which enables income tax paid by a corporate tax entity to be passed on to its members. It was first inserted into tax law in 1987.[3] It is through this system that members of a corporate tax entity obtain a credit for the underlying company tax paid on the company profits that have been distributed to them. This credit, called an imputation credit, gives rise to a franking rebate. Members use this franking rebate to reduce their income tax liability. The imputation system prevents the double taxation of income earned and distributed by corporate tax entities. Without the imputation system, income tax would be levied when income is earned by the entity and then again in the hands of the members when it is distributed to them.

The way in which the corporate tax entity passes the income tax paid by it to its members is by franking (in the sense of stamping or marking) the distribution. Only frankable distributions may be franked. In order to frank (that is, allocate franking credits to a distribution), a corporate tax entity is required to maintain a franking account.

The tax credits that can be imputed to members are recorded in the entity's franking account as franking credits. Franking credits generally reflect income tax paid by the entity, or underlying tax paid through other corporate entities that is imputed to it.

Subject to anti-avoidance rules, resident individuals, superannuation entities, registered charities and deductible gift organisations are eligible for refunds of excess imputation credits to the extent that imputation credits exceed tax payable by these entities.

To whom does the imputation system apply at present?

The rules around franking a distribution and franking accounts, and some of the anti-streaming rules, apply to corporate tax entities only. Corporate tax entities are companies, corporate limited partnerships, corporate unit trusts and public trading trusts. These entities are taxed separately from their members and are taxed at the company tax rate.

The rules on the tax effects of receiving a franked distribution apply to all entities, including individuals, corporate tax entities and superannuation entities.

It will be noted that corporate tax entities do not include partnerships and trusts (which are not corporate unit trusts and public trading trusts).

Basis of policy commitment

Government's Commitment in the ANTS package for a unified entity regime including a simplified imputation system

A key proposal in the Tax Reform: not a new tax a new tax system [4] (the ANTS package) issued by the Government in August 1998 to ensure fairness and integrity in the tax system with the introduction of the goods and services tax (GST) was the implementation of a unified entity regime (UER). This reform has been referred to by various names, including "entity taxation", "tax entity regime" "unified entity regime" and "consistent entity regime". The simplified imputation system, a significant component of the UER, was to apply to all entity distributions including trust and partnership distributions so that the tax paid by the entity was attributed to the recipients of the distributions.

The consequences of the differential treatment of entities and the inconsistent treatment of distributions and the need for reform was stated in the ANTS package as follows:

> Taxation of business entities is inconsistent
>
> The taxation of business entities requires reform across three key problem areas: inconsistent entity treatment; inappropriate taxation of company groups; and inconsistent treatment of distributions.
>
> Different treatment of entities produces unfair outcomes
>
> Under current law, vastly different treatment is accorded to investment income channelled through different entities. The treatment is different both between the various entities and at the individual investor (eg shareholder) level.
>
> Companies, fixed trusts, and discretionary trusts all offer investors the prospect of limited liability – shielding them from full personal liability for making good the entities' financial liabilities. And yet there is very different treatment across these entities of distributions out of profits freed from taxation by tax preferences ('tax-preferred' income). Such distributions by *companies* (ie franked dividends) are taxed in the hands of individual resident shareholders. In the case of *fixed trusts* these distributions are generally taxed with a delay when the interests in the trust are sold. With *discretionary trusts* the distributions are not taxed at all. The beneficiaries of discretionary trusts enjoy 'the best of both worlds', benefiting from both limited liability and the flow-through of tax preferences.

