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THE PARLIAMENT OF THE COMMONWEALTH

OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAXATION LAWS AMENDMENT (COMPANY DISTRIBUTIONS) BILL 1987

INCOME TAX (FRANKING DEFICIT) BILL 1987

INCOME TAX RATES AMENDMENT BILL 1987

EXPLANATORY MEMORANDUM

PART A

(Circulated by authority of the Treasurer,

the Hon. P.J. Keating M.P.)

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FOREWORD

Part A of this memorandum contains explanations that provide a broad guide to the three Bills that have been introduced to give effect to the commencement, from 1 July 1987, of a full imputation system of company taxation and other associated measures that were announced on 10 December 1986.

Part B of the memorandum, to be issued shortly, will contain a clause by clause explanation of the Bills.

GENERAL OUTLINE

The Taxation Laws Amendment (Company Distributions) Bill 1987 will -

- amend the Income Tax Assessment Act 1936 -

  - .. to introduce, from 1 July 1987, a full imputation system of company taxation using a qualifying dividends method under which, by a system of franking, dividends paid by Australian resident companies, to the extent that income tax paid or payable at the company level permits, will be relieved from personal income tax in the hands of resident individual shareholders (proposal announced on 10 December 1986);

  - .. to remove, in respect of the 1986-87 and subsequent income years, the liability of non-resident companies to branch profits tax (proposal announced on 28 July 1986);

  - .. to exclude all non-residents from liability to dividend withholding tax, or from tax by assessment where a non-resident carries on business in Australia at or through a permanent establishment in Australia, in respect of franked dividends paid on or after 1 July 1987 (proposal announced on 10 December 1986);

  - .. to deny the sections 46 and 46A rebates in respect of all intercorporate dividends paid before 1 July 1987, and in respect of unfranked dividends paid after 30 June 1987, on certain shares issued after 1.00pm on 10 December 1986 or used under an arrangement entered into or extended after that time (proposal announced on 10 December 1986); and

  - .. to extend the scope of provisions that deem liquidation distributions to be dividends to include distributions out of amounts (other than indexed capital gains) which are assessable income under any provision of the Income Tax Assessment Act, or out of realised capital gains on assets acquired after 19 September 1985 (proposal announced on 10 December 1986);

- amend the Crimes (Taxation Offences) Act 1980, the Taxation Administration Act 1953, and the Taxation (Interest on Overpayments) Act 1983 -

  .. to extend the operation of those Acts as appropriate in consequence of the introduction of the full imputation system;

- repeal the Income Tax (Non-Resident Companies) Act 1978 -

  .. to terminate the imposition of branch profits tax on non-resident companies in relation to the 1986-87 and subsequent income years.

The Income Tax (Franking Deficit) Bill 1987 will impose on a company that has a deficit in its franking account at the end of a franking year, a liability to pay franking deficit tax. The amount of any franking deficit tax payable by a company will be able to be offset against company tax payable at the 49 per cent rate on income of the 1986-87 or later income years that is raised in an assessment (including an amended assessment) after the end of the franking year in which the deficit arose.

The Income Tax Rates Amendment Bill 1987 will amend the Income Tax Rates Act 1986 -

- to declare the rates of tax payable for the 1987-88 and subsequent financial years by companies and registered organizations and by trustees of prescribed unit trusts, superannuation funds and ineligible approved deposit funds; and

- to declare the rate of tax payable for the 1986-87 and subsequent financial years by trustees in respect of trust income of non-resident company beneficiaries of trust estates.

FINANCIAL IMPACT

The imputation system and related measures covered by these Bills have an estimated net cost of $50 million in 1987-88 and $300 million per annum thereafter. Unquantifiable but significant savings will result from the proposed action on liquidation distributions and denial of the intercorporate dividend rebate on certain shares.

MAIN FEATURES

The main features of the Bills are described below.

Taxation Laws Amendment (Company Distributions) Bill 1987

Full imputation system
(Clause 14)

This Bill will insert a new Part - Part IIIAA - in the Income Tax Assessment Act 1936 ("the Assessment Act") to provide for the introduction of the full imputation system of company taxation that is to apply from 1 July 1987. Under this system, dividends paid on or after 1 July 1987 by Australian resident companies - to the extent that tax is paid or payable at the company level in respect of income of the 1986-87 and later income years - will carry credits for that tax to relieve personal income tax payable by resident individual shareholders.

