Time to upgrade Australia's company tax system from imputation to integration

Wayne Mayo*

Abstract

The 1981 Campbell Committee report unsuccessfully recommended that Australia replace its then classical company tax system with an integration system that allocates companies' annual pre–tax economic income (including accrued gains) to their shareholders' personal tax assessments, even when no cash distributions are made. Since then, the scene has been set for serious consideration of a practical form of integration by a number of tax changes in Australia: a full imputation system that provides shareholders with credit for company tax paid on their dividend receipts; general capital gains taxation; and refunds of excess imputation credits. Moreover, integration is needed to address serious tax revenue loss, major inequities and investment distortions that stem from the imputation system allowing taxed company income to be retained indefinitely, exacerbated by company tax rates that are well below the top personal tax rate and refundable imputation credits when taxed income is ultimately distributed. A practical version of integration, under which companies' annual taxable income (not economic income) is included in their shareholders' personal tax assessments regardless of cash distributions paid, would address these problems while also removing the tax incentive to incorporate, engendering more soundly based investment decisions with accompanying improvement in productivity and long–term growth and allowing Australia's company tax rate to be set solely on the basis of how much to tax the long–term foreign equity investor.

* Formerly of Australian Treasury. Many thanks to Peter Swan, Bob Officer, Rick Krever, Matt Benge, John Freebairn and an anonymous referee for their valuable comments and insightful questions on earlier drafts.

This article was accepted for publication on 31 July 2018.

1. Introduction and motivation for change

In 1987, Australia's current full imputation system replaced a classical system of company taxation which imposed double tax on company income, once in the company and again when after-tax dividends were distributed to non-resident and individual local shareholders. In 1981, the Campbell Committee[1] recommended that annual company income be included directly into (integrated with) shareholders' personal tax assessments so that one layer of tax applied to that income at shareholders' tax rates, even if that income were retained and not immediately distributed.

While the Campbell Committee's recommendation was not accepted, in 1985, the Australian Government decided to replace the classical system with a full imputation system of company tax. Full imputation imposes a single layer of tax at local shareholders' personal tax rates on current-year company income — but, unlike integration design, only if that income is distributed immediately. Nevertheless, imputation's initiating document states that "were an imputation system introduced it would provide an appropriate basis for extension to a full integration system were the practical difficulties of that system eventually adequately resolved".[2]

1.1 Benefits of full integration

Integrating company and shareholder income taxation has traditionally been regarded in the economic literature as the ideal income tax treatment of companies. The Carter Commission, for example, concluded that, "After an exhaustive examination of the alternative methods of taxing corporate income … we have come to the conclusion that … full integration … is without doubt the best system".[3] The "Asprey review" referred to such design as "perhaps the theoretical ideal".[4]

Complications of international flows aside, integration offers the prospect of local shareholders being taxed each year on investment income of their companies equivalently to sole traders who achieve the same income by investing directly. Company tax has no effect here: just personal tax rates apply. Income tax has no impact on the decision to incorporate. Most importantly, under integration, if annual taxable "income" of the company or sole trader to be taxed corresponds to commercial profit (net receipts plus annual change in value of investment assets and liabilities), or

1 Committee of Inquiry into the Australian Financial System, *Australian financial system: final report of the Committee of Inquiry into the Australian Financial System* (Campbell Committee) (J Campbell, Chairman) AGPS, Canberra (1981).

2 Australian Government, *Reform of the Australian tax system, draft white paper*, AGPS, Canberra (1985) p 199.

3 Carter Commission, *Royal Commission on Taxation*, Queen's Printer, Ottawa (1966) p 6.

4 Taxation Review Committee, *Final report*, (Asprey review) (K Asprey, Chairman), AGPS, Canberra (1975) p 228.

economic income, the tax landscape is set for income taxation to have neutral impact on investment and financing decisions — see, for example, Samuelson[5] and Swan.[6]

To get an understanding of the neutral impact of such design ignoring risk and some second-round effects, imagine all investment alternatives offer 10% return per annum before tax (assumed in the worked examples in this article). Then, those individuals on a 25% tax rate would be choosing between investments offering 7.5% per annum after tax and those on a 47% tax rate (the investors in worked examples in this article) would be looking across alternatives offering 5.3% per annum after tax. Investment decisions after tax should be much the same as investment decisions in the absence of tax.