> Sole traders and partners in partnerships are able to access tax-preferred income but they bear liability for losses of their businesses (unless in limited partnerships); that is, they do not have limited liability arising from the entity.
>
> Some *co-operatives* are taxed differently again from companies under complex arrangements that can result in different outcomes depending on the timing of distributions.
>
> The treatment of life insurance investments are unlikely to be taxed at the policyholder's marginal tax rate. different tax rates apply to *life insurers* depending on the type of institution offering the policy, the nature of the policy and the investor.[5]

Recommendations in the Ralph Review of Business Taxation

The A Tax System Redesigned [6]which was a report by a committee chaired by Mr John Ralph following a review of business taxation in Australia (Ralph Review) recommended the implementation of the UER. In the context of the UER the Ralph Review recommended a broad definition of distribution to enhance the integrity of the tax system. In its Overview it stated:

> A broad definition of distribution is the simplest and most equitable means of taxing benefits provided by entities to members. Such a definition adds integrity to the tax system as it restricts the situations in which value can be shifted from an entity to a member without being subject to tax. The recommended definition will apply to the provision of loans, or goods and services, at less than fair value.[7]

Government's initial acceptance of the unified entity regime as recommended in the Ralph Review

In a Press Release of 21 September 1999 the Treasurer, the Hon. Peter Costello, indicated in Attachment K that the implementation of the entity tax regime (which was a key recommendation in the Review of Business Taxation) will provide for a more consistent taxation of business entities and their members, while being fairer, simpler and having greater integrity. However, in the light of other pressures on business, the commencement of this measure was deferred to 1 July 2001.

The need for a change to the UER including a simplified imputation system was to remove inconsistencies in the current arrangements which did not contribute to the equity of the tax system. Further, the non taxation of certain benefits paid by companies and trusts presented an opportunity for tax avoidance. This was stated by the Treasurer in Attachment K of his Press Release of 21 September 1999 as follows.

> The recommendation of the Review to adopt a comprehensive definition of distribution from entities will improve the fairness of the tax system by ensuring, among other things, that benefits provided by companies to shareholders and by trusts to beneficiaries are subject to tax.
>
> … … …

> The current arrangements are characterised by an inconsistent treatment of entity distributions, no coherent approach for dealing with groups of wholly owned entities, and a lack of integrity in the treatment of inter-entity distributions. *A New Tax System* proposed reforms to address these problems, with implementation from the 2000-01 income year.

In a Press Release of 11 November 1999, the Treasurer reiterated that the unified entity tax regime will commence on 1 July 2001.

Release of Exposure Draft New Business Tax System (Entity Taxation) Bill 2000 by the Treasurer on 11 October 2000

On 11 October 2000 the Treasurer issued an exposure draft of the New Business Tax System (Entity Taxation) Bill 2000 for implementing the UER and the simplified imputation rules. In Press Release No 095 of the same date titled – Taxing Trusts Like Companies and Simplified Imputation rules – it was emphasised that the proposed legislation will introduce greater consistency into the taxation of entities and achieve the objectives outlined in the ANTS package.

> This legislation will implement the Government's policy, which was announced in *A New Tax System,* of introducing greater consistency in the taxation of entities.
>
> There has been extensive consultation in the development of this legislation. The exposure draft will provide further opportunity for comment on the operation of the new arrangements. The exposure draft legislation also covers the simplified imputation system and franking credits for foreign dividend withholding tax, and an accompanying explanatory statement.
>
> The proposed legislation for taxing trusts like companies achieves the objective of greater consistency in the taxation of entities while minimising compliance and restructuring costs. Under this approach, non fixed trusts will be taxed like companies. Broadly, companies, fixed trusts, limited partnerships and co-operatives will retain their current tax treatment. This approach removes the requirement for the introduction of a collective investment vehicle regime.

Abandonment of the proposal for an Unified Entity Regime by Government

On 27 February 2001, the Government withdrew the exposure draft of the New Business Tax System (Entity Taxation) Bill 2000 conceding that it was "not workable" and that the Government would look at alternative approaches.

