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Maximising shareholder value

Company tax rate reduction and Paid Parental Leave levy: Impact on dividends

20 June 2014

In the 2014/2015 Federal Budget handed down on 13 May 2014, the Government reinforced its commitment to a reduction in the company tax rate from 30% to 28.5%, effective from 1 July 2015. At the same time, it also confirmed its undertaking to introduce the paid parental leave (PPL) levy on "large" companies at a rate of 1.5%.

Associated with these changes, a number of matters need to be considered as regards a company's ability to best utilise its franking credits. We set out below some questions and answers, and highlight some issues that companies will need to consider in order to maximise shareholder value.

Snapshot:

- Currently, there is limited detail on the proposed reduction in the company tax rate and the proposed introduction of the PPL levy. Further, it is not certain what transitional measures, if any, will be introduced to preserve the integrity of the dividend imputation system
- The key issue is that in the absence of transitional measures, a portion of the franking credit balance as at 30 June 2015, which has been generated at a tax rate of 30%, will be "trapped" in the company's franking account. Further, there will be an increase in the effective tax rate on underlying profits of companies which are paid to shareholders as dividends. This will reduce the after tax cash available to shareholders
- In addition, after the commencement of the PPL levy on 1 July 2015, there will be further trapped franking credits on an annual basis for large companies. Again, this will increase the effective tax rate on underlying profits of a large company which is paid to shareholders as a dividend, and reduce the after tax cash available to shareholders
- In light of these points, companies should actively plan ahead to forecast future franking balances, determine the scale of trapped franking credits (especially as at 30 June 2015) and consider alternative dividend and capital management policies in order to maximize shareholder value
- Companies need to actively monitor policy development in this area.

Reduction in the company tax rate

Q: From what date is it proposed that the company tax rate will be reduced from 30% to 28.5%?
A: 1 July 2015

Q: Does this reduction in the company tax rate apply to all companies?
A: Yes (but note the impact of the PPL on large companies – refer below)

Q: With the various changes in the company tax rate in the 1990's, there were consequential changes made to the company franking account, including a restating of the franking balance. Do we expect similar changes?

A: At this stage, the Government has not announced any transitional measures or consequential changes relating to dividend imputation. Given that the current franking system is based on a tax-paid model (unlike in the 1990's), we do not expect that there will be any restating of the company franking account as a result of a prospective company tax rate change. As discussed below, transitional measures (if any) would likely focus on the definition of maximum franking credit[1].

Q: In the absence of any transitional measures made to the imputation rules, what would be the outcome?
A: In the absence of any transitional measures, it would appear that in respect of a dividend paid after 1 July 2015, the maximum franking credit will be insufficient to distribute all of the franking credits of the company as compared to the same amount of cash dividend paid prior to 30 June 2015.

Assume $100 of pre-tax profits derived prior to 30 June 2015 and subject to 30% tax				
Pre-tax profits	$100			
Company tax	$30			
After tax profits	$70			
Franking credits	$30			
Individual: top rate	49%[2]			
Dividend	$70			
	Dividend Paid Prior to 30 June 2015		**Dividend Paid After 30 June 2015**	
Maximum franking credit	= $70 x (30/70) = $30		= $70 x (28.5/71.5) = $27.9	
Trapped franking credits	Nil		$2.1	
Grossed up assessable dividend	$100		$97.9	
	Individual	**Super Fund**	**Individual**	**Super Fund**
Cash (net of tax) after distribution to shareholder	$51	$85	$49.9	$83.2
Effective tax on underlying profits after distribution to shareholder	49%	15%	50.1%	16.8%

Based on the above, in respect of a dividend paid after 1 July 2015 from profits arising before that date:

- Approximately 7% of the franking credits (2.1/30) get trapped within the company. Whilst these could be distributed if the company has other "untaxed profits"[3], this will result in an additional cash cost to the company if paid as a cash dividend
- The effective tax rate on the underlying profits rises above the shareholder's marginal rate. This is because some of the franking credits remain trapped within the company. The net cash amount in the hands of the shareholders is reduced.

Q: If the policy goal is to maintain the integrity of the imputation system and to ensure that companies are able to distribute all of their franking credits to their shareholders, how could the imputation rules be amended, in respect of a dividend paid after 1 July 2015 from profits derived before that date?
A: If the policy goal is to maintain the integrity of the imputation system, then it is considered that an amendment is required to be made to the definition of maximum franking credit. The maximum franking credit is calculated as follows:

Amount of the distribution x [corporate tax rate / (100% - corporate tax rate)]

[1] Section 202-60, Income Tax Assessment Act, 1997
[2] Assumes that the 2% Temporary Budget Repair Levy commences with effect from 1 July 2014
[3] Profits or other income which is not assessable for tax purposes, such as income subject to section 23AJ or 23AH *Income Tax Assessment Act 1936*

To avoid the above trapping of franking credits, profits derived before 1 July 2015 which have been subject to 30% tax should be able to attach a franking credit based on a 30% company tax rate. That is, the corporate tax rate as used in the formula for the maximum franking credit should remain at 30% until the franking credits generated on profits derived prior to 1 July 2015 have been distributed. The policy goal in this respect is not clear at this stage. Press reports have suggested that, in the absence of transitional measures, the pool of potentially trapped franking credits at 1 July 2015 may be as large as $5 billion, so there are significant revenue implications for the Government and shareholders in respect of this matter.