Crucial to this tax neutrality is the tax treatment of interest (the opportunity cost of capital investment, the basis of discount rates used in investment decision-making). The required treatment is simply to have interest income taxed the same as other income (nominal interest assessable in a nominal income tax system) — with symmetrical treatment (deduction) for interest payments.[7] Then, with a going annual pre-tax interest rate of 10%, the after-tax opportunity cost of investing for the investor on 47% tax rate is 5.3% per annum. Neutral tax impact is neatly achieved across investment and financing decisions. With discount rate reduced by the same proportion as the tax rate reduces commercial profit, income tax should not affect valuation of investments.[8]

Now add a utopian international scene for illustrative purposes where all countries employ integration and, despite prohibitive potential tax revenue impact, provide refundable credits to their residents for foreign taxes on their residents' worldwide income. Investment and financing neutrality would then extend worldwide — the "perfectly integrated system" of Boadway and Bruce.[9]

On the administrative and compliance front, integration design does not need to grapple with any boundary-line issues between wages and investment income: it seeks to tax annual wages and company income according to the personal rate scale. For a small business operator, for example, the owner's current year wages, interest income, income from the business (incorporated or unincorporated) and income from a share portfolio all go into the same melting pot to be subject to the personal rate scale.

---

5 P Samuelson, "Tax deductibility of economic depreciation to insure invariant valuations", (1964) 72 *Journal of Political Economy* 604-606.

6 P Swan, "Income taxes, profit taxes and neutrality of optimizing decisions", (1976) 52 *Economic Record* 166-181.

7 If only real interest is assessable/deductible, the tax-neutral income tax base then incorporates annual change in real value of investment assets/liabilities.

8 See Swan, op cit, p 172.

9 R Boadway and N Bruce, "Problems with integrating corporate and personal income taxes in an open economy", (1992) 48 *Journal of Public Economics* p 55.

1.2 Imputation sometimes aligns with integration

Despite all the attractions of integration, such company tax design is invariably quickly disregarded as being impractical — even in circumstances where the complications of foreign income and associated tax are ignored. Boadway and Bruce,[10] for example, say "in the context of a closed economy" that "an 'ideal' integrated income tax system is probably unattainable". The Asprey review[11] considered that "an arrangement of this kind could never be universally applied" because "it may be impossible to determine a correct allocation because different classes of shareholders may have differential rights to profits and those rights are not definitively expressed" and the allocation may need to "be made through a series of company shareholders". Beyond these issues, the review thought the "taxation of non-resident shareholders under this system would probably raise insuperable difficulties".[12] The review recommended for Australia "a full imputation system as the appropriate long-term target, with a partial imputation as an intermediate step".[13]

Australia's existing full imputation system of company tax, however, provides an integration-equivalent outcome when locally sourced annual income of Australian companies is distributed immediately to local shareholders. This distributed income only gets taxed once at the marginal tax rates of Australian individual shareholders, even though Australian companies are taxed on their annual taxable income and their shareholders are taxed separately on the distributions they receive.

This equivalence with integration arises because, under imputation, when Australian companies distribute their annual income: distributions out of the companies' taxable income (franked dividends) have attached refundable credits for the company tax already paid; and distributions out of income untaxed in the company (unfranked dividends) are taxed in the hands of shareholders. In these circumstances, Australian company tax is just a withholding tax. There is effectively no company tax at all on these distributions of annual company income to Australians.

Australia's imputation design does not, however, require companies to distribute at all (unlike the requirement of trusts to distribute taxable income annually). Company tax often does not operate, therefore, as a passive withholding tax on current-year income.

