Submission to the Standing Committee on Economics inquiry into the implications of removing refundable franking credits.

For the Doubters – by Lorraine, November 2018

For the doubters, here is an example which illustrates the way company tax works.

Suppose I have written a phone app that I want to market at 50c a time. I choose a company structure to limit my liability if my app inadvertently causes a phone to explode.

I set up a small company and put in $10k of my money to fund it. I can do this either by giving a loan to the company or contributing capital to the company.

In the first year my company makes $1000 and has $500 in admin costs.

In the first scenario I treat the original capital as a loan to the company and they pay me interest at 5%, so I receive $500. This is a tax deduction to the company so their profit is now $0 so they pay no company tax. I pay tax at my normal rate on the $500.

In the second scenario I treat the original capital as equity and take my $500 as a director's fee. Again this is a tax deduction to the company so their profit is now $0 so they pay no company tax. I pay tax at my normal rate on the $500.

In the third scenario I treat the original capital as equity but take my $500 as a dividend. This is not a tax deduction to the company so their profit is $500 and they pay $150 company tax. I receive $350 as a cash dividend with a $150 franking credit. I pay tax at my normal rate on the $500. If my normal tax rate is zero, I receive the $150 as a cash refund so I get my full $500.

This is not a gift from the ATO of tax paid by other taxpayers. The refund arises only because of the way the capital of the company is structured (loan or equity) and the form in which I take the payment (interest, salary or dividend).

Under the proposed rules if my normal marginal tax rate is zero then I would get no refund if I take the $500 as a dividend. I would receive only $350 of my $500 profit. I would pay tax at 30% even though my marginal tax rate is zero.

Now let's take this a step further.

The differences in the payments above occur only because interest and wages are tax deductible for the company while dividends are not.

Suppose the proposed policy was extended to all types of income. This would be done by changing the rules so interest and wages were no longer a tax deduction for the company so they paid tax on this money.

The tax paid by the company on wages would be in place of the normal PAYG tax deducted by companies and sent to the ATO, so it would simplify working out wages.

All interest paid by companies (and banks) would have 30% already deducted and sent to the ATO and all salary and wage income would have 30% already deducted and sent to the ATO. This is how dividends are treated now so these would not change.

At the end of the year taxpayers would work out their tax owing and if it was more than the amount already remitted they would pay the extra. If it was less than the 30% already sent to the ATO there would be no cash refund. That would just be hard luck mate. You can't begrudge paying 30% of your income to fund schools, roads and hospitals now can you?

It would be interesting to see the swing in election results against a political party that proposed this.

But think about it – this is exactly what is being proposed for dividend income.

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