In basic terms, the system will operate to impute or allocate tax paid at the company level as a credit to such shareholders who will be assessed on the total amount of the dividend and the imputation credit, but will be entitled to a rebate of tax equal to the imputation credit. Dividends with an imputation credit attached will be known as "franked" dividends, and the extent to which they are franked as the "franked amount" of the dividends. Where franked dividends pass from one resident company to another, the attached imputation credit will be effectively transferred to the recipient company thus enabling that company to frank a similar amount of dividends paid to its shareholders.

With the company tax rate and the top personal tax rate aligned from 1 July 1987 at 49 per cent, the rebate allowable in respect of a franked dividend received by an individual taxpayer subject to the top marginal rate (i.e., a taxpayer whose total taxable income exceeds $35,000) will completely offset the tax payable on the total of the dividend and the imputation credit. For a resident individual shareholder with a taxable income below $35,000 and subject to lower marginal personal tax rates, any excess rebate will be offset against income tax on other income, including capital gains, but will not be refundable where the rebate exceeds such tax.

The practical operation of the basic system is illustrated by the following example.

	$	$
Company level		
Taxable income		1000
Company tax (49 per cent)		490
After tax income (paid as dividend)		510
Shareholder level	49% rate	40% rate
Dividend received	510	510
Imputed credit	490	490
Assessable income	1000	1000
Tax assessed	490	400
Less rebate for imputation credit	490	490
Tax payable	NIL	NIL
Excess rebate available to offset tax on other income	NIL	90

In some cases, a company paying dividends to its shareholders on or after 1 July 1987 may not be in a position to "frank" those dividends, e.g., because it has accumulated profits but incurs a loss in 1986-87 and therefore has no tax to pay in respect of that year. In such a case, the dividends paid will be "unfranked", and will not have an imputation credit attached. Unfranked dividends paid on and after 1 July 1987 will be subject to tax in the hands of resident individual shareholders in the same way as all dividends received by such shareholders are taxed under the present law.

Between the two extremes, there will be some companies that will be able to frank only partially their dividends. For example, a company with a book profit in 1986-87 of $1,000 but entitled to a deduction of $500 for a carried forward loss will have a taxable income for that year of only $500 on which the tax payable will be $245. If the company paid a dividend of $255, that dividend would be fully franked by the tax payable. But if the company wished to pay a dividend of, say, $510, the franked amount of the dividend would be only so much of the dividend as has been franked. In other words, the dividend would comprise a franked amount of $255 (with an imputation credit of $245 attached) and an unfranked component also of $255. If the company distributed the whole of its after tax profit of $755, the franked amount of the dividend and the imputation credit attached would remain $255 and $245 respectively, but the unfranked component would be $500.

Imputation credits will not be allowed to non-resident shareholders. However, where a franked dividend is paid on or after 1 July 1987 to a non-resident shareholder - whether an individual or a company - the franked amount of that dividend will be exempt from dividend withholding tax. Where a non-resident shareholder derives on or after 1 July 1987 an unfranked dividend or a dividend that is partly unfranked, that dividend or part, as the case may be, will remain subject to dividend withholding tax at the general rate of 30 per cent or, as is more commonly the case where the shareholder is a resident of a country with which Australia has concluded a tax treaty, at the reduced rate (usually 15 per cent) applicable under the relevant treaty.

Under the present law, and subject to the provisions of an applicable tax treaty, a non-resident who carries on business in Australia at or through a permanent establishment (branch) situated in Australia is exempt from withholding tax but is subject to tax by assessment at full rates in Australia on dividends received from Australian resident companies. From 1 July 1987 this basis of liability to Australian tax will cease to apply, and all dividends paid on and after that date to non-residents, irrespective of whether or not they carry on business at or through a permanent establishment in Australia, will be subject to the dividend withholding tax rules outlined above. This more beneficial treatment will not be affected by Australia's tax treaties.

All dividends, whether franked or not, paid on or after 1 July 1987 by one Australian resident company to another will continue to be included in the assessable income of the recipient company and effectively freed from tax by the intercorporate dividend rebate provided by sections 46 and 46A of the Assessment Act. The imputation credit attached to a franked dividend will not be included in the assessable income of the recipient company (nor will a rebate be allowed to the company for that credit), but will be available to the recipient company to frank dividends it pays to its shareholders. In this way imputation credits arising from tax paid by one company will be passed through company structures until they emerge attached to franked dividends paid to the ultimate shareholders.