However, announcing a revised timetable of Business Tax Reform in a Press Release of 22 March 2001, the Treasurer stated that the Government will not be proceeding with draft legislation on entity taxation. It would therefore appear from the revised timetable that Government has no intention to resurrect the entity tax regime in the life of this Parliament. Referring to the simplified imputation system from 1 July 2002 he stated:

> The exposure draft legislation on entity taxation also contained provisions for simplifying the imputation system, including imputation credits for foreign dividend withholding tax. The consultation process has raised several issues and options which could reduce compliance costs. In giving close consideration to these, the Government recognises that sufficient advance notice and certainty of the detail of the final arrangements is necessary for taxpayers and accordingly will defer their commencement.

Abandonment of the proposal for a full franking system

The ANTS package envisaged a full franking system where all distributions to members of an entity would be subject to tax at the company rate. In the case of distributions out of taxable income the entity would have paid tax at the company tax rate and this tax would be imputed to the members. Where the distribution is out of profits which has not been subject to tax at the entity level such distributions would also be taxed at the entity level at the company tax rate and be called the 'deferred company tax'. Thus the entity tax paid on taxable income as well as the deferred company tax paid on distributions out of non-taxable income would be imputed to members of the entity. Under the simplified imputation system the entity tax so paid would be creditable to individual shareholders, beneficiaries, members of co-operatives or policy holders.

The case for a full franking system was made in the ANTS package as follows:

> There is considerable complexity in the present system caused by dividends being either franked or unfranked depending on whether they are paid out of taxable income or not. Virtually all company profits are taxed. But only taxable income is subject to company tax (with distributions of these taxed profits being franked). Other tax-preferred profits are taxed in the hands of individual shareholders as unfranked dividends when distributed.
>
> Under a full franking system, taxable income would, as now for companies, be subject to company tax. In contrast to current arrangements, however, distributions of other profits, would be taxed (at the company tax rate) at the entity level, rather than at the shareholder level. This deferred company tax would subject distributed tax-preferred income to tax at the entity level so that all distributions of profit would then be franked.[8]

The proposal for a deferred company tax on distributions other than from taxable profits was dropped following the Ralph Review which recommended against it This was mainly on the grounds that it would impact adversely on after-tax profits of Australian companies and consequently adversely affect share prices and the ability of companies to raise capital.[9]

The imputation system introduced by the three Bills would continue the complexities that flow from the existence of franked and unfranked dividends which the ANTS proposal sought to eliminate.

Announcement that the simplified imputation system will commence from 1 July 2002

On 24 May 2002, the Minister for Revenue and Assistant Treasurer announced in Press Release No. C57/02, the Government's program for delivering the next stage of business tax reform measures. In that press release, the Minister confirmed that the simplified imputation system will commence on 1 July 2002.

Main Provisions

This section of the Digest highlights the more significant provisions which bring about changes to the current imputation system. To appreciate the changes it is necessary to know what additional objects the simplified imputation system is to serve over and above those served by the current imputation system

The Explanatory Memorandum in paragraph 1.20 states that the new imputation system introduced by the three Bills have the additional objectives of ensuring that:

- the imputation system is not used to give the benefit of income tax paid by a corporate tax entity to members who do not have a sufficient economic interest in the entity
- the imputation system is not used to prefer some members over others when passing on the benefits of having paid income tax, and
- the membership of the corporate tax entity is not manipulated to create either of the above outcomes.

The Explanatory Memorandum sets out succinctly explanations of the main provisions of the three Bills and the reader is invited to refer to the EM for greater details.

The simplified imputation system applies only to a corporate tax entity

The simplified imputation system will apply to a corporate tax entity defined in section 960-115 of the ITAA 1997.

A corporate tax entity is:

- a company
- a corporate limited partnership in relation to the income year
- a corporate unit trust in relation to the income year, or
- a public trading trust in relation to the income year.

The following entities are not corporate tax entities:

- a non-fixed trust
- a fixed trust (other than a corporate unit trust or a public trading trust)
- a complying superannuation fund
- a complying approved deposit fund, and
- a pooled superannuation trust.