Consequently, full imputation works best when the company tax rate is aligned with the top personal tax rate. There is then incentive to distribute to shareholders, resulting in greater likelihood that company income will be taxed at the marginal rates of shareholders in the year the income is earned (ignoring assessment lags). There was a brief period in Australia around the time imputation was introduced

10 Ibid, p 40.
11 Ibid, p 228.
12 Loc cit.
13 Ibid, p 238.

when the company and top personal tax rates were aligned. Since then, the company rate has fallen below the top personal rate with the gap continually widening. Pressure for further cuts to the company rate(s) continues, with little foreseeable prospect of significant reductions in the top personal rate.

1.3 Flaws in imputation design

When, as now, the top personal marginal rate is significantly higher than the company tax rate, the incentive to distribute is diluted. Retaining income taxed only at the corporate rate enables shareholders to delay, perhaps indefinitely, paying their top personal rate on that income. Beyond those widely held companies which pay out much of their annual profit and those small and medium companies which have to pay out dividends in order for their shareholders to meet living expenses, there is no assurance that marginal personal tax rates of local shareholders will apply even to the annual taxable income of companies. Moreover, a range of costly tax minimisation strategies is stimulated by the rate gap, delayed distribution of taxed income and refundable imputation credits.

The Australian Board of Taxation[14] provides much detail on these tax minimisation strategies in its second discussion paper reviewing Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). Division 7A focuses particularly on stopping shareholders from permanently accessing company income (taxed at most at the corporate rate) that is loaned to them by their company.

The Board of Taxation[15] provides detailed analysis of business activities set within complex but off-the-shelf company-trust arrangements (incorporating "bucket" companies filling with retained taxed income and franking credits) that offer the ultimate prize of no net tax at all on company income. At the simplest level, for example, tax is paid on taxable company income retained in one year when shareholders are subject to high marginal rates. Later, all that prior company tax is refunded to shareholders in years when their marginal tax rates are zero (though the value of the refunded imputation credits has declined the longer the delay involved[16]).

A most inequitable and inefficient tax landscape is the result. Personal taxpayers are stuck with the progressive personal rate scale applying to their wages income and to their dividend receipts of current company income. For others, the company rate is the maximum tax rate faced by them over many years. Yet others are able to aspire to achieve a prize of no tax ultimately paid on their past income.

These tax minimisation strategies highlight fundamental problems with Australia's current imputation landscape. Integration would address these problems directly by

14 Board of Taxation, *Post implementation review of Division 7A of the Income Tax Assessment Act 1936*, second discussion paper, Australian Treasury (March 2014).

15 Ibid.

16 A point made to the author by Bob Officer.

requiring company income to be taxed in the year it arises in the hands of shareholders even when that income is not distributed.

With imputation arrangements and refundable credits retained under integration, the setting of the company tax rate under integration can independently focus on the foreign investor, not any impact on resident shareholders with low or zero tax rates were refundable credits not available. Selecting the (company) tax rate to apply to long-term non-resident equity investors could provide an ideal opportunity to assess the appropriateness of the tax treatment of non-residents' capital gains, interest income and withholding taxes across and ever-expanding range of investment vehicles.[17]

1.4 Recent Australian reports propose replacing imputation but not with integration

Australia has already done much of the difficult preparatory work to move from imputation to integration and is, consequently, in a unique position to be able to contemplate such design change:

- the revenue cost of moving from classical design to full imputation has been absorbed;
- the intricate systems required for full imputation have been bedded down and refined, including through changes recommended by the Review of Business Taxation;[18]
- the cost of refundable imputation credits, essential to integration design that incorporates company tax and imputation arrangements, has been absorbed; and
- general capital gains taxation (CGT) was introduced from 1985, including CGT cost base adjustments for distributions of contributed capital from companies (and of untaxed amounts from fixed trusts) — again features that are crucial for the integration design presented in this article, both for the basic operation of the system and to address potential arbitrage across different shareholder groups.

The depth of this opportune preparatory work is a clear invitation to test fully the feasibility of integration, an invitation made more urgent by proposals to remove refundable imputation credits and, more particularly, by two recent reports that propose the replacement of imputation with systems other than integration — though neither report provides clear specification of replacement design.

17 An issue raised in communication with John Freebairn.

18 Review of Business Taxation, *A tax system redefined*, "Overview, recommendations, estimated impacts" (J Ralph, Chairman), AGPS, Canberra (July 1999).