Where franked dividends are paid to a trustee of a trust estate or to a partnership, the attached imputation credits will be included in the assessable income of the trustee or partnership to determine the relevant net income. An appropriate proportion of the imputation credits included in the net income of a trust or partnership grossed up in this way will flow through to each entitled beneficiary or partner to be dealt with on the basis outlined above depending on whether the beneficiary or partner is a resident individual or company, or is a non-resident.

The rebate of tax to be available to resident individuals in relation to imputation credits included in assessable income will also be available on the same basis to trustees who are liable to be assessed on any net income of a trust estate in accordance with Division 6 of the Assessment Act. The rebate will be similarly available to taxpayers or trustees liable to be assessed in accordance with Division 6AA (relating to certain income of minor children), and to trustees of superannuation funds and ineligible approved deposit funds who are liable to be assessed, respectively, under section 121CC, 121DA or 121DAB, and section 121DAA, of the Assessment Act.

Imputation credits attached to franked dividends will not form part of "separate net income" for dependant rebate purposes, but will be included in the tax base for Medicare levy. The rebate allowable in respect of imputation credits included in assessable income will not offset Medicare levy.

The extent to which dividends paid on and after 1 July 1987 are franked will be determined by the amount of company tax paid or payable by the company concerned on its income of the 1986-87 and subsequent income years, and the amount of dividends that company receives which are franked by the payment of company tax by another company. The general rule is that a company will be required to frank dividends it pays to the extent allowed by the surplus balance in its franking account at the time of payment after taking account of any future dividends that the company is committed to pay. The franking account balance, which could be in surplus or deficit at any time, will be calculated on an ongoing basis by deducting from the franking credits of the company up to that time, its franking debits to that same time. As explained in more detail below, a credit will most commonly arise when an instalment of company tax is paid or a company tax assessment is issued, and a debit when a franked dividend is paid.

Where a company's franking surplus is insufficient to fully frank the dividends it is to pay at a particular time, but the company expects to have further franking credits arise before the end of its franking year, it may, at its option, frank the dividends by more than the surplus would allow at that time - this is referred to as "over-franking". In doing so, however, the company will be required to have regard to the expected level of franking credits and of future dividend commitments in the relevant year. (In no circumstance will a company be permitted to frank a dividend beyond the amount determined by the relevant company tax rate, that is, at the 49 per cent company tax rate that is to apply to income of the 1986-87 and subsequent income years, by more than $49 for each $51 of dividends paid.)

If a company over-franks a dividend and it turns out that its franking debits for the year exceed its franking credits so that a franking deficit exists at the end of the year, the company will be required to make a payment of franking deficit tax shortly after the close of the year. Franking deficit tax so payable will be offset against any company tax (on income of the 1986-87 or any later income year) that becomes due under an assessment or amended assessment raised after the end of the year in which the deficit arose. Where the level of the franking deficit tax is such as to indicate that a company has not reasonably estimated its expected franking credits and debits, a penalty of up to 30 per cent of the franking deficit tax payable may be imposed.

At the time of paying a dividend, a company will be required to make a declaration of the extent to which the dividend is to be franked. All dividends which are paid as part of the one distribution, e.g., an interim distribution paid to ordinary shareholders, will be required to be franked to the extent declared. However, subject to the required franking amount rules discussed later, there will be no requirement to frank interim and final dividends equally, nor dividends on different classes of shares (broadly, shares carrying different rights). A franking declaration cannot be varied or revoked, and will be required to be lodged by the company, together with an annual reconciliation of its franking account - by the end of the month following the end of its franking year where franking deficit tax is payable, or with annual income tax returns in other cases. Companies will be required to provide shareholders with a statement giving, amongst other things, details of the franked amount of dividends paid, the imputation credit attached and, in the case of non-residents, any withholding tax deducted.

Within the above broad framework there are various rules that will apply, and these and other features of the system are discussed below under headings of phrases and expressions used in the Bill.

Franking year

The franking credits and franking debits of a company are to be reconciled annually on the basis of a "franking year" (sometimes called a reconciliation period) to determine the franking surplus or deficit for the year. For early balancing companies, that is, those with a substituted year of income ending before 1 June in lieu of the following 30 June, the franking year will be the substituted instalment period of the company (the period ending on the last day of the month during which the substituted year of income ends, or 31 December, whichever is the later). For companies on any other balancing period for tax purposes (including late balancing companies), the franking year will be the period from 1 July to 30 June. A special transitional franking period may apply in circumstances where a company is granted leave to vary its accounting period.