It will thus be seen that partnerships (other than limited partnerships) and trusts (other than corporate unit trusts and public trading trusts) are not covered by the simplified imputation system.

The Franking Period rules

Under the current imputation rules a company that has an early balance date (ie in lieu of the next succeeding 30 June) has a franking year that is aligned to its income year. A company that has a late balance date (ie in lieu of the preceding 30 June) has a franking year that ends on 30 June. This disparate treatment of companies that have a late balance date has lead to unnecessary complexities.

Proposed section 203-40 deals with the *franking period* rules for an entity that is not a private company. It will result in all corporate tax entities having a franking year that is aligned with its income year and will remove the complexities that arise to companies with late balancing dates. The franking periods are generally for six months and frankable distributions made during such six month periods must be franked to the same extent.

Proposed section 203-45 provides that the franking period for an entity that is a private company is the same as the income year.

Changes to the basis of maintaining Franking Accounts

Proposed Division 205 deals with franking accounts. It:

- creates a franking account for each entity that is, or has been, a corporate tax entity
- identifies when franking credits and debits arise in those accounts and the amount of those credits and debits
- identifies when there is a franking surplus or deficit in the account, and
- creates a liability to pay franking deficit tax if the account is in deficit at certain times.

These rules essentially replicate the rules relating to franking credits and debits in the current law. The most significant departures from the current law are that:

- entries are to be recorded on a tax paid basis rather than an after-tax distributable profits basis, and
- the franking account will operate on a rolling balance account rather than an yearly account with an annual balance transfer.

Entries to be recorded on a *tax-paid* basis

Under the current system a company credits its after-tax profit available for distribution to its Franking Account. Thus if a company derives a taxable profit of $100 and pays tax of $30, at a rate of 30%, it would credit its Franking Account by $70. The current system operates on a *qualified dividend account* basis or *taxed income* basis. To accommodate the changes in company tax rate over time companies at present maintain a number of different classes of franking accounts and must carry out a number of complex conversions.

To avoid these complex conversions the new imputation provisions in **proposed Division 205** provide that a franking account will record franking credits on a *tax-paid* basis. Thus if a company paid income tax of $30 the corresponding franking credit will be $30. Corporate entities will not have to convert entries in the franking account to reflect taxed income.

Franking account will operate on a rolling balance account

Under **proposed item 5 in the table in section 205-15** a franking credit will arise if an entity incurs liability for franking deficit tax. The credit arises by incurring liability for, rather than payment of, franking deficit tax. Further, the balance of the account at the end of the year is brought forward to the beginning of the next income year whether the account is in surplus or deficit. The effect of the proposed measure is that the franking account will operate as a rolling balance account compared to the current imputation rules that require companies to establish new franking accounts from one franking year to the next.

The Benchmark Rule

Under the current franking rules a company is required to frank a dividend to the maximum extent possible having regard to the surplus in its franking account at the time of its payment. The current system also permits a company to allocate franking credits representing tax paid on behalf of all members of an entity to only some of them.

Proposed Division 203 introduces a *benchmark rule* where a corporate tax entity must frank all frankable distributions made within a franking period at a franking percentage set as a benchmark for that period. The rule for determining the franking percentage is set out in **proposed section 203-35.** The franking percentage of a distribution is calculated as follows:

> 100 x Franking credit allocated to the frankable distribution/maximum franking credit for that distribution

Proposed subsection 202-60(2) ensures that as in the current law an entity cannot allocate a greater franking credit to a distribution than tax paid by the corporate tax entity on its underlying profits.

Proposed section 203-15 states that the object of Subdivision 203-15 is to ensure that one member of a corporate tax entity is not preferred over another when the entity franks distributions. The Explanatory Memorandum in paragraph 2.48 elaborates on this further and states that the object of the benchmark is to discourage 'dividend streaming' as follows:

> 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 that originally intended. Instead the benchmark rule ensures that, over time, the benefit of franking credits is spread more or less evenly across members in proportion to their ownership interest in the entity.[10]

The benchmark rule is therefore directed at dividend streaming and the proposed measures include penalties for the breach of the benchmark rule as discussed below. The anti-streaming rules are dealt with in **proposed Division 204.**

Proposed subsection 203-20(2) provides that the benchmark rule does not apply to a company if at all times during the franking period, the company is a listed public company with a single class of membership interest.

