HOW DO FRANKING CREDITS WORK?

So, have you ever asked yourself, “how do franking credits work?” Well, wonder no more, as here is an explanation.

Dividends to shareholders are paid out of profits. Companies have already paid tax on these profits at the company tax rate, which is currently 30%.

These dividends are described as being ‘franked.’ Franked dividends have a franking credit (tax credit) attached to them, which represents the amount of tax the company has already paid. Franking credits are also known as imputation credits.

As the company has already paid tax on the dividends that you end up with, you are entitled to receive a credit for any tax the company has paid. If your tax rate is less than the company’s tax rate, the Australian Tax Office (ATO) will refund you the difference.

Case Study

John’s SMSF receives a tax refund (see Column 15% in Table below).

John’s’ super fund owns shares in a company. The company pays the super fund a fully franked dividend of $700. John’s dividend statement says there is a franking credit of $300. This represents the tax the company has already paid. This means the dividend before company tax was deducted, would have been $1,000 ($700 + $300).

Come tax time, John’s fund must declare $1,000 (the $700 dividend plus the $300 franking credit) in the taxable income. If the marginal tax rate were 15%, he would have paid $150 tax on the dividend ($1,000*15%). Because the company has already paid $300 in tax, John will receive a refund of the difference, which is $150 ($300 tax paid by the company less tax he would have paid at 15% or $150).

So, John keeps the $700 he received and also gets a further $150 as a tax refund.

Please see the table below for the different tax rates and the box further below for a written explanation of this table:

Tax Rate	0%	15%	30%	45%
Dividend	$700	$700	$700	$700
Imputation Credit	$300	$300	$300	$300
Assessable Income	$1,000	$1,000	$1,000	$1,000
Gross Tax	Nil	$150	$300	$450
Less imputation credit (tax offset)	-$300	-$300	-$300	-$300
Tax Refund for excess imputation credits	**$300**	**$150**	**Nil**	**$150 extra tax to pay**
Full Entitlement	$1,000 ($700 + $300 tax refund)	$850 ($700 + $150 tax refund)	$700 (keep the full dividend received)	$550 ($700 - $150 extra tax liability)

So, you can see how valuable franking credits are to a super fund, that pays 15% tax in accumulation phase & 0% in pension phase (under $1.6m).

The lower your tax rate, the more franking credits work for you, one of the main reasons that so many voters rejected Labor’s proposed changes to the franking credits.

Further explanation of above table.:

1. **A tax rate of 0%,** if a super fund is in pension phase (for the super balance of less than $1.6m) – Tax due on the dividend is $0 ($1,000*0%). Because the company has already paid $300 in tax, a refund of $300 is received ($300 tax paid by the company less tax that would have paid $0 ($300-$0=$300). **So, John keeps the $700 he received and also gets a further $300 as a tax refund.**

2. **A tax rate of 15%,** he would have paid $150 tax on the dividend ($1,000*15%). Because the company has already paid $300 in tax, a refund of $150 is received ($300 tax paid by the company less tax that would have paid $0 ($300-$150=$150). **So, John keeps the $700 he received and also gets a further $150 as a tax refund.**

3. **A tax rate of 30%,** he would have paid $300 tax on the dividend ($1,000*30%). Because the company has already paid $300 in tax, John will not receive a refund nor have more tax to pay ($300 tax paid by the company less tax he would have paid at 30%, or $300). **So, John keeps the $700 he received and has no further tax to pay.**

4. **A tax rate of 45%,** he would have paid $450 tax on the dividend ($1,000*45%). Because the company has already paid $300 in tax, John will have to pay an extra $150 in tax**. So John must pay a further $150 in tax on this dividend.**

For more information, please click the ATO website for more details on dividend imputation.

If you would like to know further on how you can benefit from franking credits, please contact AAG team on (08) 9227 6300 or email clientservices@austasiagroup.com.

How can we help you?

AustAsia Group
Business, Finance & Taxation Solutions

AustAsia House, 412 Newcastle Street, West Perth WA 6005
PO Box 332, Leederville WA 6903

T: (08) 9227 6300 **F:** (08) 9227 6400 **E:** clientservices@austasiagroup.com

www.austasiagroup.com

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