Frankable dividend

A frankable dividend is, broadly, one which is paid on or after 1 July 1987 and is either a dividend within the meaning of that term in section 6 of the Assessment Act or a liquidation distribution to which subsection 47(1) of the Assessment Act, as proposed to be extended by this Bill, applies. However, dividends paid on or after 1 July 1987 as part of a distribution in relation to which dividends were first paid before that date, will not be frankable dividends - see later notes on "reckoning day". Franked dividends do not include a dividend paid by co-operatives which are deductible under section 120 of the Assessment Act, or by a company which is a resident of a prescribed territory within the meaning of Division 1A of Part III of the Assessment Act (Norfolk Island and Cocos (Keeling) Islands) out of income from sources within those territories or outside Australia to a resident of those territories.

Franking credits and franking debits

A franking credit arises where a company which is sufficiently resident (broadly, a resident for more than one-half of the year of income or a resident for the whole period of its existence in an income year) -

- carries forward a franking surplus from the preceding franking year;
- pays a company tax instalment;
- receives a company tax assessment or debit amended assessment for 1986-87 or any later income year;
- receives franked dividends from another company (either directly, or indirectly through a partnership or trust - see later);
- is served with a notice of a determination reducing the amount of a franking deficit tax offset (see later) to which the company is entitled, or reducing a foreign tax credit allowable to the company; or
- has an estimated debit determination that lapses, or a later estimated debit determination is substituted for an earlier determination (see later).

A franking debit arises where a company -

- pays a franked dividend;
- has all or part of its company tax instalments applied to reduce a tax liability (usually on assessment) or refunded;
- receives an amended company tax assessment which reduces the company tax for 1986-87 or any later income year;

- is served with notice of a determination of a franking deficit tax offset or of an increase of an offset of franking deficit tax;

- is served with notice of a determination of a foreign tax credit or an increase in the amount of a foreign tax credit;

- receives an estimated debit determination (see later); or

- under-franks a dividend.

Franking surplus or franking deficit

A franking surplus exists on a particular day where the total of the franking credits arising during the franking year up to that day exceeds the total franking debits to that day. A franking deficit exists in the reverse situation - where the total franking debits arising during the year up to the relevant day exceed the franking credits. The franking account balance is the franking surplus or franking deficit at a particular time.

Franking of dividends

Where a company pays a frankable dividend it will be required to frank that dividend at least to the extent determined by the required franking amount rules explained later. Franking will occur where a dividend is paid by a resident company and the company declares that the dividend is franked to the extent specified in a declaration. Shareholders will be able to ascertain the extent to which a dividend is franked from the dividend advice statement that companies will be required to give them.

Required franking amount

Statutory rules will apply to determine the required franking amount in relation to a dividend that is to be paid by a company. These rules cover a range of circumstances and specify, in any given situation, the minimum extent to which a dividend will be required to be franked.

The first and basic rule requires a dividend to be franked to the extent permitted by the company's franking surplus at the date of payment of the dividend. Where the franking surplus is not less than the amount of a dividend, the dividend must be fully franked. Where the franking surplus is less than the dividend, and subject to a relieving provision mentioned below in the case of small surpluses, the dividend must be partly franked to the extent of the surplus. This basic rule is subject to two further rules which will apply where a company, at the date of payment of a dividend, is to pay a further dividend on that day, or has an obligation to pay a frankable dividend at a later time in the year - a committed future dividend (see below). In these cases, unless the company's franking surplus is sufficient to fully frank all of the relevant dividends, the company will be required to pro-rate its franking surplus over all of the dividends being paid on that day and the committed future dividends.

Special rules also apply where a company has over-franked a dividend paid when it has a committed future dividend. In these circumstances, the company will be required to frank the committed future dividend to the same extent as the earlier over-franked dividend.

And finally, if more than one dividend is paid on the same day and one of the dividends is over-franked, the other dividend or dividends will be required to be franked to the same extent.

It is possible that more than one of the required franking amount rules will apply to a particular dividend. In such cases, the required franking amount of the dividend is the greater or greatest of the required franking amounts determined under the various rules.

Over-franking and under-franking

The above rules specify the minimum extent to which a dividend must be franked. However, a company will be permitted, at its option, to anticipate franking credits which it reasonably expects will arise later in a year in order to frank a dividend payable before the credits arise. In such cases, the company will be free to frank a dividend in excess of the required franking amount, but where it does so and a franking deficit exists at the end of the franking year, the company will be liable to pay franking deficit tax.