Commissioner's powers to permit a departure from the benchmark rule

Proposed section 203-55 gives the Commissioner of Taxation (the Commissioner) the power to permit a departure from the benchmark rule in extraordinary circumstances by a determination made either before or after the frankable distribution is made. The entity must make its application in writing under **proposed subsection 203-55(6).** If the entity or a member of the entity is dissatisfied with the determination of the Commissioner, the entity or member may under **proposed subsection 203-55(7)** object to it in the manner set out in Part IVC of the *Taxation Administration Act 1953.*

Penalties for breach of the benchmark rule

A breach of the benchmark rule will not invalidate the allocation of franking credits made to the distribution. However it will result in a penalty to the corporate tax entity. The penalty is calculated by reference to the difference between the franking credits actually allocated and the benchmark percentage. The penalty is under **proposed subsection 203-50(1)** either:

- over-franking tax, if the franking percentage for the distribution exceeds the benchmark franking percentage, or
- a franking debit (penalty debit), if the franking percentage for the distribution is less than the benchmark franking percentage.

The over-franking tax is imposed by measures in the proposed New Business Tax System (Over-franking Tax) Bill 2002.

A franking debit is equivalent to the extra franking credit that should have been allocated according to the benchmark rule. The additional debit cancels the unused credit. In consequence, if a franking account is in deficit on the last day of an income year, the entity will be liable to pay franking deficit tax under the proposed New Business Tax System (Franking Deficit Tax) Bill 2002.

Anti-streaming rules

The benchmark rule sets the framework for ensuring that over time the benefit of franking credits is spread more or less evenly across members in proportion to their ownership interest in the entity. The anti-streaming rules in **proposed Division 204** are intended to prevent the benchmark rule being undermined. The four specific rules designed to prevent anti-streaming are as follows.

- **Proposed Subdivision 204-B** deals with linked distributions and prevents the exploitation of a corporate tax entity's benchmark percentage by another corporate tax entity, or that other entity's members, by imposing a franking debit where there is exploitation. This rule is based on subsections 160AQCB(3) and (4A) of the ITAA 1936 of the current imputation system
- **Proposed Subdivision 204-C** prevents the substitution of a tax-exempt bonus share for a franked distribution by imposing a franking debit on the issue of the share as if it were a franked distribution. This rule is based on subsection 160AQCB(2) of the ITAA 1936 of the current imputation system
- **Proposed Subdivision 204-D** prevents the streaming of imputation benefits to one member of a corporate entity in preference to another by either imposing a franking debit or denying an imputation benefit where there is streaming. This rule replicates section 160AQCBA of the ITAA 1936, and
- **Proposed Subdivision 204-E** requires an entity to notify the Commissioner where there is a significant difference in its benchmark franking percentage over time, so that the Commissioner can assess whether there is streaming. This is a new disclosure rule

Consistent treatment of franked dividends received by entities

The current tax system has 2 different mechanisms that are designed to prevent the double taxation of company profits, namely:

- an intercorporate dividend rebate for companies and entities taxed like companies, and
- a gross-up and credit approach for all other entities.

The provisions in **proposed Subdivision 207-A of Division 207** are intended to ensure greater integrity and consistency by bringing corporate tax entities receiving franked distributions wholly within the imputation system instead of relying on the intercorporate dividend rebate in section 46 of the ITAA 1936. The new imputation system will provide a single rebate/tax offset mechanism, to prevent double taxation of company profits, which is consistent across all entities. It will achieve this by using a gross-up and credit approach that is consistent with that currently used by individuals, superannuation funds and trustees assessed under Division 6 of the ITAA 1936.

