The recent retirement income reviews have again raised the vexed issue of franking credits and how they are calculated.

However, an important bit is missing. Many seem to still believe that franking credits are a tax refund for owning shares and that it only applies to retirees. Not true.

What are some critics missing?

A franking credit is not just a tax refund but **also additional taxable income**. Each shareholder, as part owner of the company, is responsible for including in their personal income tax return, their share of the company's profits, not just the bit they receive as dividend. The taxable income of shareholder/taxpayers **must also include the company tax previously paid to the ATO before the dividend was distributed** as well as the cash dividend they receive in their bank account.

Imagine a company with 1,000 shareholders each with equal shares and assume the company makes $2 million profit. By law the company must pay company tax at 30%, or $600,000, leaving $1.4 million in after-tax profits to be deployed at the discretion of the directors.

Assume the company has a policy of paying 50% of its profits in dividends, that is, a payout ratio of 50%. Dividends are paid out of after-tax profits. With $700,000 to be distributed among 1,000 shareholders, each shareholder receives $700 in dividends.

As part owners of the company, each shareholder receives a dividend of $700 in their bank account, but their taxable income is actually $1,000 because it must include the company tax pre-paid on those dividends. That is why the dividend needs to be 'grossed up' in the tax return to include this company tax component. Each dividend statement clearly identifies this additional taxable amount.

Too many people miss this point.

The money is already paid to the ATO

The bad news is that each shareholder is responsible for tax on income, already held by the ATO, that they never received. The good news is, that because this money is already held by the ATO, it is available as a tax credit to pay some or all of their personal income tax.

It is called a franking credit simply because it is pre-paid.

All Australian taxpayers are subject to the same income tax laws. It makes no difference whether the taxpayer is a salary earner, church, union, retiree, super fund, company, family trust or non-working spouse. In each case, a dividend of $700 from this company translates into additional taxable income of $1,000. The franking credit has the same value to all shareholders regardless of their marginal tax rate, in this case $300.

For Australian shareholders, what happens next depends on the individual shareholder's marginal tax rate. If they are required to pay 49% tax on any additional income, they would expect to pay $490 on a taxable income of $1,000 they receive from this dividend. The money already held by the ATO ($300) now becomes a tax credit. Therefore, the taxpayer only has to find an additional $190 to pay their tax on the $700 dividend that was deposited in their bank account.

If the taxpayer had a 30% marginal tax rate, their tax liability would be $300 and their tax credit would also be $300. In other words, the tax credit has cancelled out their tax liability.

As the new legislated tax cuts come into effect, the 30% tax bracket will extend to $200,000 in income. It means that, assuming all the income is derived from franked dividends, a taxpayer could earn a large income from these dividends and pay no additional tax because the franking credits attached to those dividends cancel out all of the tax payable on that income.

In this way franking credits can be used to pay some or all of a taxpayer's personal tax.

Super funds and zero taxpayers

A super fund in accumulation phase is required to pay 15% tax on its earned income. Its tax liability on $1,000 is $150 but the tax credit is $300. Similar to an employee who finds that, if the tax paid by their employer on their behalf exceeds their tax liability (based on their taxable income, deductions and tax offsets), they are entitled to a tax refund of any excess tax. In this case the super fund is entitled to a refund of $150.

If the taxpayer has a zero marginal tax rate, the tax liability is zero but the tax credit is $300. Since 2001, any franking credits collected on behalf of a taxpayer that exceeds their legal tax liability is refunded as cash. It means that this taxpayer, like the taxpayer above, receives a cash refund of unused franking credits from the ATO. This is because it is additional income on which no tax is payable.

There are several types of taxpayer who have a zero marginal tax rates. They include universities, unions, churches and since 1992, <u>all</u> super funds that pay a pension.

Industry super funds are single taxpayers paying tax on behalf of all their members, some of whom are in accumulation phase and some in pension phase. In most industry super funds, these franking credits will be used to pay the fund's tax liability that stems from income from all sources on behalf of all their members and the pension fund's tax-free status will be reflected in their unit prices.

An SMSF in pension phase has no other tax liability and so the tax on that income is zero regardless of the size of that income. That is why Treasurer Morrison in 2017 introduced the Transfer Balance Cap (now $1.7 million) to limit the size of that tax concession. To the extent that SMSFs in pension phase invest in fully franked Australian shares, the franking credit refund can represent up to 30% of the income earned by the fund. The same is true of all the other taxpayers whose marginal tax rate is zero.

All Australian shareholder/taxpayers benefit from the pre-paid company tax that needs to be accounted for in preparing their own tax return. For some taxpayers it can be used to reduce or eliminate their personal tax liability. For others, if they have unused tax credits because their marginal tax rate is less than 30%, it means a cash refund.

The size of the cash refund has nothing to do with the taxpayer's age or employment status, it is simply a function of their marginal tax rate.

If there was no company tax and profits were simply distributed as dividends, Australian investors would just pay tax on their share of a company's profit at their marginal tax rate (but foreign investors would pay no tax at all in Australia).

It is a fair system

The franking credit system is complex but fair because it ensures that foreign investors always pay Australian tax on their share of a company's profit at the company tax rate.

Because the franking credit system adds the company tax portion back on to personal taxable income, it ensures that Australian investors always pay tax on their share of a company's profit at their personal marginal tax rate.

That is its strength.