1.4.1 Board of Taxation

First, the Board of Taxation,[19] in its final report on Div 7A, does not propose integration design to address the shortcomings of Australia's imputation landscape that it so clearly identified in its second discussion paper.[20] That is despite the fact that integration would also directly address problems the board identified with Div 7A. Integration would short-circuit the need for much of Div 7A by taxing annual company income at shareholders' current tax rates.

Instead, the Board of Taxation recommends, along with a range of complex changes to Div 7A, fundamental change to the treatment of companies and trusts. Central to that fundamental change is recommendation 1[21] for retained "business" profits ("business accumulations") to be taxed at a common "business tax rate" regardless of business structure used (namely, companies or trusts). The board's recommendations do not specify the treatment of retained income when it is ultimately distributed.

At one level, the board's recommendations seem to surrender to the timing problems inherent in current imputation design. At another level, the design recommended would seem to be some sort of ad hoc dual income tax system: wages income taxed at progressive marginal rates and investment income earned by companies and trusts (but not that of sole traders) taxed at a relatively low flat rate like the company tax rate.

1.4.2 Henry review

Second, the "Henry review"[22] recommends (recommendation 37) that alternatives to imputation should be considered "as part of a further consideration of company income tax arrangements".[23] The review notes a range of benefits of full imputation compared to prior classical taxation arrangements, including: removal of double tax domestically, taking the taxing of companies closer to that of trusts and sole traders; providing better balance in company financing and distribution choices; removal of dividend withholding tax on franked dividends paid to non-resident shareholders (so that only one layer of Australian tax applies); and "integrity benefits"[24] arising from the incentive for resident companies to pay local tax. Nevertheless, the review concludes that the "benefits of imputation have declined as the Australian economy has become more integrated into the global economy".[25]

---

19 Board of Taxation, *Post implementation review of Division 7A of the Income Tax Assessment Act 1936*, report to the Assistant Treasurer, Australian Treasury (November 2014).

20 Board of Taxation (March 2014), op cit.

21 Board of Taxation (November 2014), op cit, p 10.

22 Australian Treasury, *Australia's future tax system*, Report to the Treasurer (Henry review), part two detailed analysis, (K Henry, Chairman), Canberra (2009).

23 Ibid, p 198.

24 Ibid, p 194.

25 Ibid, p 198.

This conclusion seems to be based mainly on:

- a belief that "increasingly integrated world capital markets" mean that imputation "will become less effective in reducing the cost of capital"[26] (but no matter what the relative influence of local or foreign investors on risk-inclusive returns to investments by local companies, imputation seeks to apply only a single layer of tax to those returns);
- the fact that,[27] under current imputation design, local shareholders can face double tax on the foreign income of their companies (however, as acknowledged,[28] imputation could remove such double tax by allowing verifiable foreign taxes on this foreign income to be added to the companies' imputation credits if the potentially very large tax revenue hit from such a change were accepted);
- the observation that non-resident shareholders "cannot directly benefit from imputation credits"[29] (even though imputation ensures that the non-residents' home countries can, if they wish, provide credit for Australian company tax underlying dividends received and the non-residents can themselves seek to access the going value of franking credits by selling their Australian shares); and
- the concern that imputation credits to resident shareholders may be "a refund for company income tax that they have not entirely borne given that Australia is an open economy".[30]

This latter concern that imputation credits represent a subsidy to local shareholders comes from the idea that Australia's company tax rate chokes off foreign inwards investment, pushing up pre-tax returns of local company investments above returns available to the non-corporate sector — at the extreme, resulting in post-tax corporate returns matching pre-tax non-corporate returns.

Imputation credits are not a subsidy, however. Higher returns to particular activities cannot be quarantined to corporate players in those activities. The risk-adjusted return to a particular local activity is the result of competitive interplay between local and foreign corporate and non-corporate equity and debt investors. All the while, the imputation system works away dispassionately removing double taxation on the resulting returns realised by local companies. In any case, any increase in pre-tax returns arising from foreign investment diverted elsewhere is caused by an excessively high company tax rate, not the imputation system.[31] Were a classical system operating instead, presumably the concern would then be that local shareholders are subject to one layer of tax not two.