General rule for grossing-up and tax offset

Proposed section 207-20 sets out the general rule of grossing-up and tax offset as follows:

> (1) If an entity makes a franked distribution to another entity, the assessable income of the receiving entity, for the income year in which the distribution is made, includes the amount of the franking credit on the distribution. This is in addition to any other amount included in the receiving entity's assessable income in relation to the distribution under any other provision of this Act.
>
> (2) The receiving entity is entitled to a tax offset for the income year in which the distribution is made. The tax offset is equal to the franking credit on the distribution.

Effect of receiving a franked distribution through certain partnerships and trusts

Proposed Subdivision 207-B sets out the effect of receiving a franked distribution through certain partnerships and trusts. Under these provisions:

- a franked distribution to certain partnerships and trusts is treated as flowing indirectly to members of the partnership or trust
- each member's share of the franking credit on the distribution is included in that members assessable income
- each member is then given a tax offset equal to that share of the franking credit, provided the member is not itself a partnership or trust through which the distribution flows indirectly, and
- where the trustee, rather than a member, is the taxpayer on a share of the distribution, it is the trustee in that capacity who is given the tax offset under this Subdivision.

Residency requirements for the application of the general rule of grossing-up and tax offset

Some recipients of a franked distribution must satisfy a residency requirement under **proposed Subdivision 207-C** if their assessable income is to include the franking credit on the distribution, and they are to be entitled to a tax offset, under the general rule.

Proposed section 207-75 provides that if an entity mentioned below is resident in Australia at the time a franked distribution is made it is entitled to the gross-up and tax offset:

(a) an individual;

(b) a company;

(c) corporate limited partnership;

(d) corporate unit trust; and

(e) a public trading trust.

Concluding Comments

It is arguable whether the simplified imputation system proposed to be put in place into the *Income Tax Assessment Act 1997* by the three Bills is anything more than a tax law improvement project. The imputation system as envisaged under the Exposure Draft released in October 2000 as an important component of the unified entity regime (UER) would have been properly classified as a New Business Tax System reform measure. However, given the abandonment of the UER by Government in February 2001 any claims that the proposed simplified imputation system is a true tax reform measure cannot be supported. This is particularly the case as the Explanatory Memorandum states in paragraph 1.18 that the new imputation system changes the mechanics of the current system and will provide the same outcome as the current imputation system

Further, it is clear that the simplified imputation system as proposed by the three Bills is not comprehensive. The Explanatory Memorandum states in paragraph 1.4 that further rules are to be included in a later bill and deal with largely with consequential amendments. It envisages that further amending legislation will be required to cover rules relating to:

- venture capital franking
- life insurance and exemption companies
- share capital tainting
- holding period and related payment rules, and

- certain transitional and machinery provisions.

Endnotes

1 The joint Explanatory Memorandum to the New Business Tax System (Imputation) Bill 2002; the New Business Tax System (Over-franking Tax) Bill 2002 and the New Business Tax System (Franking Deficit Tax) Bill 2002 (the Explanatory Memorandum); paragraph 1.18.

2 ibid., p. 3.

3 *Taxation Laws Amendment (Company Distributions) Act 1987* inserted Part 111AA to the ITAA 1935 dealing with franking of dividends.

4 *Tax Reform: not a new tax; a new tax system: The Howard Government's Plan for a New Tax System* (ANTS package); Circulated by the Hon. Peter Costello MP, Treasurer of the Commonwealth of Australia (AGPS) August 1998.

5 ibid., p. 109.

6 Publication: *Review of Business Taxation - A Tax System Redesigned*, (Ralph Review).

7 ibid., Overview ; para. 289, p. 64.

8 ANTS package, p. 116.

9 Ralph Review; Overview para.281, p. 62.

10 Explanatory Memorandum; para. 2.48, p. 24.