The ability of a company to over-frank a dividend, provided its estimates of future franking credits and debits are soundly based, will be of particular relevance to companies in the early stages of the imputation system and also later where, for example, a company is moving from a loss to a profitable situation.

Under-franking arises where a company franks a dividend to an extent less than the required franking amount. Under-franking will not occur where the required franking amount for a dividend is less than 10 per cent of the dividend. Where, however, the required franking amount is more than 10 per cent of the dividend and the dividend is not franked to the required amount, a franking debit arises equal to the amount by which the required franking amount exceeds the franked amount of the dividend (if any). In other words, the company will be effectively treated as if it had franked the dividend to the required extent, thereby reducing its franking account balance otherwise available for franking future dividends.

Committed future dividends

Dividends will be treated as committed future dividends if, at a particular time-

(a) a resolution has at that time been made to pay the dividends no later than the end of the franking year; or

(b) the dividends are to be paid before the end of the franking year, the amount of the dividends is fixed and the rights of shareholders to be paid the dividends are established in the company's constituent documents.

Estimated debit determinations

A company which anticipates that a franking debit will arise due to a request for a credit amendment, the lodgment of an objection, a claim for a foreign tax credit or an offset of franking deficit tax (referred to as "liability reduction action"), or because it expects to receive a refund of company tax instalments paid, will be able to apply to the Commissioner for a determination of the estimated debit which would arise if the action is successful or it receives the refund. By this mechanism, a company will be able to anticipate a future franking debit that is expected to arise in the circumstances specified and will result in a reduction of its franking account balance, in order to avoid an inappropriate application of the required franking amount rules discussed above.

Where a company receives notice of an estimated debit determination, a franking debit equal to the amount specified in the notice arises at that time. Once a liability reduction action terminates, e.g., because an amended assessment issues or an objection is disallowed, a franking credit arises equal to the estimated debit and offsets the entry created by the debit determination. Any subsequent debit which results from a successful liability reduction action, e.g., a refund of company tax accompanying the credit amendment notice, will adjust the company's franking account balance to reflect the true position.

Reckoning day

The rules incorporated in the imputation system operate on the basis of the day of payment of a dividend. In some cases, although dividends may be part of one distribution they may not all be paid on the same day. So that undue changes in the required franking amount established under the rules discussed earlier will not arise where such dividends are not all paid on the one day, a concept of "reckoning day" has been incorporated in the legislation. The reckoning day for a dividend will be the day of payment of the dividend if no other dividends are to be paid under the same resolution. Where more than one dividend is payable under a resolution, the reckoning day for each dividend is the day on which the first of those dividends is paid. For this purpose, where a resolution covers the payment of dividends on more than one class of shares, the company will be treated as having a separate resolution for each class. By these rules, the required franking amount for a dividend will be fixed as at the date on which another dividend in the same distribution is first made. (This mechanism will prevent a company from being penalised by being treated as having over-franked or under-franked dividends in relation to which the franked amount has been set by a franking declaration.)

Dividend statement

No later than the time of payment of a dividend to a shareholder, a company will be required to provide the shareholder with a dividend statement which specifies whether the dividend is franked or not and, if it is franked -

- the franked amount of the dividend;
- the unfranked amount of the dividend;
- the imputation credit attached to the dividend; and
- the amount of any dividend withholding tax deducted (where unfranked dividends are paid to non-resident shareholders).

Franking deficit tax

A company will be liable to pay franking deficit tax (to be imposed by the accompanying Income Tax (Franking Deficit) Bill 1987) on the amount of any franking deficit which exists at the end of a franking year. Franking deficit tax will be due and payable on the last day of the month following the end of the company's franking year. For a company with a franking year corresponding to the financial year this will be 31 July. The tax will be self-assessed on the basis of the reconciliation return.

Franking deficit tax is not a penalty. It is simply a payment that is required to make up the amount of company tax that has been imputed by the payment of franked dividends in a franking year that has not actually become available by the end of that year. Reflecting this, the franking deficit tax payable will be an amount corresponding to the company tax that would have been payable on an amount of income equivalent to the franking deficit, grossed up by that company tax. Where a company has become liable to pay franking deficit tax, it will be entitled to offset this amount against any company tax assessed after the end of the franking year concerned on income of the 1986-87 or any later income year (including on an amended assessment increasing the tax assessed).