---

26 Ibid, p 199.

27 Ibid, p 196.

28 Ibid, p 201.

29 Ibid, p 198.

30 Ibid, p 76.

31 P Swan, "Investment, the corporate tax rate, and the pricing of franking credits" (Draft), (March 2018), pp 1-45, explains how, by trading outside the 45-day rule, some inwards foreign investors may obtain a high proportion of the benefit of local franking credits — with correspondingly

The Henry review discusses a number of alternative possible future company income tax systems to replace imputation (though not the upgrading of imputation to integration) — as do a number of authors, like Ingles and Stewart[32] and Cormick and McLaren,[33] who draw heavily on discussion in the Henry review. The review says "consideration could be given to a partial integration system that is common overseas, while at the same time reducing the company income tax rate"[34] — even though a distortive partial system would ensure permanently reduced productivity and long-term growth, while reducing the company tax rate would be seeking a one-off lift in activity level from an increase in inwards foreign investment. However, the review seems to favour a "more radical approach"[35] reflected in recommendation 26[36] for a form of a "business level expenditure tax" (which would not tax normal investment returns at all) while recommending that the imputation system be retained until Australia could join "at an early stage" a possible future trend by other countries "towards such systems".

Cormick and McLaren[37] prefer arrangements where companies receive deductions for dividend distributions. Stewart and Ingles[38] discuss cash flow and dual income tax arrangements, like the Henry review, but focus more on the so-called comprehensive business income tax (CBIT). The CBIT, one of three "prototypes" for removing double tax on company income canvassed by US Treasury,[39] seeks to achieve a single layer of tax on both corporate equity and debt by denying companies interest deductions on debt but then removing personal tax on companies' dividend and interest payouts. Consequently, the CBIT does not attempt to tax current-year company income at shareholders' marginal tax rates, in sharp contrast to full integration design of US Treasury in 1977[40] and in the integration "prototype" of US Treasury in 1992[41], which has companies' income allocated annually to tax assessments of ongoing shareholders.

In the interim before its foreshadowed abolition of imputation, the Henry review recommends (recommendation 14[42]), possibly as a precursor to a future generally

---

reduced impact of Australia's corporate tax rate on them — while retaining an ongoing interest in Australian companies. Such foreign investors should view pre-tax returns from Australian corporate activities, as well as their valuations, similarly to local investors.

32 D Ingles and M Stewart, "Australia's company tax: options for fiscally sustainable reform", (2018) 33(1) *Australian Tax Forum* 101-139.

33 R Cormick and J McLaren, "Dividend imputation: a critical review of the future of the system", (2018) 33(1) *Australian Tax Forum* 141-161.

34 Ibid, p 199.

35 Ibid, p 199.

36 Ibid, p 165.

37 Ibid.

38 Ibid.

39 US Department of the Treasury, *Integration of the individual and corporate tax systems: taxing business income once*, US Government Printing Office, Washington DC (1992).

40 US Department of the Treasury, *Blueprints for basic tax reform*, US Government Printing Office, Washington DC (1977).

41 US Treasury (1992), op cit.

42 Ibid, p 70.

applicable dual income system, an ad hoc dual income tax system that excludes from tax 40% of the income of a selected range of investments — like some interest income (even though neutral income taxation requires no special treatment of interest) and income from rental properties. The review considers that these selective income discounts could later morph into a general dual income tax system (like those in Scandinavian countries) replacing imputation by extending "the savings income discount … to business income through a business allowance"[43] (to split the income from investments outside widely held companies into differentially taxed labour and capital components).

Overall, such dual income tax systems seek to tax wages income as usual under the progressive personal tax rate scale but tax all investment income at a flat, relatively low tax rate. Despite the attractiveness of a flat rate of tax applying to all investment income, Scandinavian countries have found major practical problems arise across the boundary line between wages and investment income of, for example, sole traders and small and medium sized companies. As noted, integration design does not need to grapple with such boundary-line issues.