Q: Is the trapping of franking credits only a one-off issue as at 30 June 2015?
A: No. there will be a further trapping of franking credits for large companies subject to the PPL levy (refer below).

Q: On the assumption that the definition of maximum franking credit is unchanged and there are no other transitional measures, what actions should companies be considering?
A: Companies need to forecast their expected balance of 30% franking credits having regard to their proposed dividend and capital management strategies prior to 30 June 2015. If there is a material balance of franking credits that would otherwise not be distributed prior to 30 June 2015, companies should consider alternative distribution and capital management strategies (eg, special dividends, non-cash dividends, share buy backs). Please contact your Deloitte client service team member should you wish to discuss these potential strategies in more detail.

PPL levy

Q: From what date is the PPL levy proposed to commence?
A: 1 July 2015 (our comments on the PPL levy are based on the 2013 pre-election Coalition policy document)

Q: Which entities will be subject to the PPL levy?
A: It is expected that the PPL scheme will only apply to companies with taxable incomes in excess of $5 million (large companies). It is estimated that there are only around 3,000 companies in this “large” category. Further, the levy is proposed to be applied only to the portion of taxable income in excess of $5 million.

Q: Will the PPL levy create franking credits?
A: We understand, based on numerous media reports and Treasury statements to the Senate Estimates Committee, that the PPL levy will <u>not</u> create franking credits.

Q: Will the levy be a deductible expense?
A: The PPL levy is an amount based on taxable income and we expect that it will not be allowed as a tax deduction (ie, it will be treated in the same way as income tax).

Q: What will this mean for large companies paying out fully franked dividends from post 30 June 2015 profits?

Assume $100 of pre-tax profits derived after 30 June 2015 and subject to 28.5% tax and 1.5% PPL levy	
Pre-tax profits	$100
Company tax	$28.5
PPL levy	$1.5
After tax profits	$70
Franking credits	$28.5
Individual: top rate	49%
Dividend paid	$70
Maximum franking credit	= $70 x (28.5/71.5) = $27.9
Trapped franking credits	$0.6
Grossed up assessable dividend	$97.9

Assume $100 of pre-tax profits derived after 30 June 2015 and subject to 28.5% tax and 1.5% PPL levy		
	Individual	**Super Fund**
Cash (net of tax and PPL levy) after distribution to shareholder	$49.9	$83.2
Effective tax rate (incl PPL levy) on underlying profits after distribution to shareholder	50.1%	16.8%

Based on the above, we note the following:

- Even though the company tax rate is 28.5%, the distributable profit, net of the PPL levy, is $70. However, the resulting $28.5 franking credit is only for the company tax payment and does not include the PPL levy
- There is a trapping of approximately 2% of the $28.5 franking credits (0.6/28.5). Whilst these could be distributed if the company has other "untaxed profits", this will result in an additional cash cost to the company if paid as a cash dividend
- The effective tax rate on the underlying profits is above the shareholder's marginal rate. The net cash amount in the hands of the shareholders is reduced

Q: If a large company pays the PPL levy on its taxable income and declares a dividend to another large company shareholder, will the large company shareholder have to pay the PPL levy on its dividend income?
A: Treasury is aware of this issue and refers to it as "cascading". The policy intention is clearly that there should be no cascading, however the mechanism to achieve this has not been finalized.

Q: Will the PPL levy be paid on an instalment basis?
A: Treasury is considering this issue at present.

Q: Will the PPL levy be eligible to be claimed as a foreign tax credit, for example, where a foreign investor holds shares in the Australian large company?
A: This issue will need to be raised with the foreign shareholder for them to consider under their home country law.

Q: Will the PPL levy paid by a large company be included in the calculation of its "income tax payable" for purposes of the foreign income tax offset (FITO) limit calculation?
A: This issue will need to be considered as more details of the levy become available.

Q: Will the levy be a tax for the purposes of AASB112 – Income Taxes?
A: This issue will need to be considered further as more details of the levy become available.

If you would like to discuss any aspect of the above, please contact your Deloitte client service team member who would be happy to discuss any of these matters in more detail.

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