Franking deficit tax will not be offset against instalments of company tax, but may be taken into account in seeking a variation of those instalments.

Penalty for substantial over-franking

A fundamental design of the imputation system contained in this Bill is that imputation credits attached to franked dividends will arise only from income tax that is paid or payable at the company level. As indicated above, the franking deficit tax is designed to do no more than ensure that, where imputation credits attached to franked dividends exceed tax paid or payable at the company level - as reflected by a deficit in a franking account at the end of a franking year - the shortfall in company tax paid or payable is made good shortly after the end of that year.

The franking deficit tax is not intended to be a facility by which a company can opt to over-frank dividends to an extent obviously greater than a reasonable estimate of its future franking credits and debits will allow. Reflecting this, the Bill provides for the imposition of a penalty of up to 30 per cent of the franking deficit tax payable at the end of a franking year. Before the penalty can apply, however, certain pre-conditions must exist. These are that the company must have -

- franked a dividend paid during the franking year to an extent greater than its franking account surplus at the time of payment; and

- a franking deficit at the end of the franking year that is more than 10 per cent of the franking credits that arose during that year.

The penalty will not therefore apply where -

- a dividend paid during the year has been over-franked, but the franking deficit at the end of the year is not more than 10 per cent of the total of the franking credits during that year; or

- if the franking deficit at the end of the franking year is greater than 10 per cent of the total of the franking credits for that year, but no over-franking of a dividend occurred during that year. (This situation could arise where a company properly franks a dividend on the basis of the surplus in its franking account at the time of payment of the dividend, but subsequently receives an amended assessment reducing company tax of which it was previously unaware and in relation to which it had not sought an estimated debit determination (see above) that results in a franking deficit at the end of the year.)

The Bill also contains a provision for the 30 per cent penalty that would otherwise apply where the pre-conditions mentioned above exist to be remitted in appropriate circumstances, e.g., where a dividend paid during the franking year was over-franked on the basis of a reasonable estimate of future franking credits, but a franking deficit arose at the end of the year because of circumstances beyond the control of the company such as where there is a delay in the issue of its company tax assessment.

Other penalties

In addition to the case already mentioned where significant over-franking occurs, a company will become liable to pay, by way of penalty, additional tax if -

- it provides incorrect advice in a dividend statement;
- it makes false or misleading statements or omits from a statement a material matter so as to reduce the amount of franking deficit tax otherwise payable; or
- it refuses or fails to furnish, when and as required under the Assessment Act, a return or other information relating to a franking year.

Dividends paid to partnerships and trusts

As mentioned earlier, individual resident shareholders who receive franked dividends will be entitled to rebates of tax in their assessments for the year of income in which the dividends are paid. Beneficiaries and partners who receive a share of franked dividends through a trust estate or partnership (or through a combination or chain of partnerships and trusts) are to be entitled to a corresponding share of the imputation credit attached to those dividends undiminished by expenses of the trust estate or partnership. This approach places beneficiaries and partners in the same position, in relation to the imputation credit, as they would have been if they had received the franked dividend directly as a shareholder and had obtained deductions in their own right for the expenses. In this way, a resident beneficiary or partner will be entitled to a rebate if he or she is an individual or, in the case of a company, to a franking credit. Consistent with the principles of the imputation system, a dividend rebate or franking credit will not arise under these provisions if the beneficiary or partner is a non-resident in relation to the franked dividend.

As also indicated earlier, where an individual resident shareholder receives a franked dividend in a year of income, the attached imputation credit will be included as assessable income of the shareholder. This same rule will apply where a partnership or trustee is paid a franked dividend. The amount that is included in the assessable income of the trust estate or partnership will be apportioned between, and therefore included in the assessable income of, the persons (including a trustee assessed under sections 98, 99 or 99A) who are to be assessed in relation to the net income of the partnership or trust estate. This apportionment will be made on the basis of the proportion of the income attributable to the franked dividend that is included in the net income of the trust or partnership that is assessed to the beneficiary, trustee or partner.

A resident individual who is entitled to some or all of the franked dividends paid to a partnership or trust will also be entitled to a rebate of an amount equal to his or her share of the imputation credits in relation to those franked dividends. The amount of rebate calculated in this way is called the "potential rebate amount". The potential rebate amount in relation to which a company partner or beneficiary is entitled will give rise to a franking credit in the company's hands, but will not be included in its assessable income. These rules will also ensure that the benefit of an imputation credit in relation to franked dividends included in the assessable income of a partnership flows through to the partners where there is a partnership loss, but no such benefit will flow to beneficiaries where a trust has no net income or incurs a loss.