1.5 Design of integration in this article

1.5.1 Integration of taxable income

The Campbell Committee's recommended design of integration has companies' annual economic income (including companies' accrued capital gains) integrated with shareholders' personal tax assessments. The taxation of accrued capital gains is a contentious issue and is not a general feature of Australia's CGT arrangements. Practical versions of integration design — including the design of Benge and Robinson,[44] US Treasury[45] and Mayo[46] — seek to integrate taxable income rather than economic income. That is the practical approach to integration taken in this article.

Consistent with that, in relation to international taxation, any taxable income under current arrangements from outwards foreign investment of Australian companies would be integrated with the personal taxation of Australian shareholders under this article's design. As now, foreign taxes associated with that taxable income would not add to local companies' franking credits.

The design presented assumes a uniform rate of Australian company tax (with imputation systems and refundable credits retained) regardless of size of company. The

43 Ibid, p 77.

44 M Benge and T Robinson, *How to integrate company and shareholder taxation: why full imputation is the best answer*, Victoria University Press for the Institute of Policy Studies, Wellington (1986).

45 US Treasury (1992), op cit.

46 W Mayo, *Taxing investment income: without affecting worldwide investment decisions*, Kyscope Publishing, Canberra (2011).

setting of the rate is focused on how much tax to impose on foreigners undertaking ongoing investment in, or through, domestic companies.

1.5.2 Integration for all resident companies

This article focuses solely on design of a practical integration regime for the whole resident corporate sector. Local shareholders face tax at their current tax rates on their companies' current-year taxable income, not only as now under imputation when taxed income is distributed as cash, but also when their companies retain taxed income. Companies keep their retained taxed income for investment purposes and their local shareholders pay extra tax on that income or receive excess tax credits (and cash refunds if necessary) if their tax rates are higher or lower respectively than the company rate — resulting in tax outcomes equivalent to those of unincorporated direct investors. Ongoing foreign shareholders pay the corporate rate on their share of taxable income.

Integration of taxable income offers the prospect of local incorporated and unincorporated investors paying the same tax on equal amounts of current-year income (horizontal equity) and paying more tax on higher levels of current-year income consistent with the progressive personal tax system (vertical equity) — an outcome that would be ultimately achieved if tax preferences declined over time (taxable income approached economic income). With all current-year company taxed income and associated tax credits passed to shareholders regardless of whether or not a company's taxed income is distributed, integration of taxable income no longer allows companies to ignore the opportunity cost of retaining taxed income.[47] As US Treasury explains, "corporate tax payments are drawn from resources belonging to people that would otherwise be available to them for present or future consumption".[48]

The article does not therefore propose design changes that would apply only to closely held companies. Thus, not considered is restricting integration to particular companies — like the recommendation of the Asprey review[49] to allow an election for integration design (providing partnership treatment) to be made by small companies in circumstances which remove the review's general concerns over integration's impracticability.

Not proposed also are arrangements designed to achieve imputation-equivalent outcomes in Australia more simply. Taylor[50] proposes an optional dividend deduction system, with its own set of wide-ranging rules, for unlisted resident companies with only limited numbers of resident shareholders of a single class. Cormick and McLaren

47 An observation made to the author by Bob Officer.

48 US Treasury (1977), op cit, p 4.

49 Ibid, p 239.

50 C Taylor, "An old tax is a simple tax: a back to the future suggestion for the simplification of Australian corporate-shareholder taxation", (2006) 2 *Journal of The Australasian Tax Teachers Association* 30-57.

suggest a more general dividend deduction system incorporating "a withholding tax at the corporate level on dividends paid".[51] Necessarily like imputation, however, dividend deduction arrangements postpone tax at personal rates on retained income until the income is ultimately distributed (presumably then with some sort of tax credit for company tax previously paid).

Taylor explains that dividend deduction arrangements, or split-rate systems (retained income taxed at the corporate rate and cash dividends deductible to the company and assessable to shareholders), are part of Australia's interesting history of corporate taxation. Taylor[52] acknowledges that, under "an optional dividend deduction approach corporate income would only bear tax at the corporate rate" while retained (as with imputation) and, consequently, such as approach "would not of itself do anything to counteract any tax planning that diverted personal services income to companies" (in circumstances where the company tax rate is below the top personal marginal tax rate). In contrast, integration would address such tax planning directly.

Similarly, not proposed are targeted amendments aimed at addressing problems caused by the gap between the top marginal rate and the company tax rate(s) with closely held or private companies, amendments like the reintroduction of the former administratively burdensome Div 7 (ITAA36) undistributed profit tax. Abolition of Div 7 was enabled by the removal of double tax on dividends on introduction of imputation and by the ensuing (albeit brief) period of alignment of the top marginal and company tax rates. Of Div 7, Swan[53] refers to "the highly troublesome, unpopular and discriminatory measure" and the Campbell Committee[54] says it "impacts unevenly as between shareholders and unincorporated proprietors".

Integration design in this article also does not require companies to distribute cash dividends at least totalling annual taxable income, or institute equivalent dividend reinvestment arrangements, as trusts are generally required to do (a requirement that would maintain the nexus under imputation between a company's cash dividends and its taxed income). There is no specific requirement for companies to distribute any particular level of cash dividends. The allocation of current-year taxable income across each company's various share classes is always required, however, regardless of cash distributions made.

---

51 Ibid, p 60.

52 Ibid, pp 50-51.

53 P Swan, "Further notes on the integration of company and personal taxation", Australian Financial System Inquiry, *Commissioned studies and selected papers*, Part 3 – Business taxation and the financing of industry, AGPS, Canberra (1982), p 99.

54 Ibid, p 220.

1.5.3 Capital gains taxation

The design presented also assumes no CGT discount applies to capital gains realised by individual resident shareholders (already the case with companies). The integration design could still operate with the current CGT discount, but removal of the discount would strengthen both the design of integration and its accompanying broader economic benefits. Removing the CGT discount from share sales in isolation would address the types of tax arbitrage problems under integration identified by Benge and Robinson.[55] It would also support tax-neutral pricing of shares (without much net effect on tax revenue). Across-the-board removal of the CGT discount would improve investment decision-making generally, increase tax revenue and see tax outcomes from investing via companies under integration align better with those from investing direct or via trusts.

Consistent with integration design in this article, Head[56] saw "the more moderate proposal for full taxation of realised capital gains" (applying across the board) as a practicable accompaniment to integration. The Carter Commission[57] observes that, "We could not countenance the unwarranted benefits that some shareholders would obtain from full integration if share gains were not taxed in full". Such practical CGT design contrasts the narrow taxing of accrued capital gains by companies inherent in the recommendation of the Campbell Committee[58] for integrating companies' pre-tax "income" (including accrued gains). Absent taxation of accrued gains, only taxable income is integrated with shareholders assessments in the article's design, not tax losses, which remain with the company — consistent with integration design by US Treasury.[59]

1.6 Structure of article

Sections 2 and 3 look at the basic design features and operational issues, respectively, of integration of taxable income under the restrictive circumstances of just one class of share and only local shareholders, drawing on worked examples of the operation of integration in Attachment A. Sections 4 and 5 deal with multiple share classes and non-resident shareholders, respectively, the two issues that are perhaps most often cited as reasons why integration is not feasible.

---

55 Ibid, p 79.

56 J Head, "Company income tax in Australia", Australian Financial System Inquiry, *Commissioned studies and selected papers*, Part 3 – Business taxation and the financing of industry, AGPS, Canberra (1982), p 162.

57 Ibid, p 28.

58 Ibid, p 217.

59 US Treasury (1992), op cit, p 28. Integration design in US Treasury (1977) — op cit, p 69 — passes company tax losses to shareholders.

2. Basic design features

This section provides the design features of integration of taxable income in the vanilla circumstances of companies having: just one class of share with equal dividend rights; shareholders who only sell out at year's end; and only locally sourced income.

These vanilla circumstances put a focus on the core part of integration of taxable income: the treatment of companies' retained taxed income and cash distributions.