A non-resident will not be subject to tax on the potential rebate amount, and will also be exempt from withholding tax on franked dividends included in the net income of a partnership or trust to which he or she is entitled.

Where the whole or part of the net income of a trust estate is assessed to the trustee of a trust estate pursuant to section 99 or 99A of the Assessment Act, the provisions of the Bill outlined above will ensure that an appropriate portion of the imputation credit in relation to any franked dividends derived by the trust is included in the net income assessed under those sections. A rebate will be allowed in the assessment equal to the trustee's potential rebate amount in relation to the franked dividend. In this way income from franked dividends that is accumulated in trusts will be relieved from any further tax.

<u>Dividends paid instead of interest</u>
(Clauses 6, 7, 9 and 10)

Amendments to the income tax law announced on 7 April 1986 and contained in the Taxation Laws Amendment Bill (No. 5) 1986 effectively treat share based finance arrangements for periods of two years or less as debt for income tax purposes. They do this by denying the intercorporate dividend rebate provided by sections 46 and 46A of the Assessment Act in relation to the dividends paid on the relevant shares, but allowing a deduction to the issuer as if the dividends were interest payments.

The amendments proposed by this Bill will go further and will deny the intercorporate dividend rebate in relation to dividends paid on shares used in any finance arrangements where the dividends may reasonably be regarded as equivalent to the payment of interest on a loan. In the case of such dividends paid on and after 1 July 1987, only so much of the dividend as has not been franked under the new imputation system will be denied the dividend rebate under this new measure. Unlike the earlier measures, the payment of dividends subject to the provisions of this Bill will not entitle the issuer to a deduction.

The new measures will apply to dividends that are paid after 1.00pm, Australian Eastern Summer Time (AEST), on 10 December 1986 in respect of shares issued after that time, or used under a finance arrangement entered into after that time.

A finance arrangement for the purposes of the proposed amendments includes any arrangement that has the purpose of enabling a company to obtain finance (whether by the issue of shares or otherwise), or an extension of the period for which finance has been obtained under an earlier arrangement.

The new measures will apply on the basis outlined above where any of the entities concerned are corporate unit trusts or public trading trusts the trustees of which, in accordance with Divisions 6B and 6C respectively of the Assessment Act, are treated as companies for income tax purposes.

<u>Distributions by liquidator</u>
(Clauses 8 and 18)

This Bill will also implement the proposal, announced on 10 December 1986, to bring within the scope of subsection 47(1) of the Assessment Act distributions to shareholders of a company by a liquidator in the course of winding up the company to the extent to which the distributions are paid out of amounts included in the assessable income of the company or from capital gains on assets acquired after 19 September 1985 without regard to indexation.

The amendment of subsection 47(1) will not apply to a liquidator's distribution in the course of winding up a company where the winding up commenced before 1.00pm, AEST, on 10 December 1986, i.e., where an application for the winding up of the company was lodged with the Court before that time, or a special resolution for voluntary winding up was passed by the company in general meeting before that time.

Where subsection 47(2A) applies in the case of an informal winding up of a company, any distribution of money or property of the company that is made after 1.00pm, AEST, on 10 December 1986, is to be treated in the same way as a distribution made by a liquidator in the course of the winding up of a company which commenced after that time.

Liability to withholding tax
(Clauses 11, 12 and 18)

The Bill will implement the proposal, also announced on 10 December 1986, to exclude all non-residents from liability to withholding tax in respect of the franked amount of dividends paid to them after 30 June 1987. The Bill will also give effect to the proposal that dividends derived after that date by non-residents who carry on business in Australia at or through a permanent establishment of the non-resident in Australia, will not be subject to tax by assessment but will be brought within the withholding tax regime. This will mean that the franked amount of the dividends paid to such non-residents will be free of any Australian tax at the shareholder level. The unfranked amount of dividends paid to any non-resident will continue to be subject to withholding tax.

Income of non-resident companies
(Clauses 13 and 18)

Another measure associated with the introduction of imputation to be given effect by this Bill is the abolition of the additional tax on the reduced taxable income of non-resident companies (the "branch profits tax"). Branch profits tax will last apply to income derived in the year of income that commenced on 1 July 1985, that is, it will not apply to income of the 1986-87 or any later income year.

Crimes (Taxation Offences) Act 1980
(Clauses 3 and 4)

The definition of income tax in the Crimes (Taxation Offences) Act 1980 is to be amended so as to include any amount payable to the Commissioner under the new imputation measures contained in Part IIIAA of the Assessment Act which is proposed to be inserted by this Bill.

Income Tax (Non-Resident Companies) Act 1978
(Clauses 20 and 21)

Reference was made earlier in this memorandum to the repeal of Division 11B of Part III of the Assessment Act under which non-residents are liable to pay a branch profits tax. The Income Tax (Non-Resident Companies) Act 1978, which imposes the tax, is also to be repealed by this Bill.

Taxation Administration Act 1953
(Clauses 22, 23 and 24)

Section 8ZE of the Taxation Administration Act 1953 renders certain penalty taxes not payable unless and until any prosecution action taken with respect to the same matter is withdrawn. The section is to be amended by this Bill so that it covers any penalty for setting out incorrect amounts in a dividend statement, for failure to furnish a reconciliation return and for making a false or misleading statement in relation to franking deficit tax under the new imputation arrangements.

The Bill will also amend section 14ZKA of the Taxation Administration Act which modifies the operation of limitation laws in force in States and Territories as they affect additional tax imposed by way of penalty. The section is to be amended so that it covers additional tax imposed by way of penalty pursuant to the new imputation provisions contained in Division 10 of Part IIIAA that is to be inserted in the Assessment Act by this Bill.

Taxation (Interest on Overpayments) Act 1983
(Clauses 25, 26 and 27)

The Taxation (Interest on Overpayments) Act 1983 authorises the payment of interest in respect of certain overpayments of tax. Amongst other things, the Act applies to decisions in relation to objections, the scope of which is to be extended to cover objections under the relevant provisions of the new Part IIIAA of the Assessment Act.

Basically, interest under this Act is only payable in respect of a period ending when overpaid tax is refunded or applied against a liability to the Commonwealth. A further amendment will make it clear that, when franking deficit tax is offset against company tax assessed, the amount offset is to be taken to have been applied against a liability of the company to the Commonwealth.

Income Tax (Franking Deficit) Bill 1987

This Bill will impose the franking deficit tax which may become payable under the new imputation system being introduced by the Taxation Laws Amendment (Company Distributions) Bill 1987 and described earlier in these notes.

Income Tax Rates Amendment Bill 1987

The Income Tax Rates Act 1986 is to be amended by this Bill to declare the rates of tax payable for the 1987-88 and subsequent financial years by companies, by registered organizations, and by trustees of prescribed unit trusts, superannuation funds and ineligible approved deposit funds.

The Bill will give effect to the proposal announced in the 19 September 1985 Statement on Reform of the Australian Taxation System to align the company tax rate with the new maximum personal marginal tax rate of 49 per cent, commencing with the 1987-88 financial year (clauses 4,5,6, and 10). The rate of tax payable by registered organizations will remain at 20 per cent.

The Bill will also give effect to various rate changes for superannuation funds and ineligible approved deposit funds for the 1987-88 and subsequent financial years consequential on the commencement, from 1 July 1987, of the second stage of reductions in the personal income tax rate scale. In that respect, this Bill will reduce the rate of tax payable by a trustee of a superannuation fund assessed under -

- section 121CA or 121CB of the Income Tax Assessment Act 1936 ("the Assessment Act") from 50 per cent to 49 per cent (clause 7);
- section 121CC of the Assessment Act from 24.42 per cent to 24 per cent (clause 7);
- section 121DA of the Assessment Act from 57.08 per cent to 49 per cent (clause 7); and
- section 121DAB of the Assessment Act from 44.25 per cent to 40 per cent (clause 7).

The rate of tax payable by a trustee of an ineligible approved deposit fund assessed under section 121DAA of the Assessment Act is to be reduced from 44.25 per cent to 40 per cent (clause 8).

A further amendment to be made by this Bill will declare the rate of tax payable for the 1986-87 and subsequent financial years by trustees assessed under subsection 98(3) of the Assessment Act in respect of trust income of non-resident company beneficiaries of trust estates. Reflecting the company rate of tax to apply from the 1987-88 financial year (that is, in respect of company incomes for the 1986-87 and subsequent income years), the rate of tax payable by trustees to whom subsection 98(3) applies is to be 49 per cent (clauses 9 and 10).

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