The overarching design feature of integration of taxable income is that, for income tax purposes, annual taxed income is always distributed, never retained (as it can be under imputation).

2.1 Retained taxed income

Under imputation, retention of taxed income by Australian resident companies has no immediate tax implications for shareholders. Taxation of existing shareholders under imputation revolves around cash distributions.

In contrast, under integration, a lot of things happen when a company decides not to distribute annual taxed (franked) income as cash to shareholders. For tax purposes, a cash distribution to shareholders of retained taxed income is deemed to have occurred (and included in assessable income of shareholders) followed by the shareholders' reinvesting the cash back into the company. When only ongoing ordinary shareholders with equal dividend rights are involved, current-year taxed income is allocated pro rata across all shareholders.

The shareholders also receive increases in the CGT cost bases of their existing shares matching the amount of retained taxed income of their companies included in their tax assessments (along with credits for company tax paid) — a feature applying to retained and allocated annual company income under integration design in Carter Commission[60] and US Treasury.[61] That is consistent with the implicit distribution and reinvestment of the companies' taxed income. Mayo[62] shows how the CGT cost base increase also removes the potential for temporary double taxation of income that can arise under current imputation arrangements when taxed income is retained (with consequent share price rise) and shares sold.

The deemed distribution (or allocation or attribution) and re-investment of retained taxed income is similar in effect to current dividend reinvestment plans (DRPs) voluntarily entered into by shareholders (though new shares are then received, instead of integration's CGT cost base increases). The key difference is that shareholders decide

60 Ibid, pp 83-84.
61 US Treasury (1977), op cit; and US Treasury (1992), op cit.
62 Ibid, pp 176-182.

individually to sign up to DRPs whereas, under integration, a decision to reinvest taxed income is effectively imposed on shareholders when, say, a company makes no cash distribution in a year despite earning taxable income in that year. A DRP also applies to any untaxed component of a cash distribution whereas integration of taxable income only imposes reinvestment on allocated taxed income.

Because "retained" income is deemed to be distributed and reinvested under integration, it is not classed as retained earnings by the company but as new shareholder contributed capital. This approach, which is central to integration design, is consistent with the view of Swan:[63]

> "Company earnings net of withholding tax which are retained have already been fully taxed so that it is just as if earnings were fully paid out and a new issue of equity shares was subscribed to by the original set of shareholders. To prevent shareholders being taxed twice when the company is wound up or a reduction in capital occurs retained earnings should be treated as an increase in paid-up capital."

Unlike taxed income, untaxed income is not allocated to shareholders regardless of cash distributions made. Integration of taxable income is the design, not integration of economic income (or commercial profit).

2.2 Cash distributions

2.2.1 Taxed income

Under integration, taxed income, whether implicitly reinvested or distributed as cash, is always included in shareholders' tax assessments together with associated tax credits. There are no unallocated credits to be stored in a franking account.

When cash distributions have been made for a year to a class of shareholders (restricted here to ongoing ordinary shareholders with equal dividend rights), as much as possible current-year taxed income is absorbed by the distributions. If the cash distributions happen to match end-year allocation of taxed income, the cash distributions will comprise fully franked dividends. Only if the cash distributions are less than current-year taxed income does the excess taxed income get allocated to shareholders' contributed capital account (with matching increases to CGT cost bases). When cash distributions exceed current-year taxed income, the excess is either unfranked dividends (distributed income not in taxable income) or a return of capital (including prior-years' allocated taxed income not distributed as cash).

63 P Swan, "Is there a case for complete integration of corporate and personal income taxes?", Australian Financial System Inquiry, *Commissioned studies and selected papers*, Part 3 – Business taxation and the financing of industry, AGPS, Canberra (1981) p 15.

2.2.2 Untaxed income/returns of capital

Under imputation, distributions of unfranked income (from any year) are taxed in shareholders' hands. Unfranked dividends arise, for example, from distributions of company income freed from tax by tax preferences like accelerated depreciation or delayed tax on accrued capital gains. Returns of capital attract matching reduction in the CGT cost base of shareholders' shares — so that an unwarranted capital loss is not allowed, say, when shares are sold or a company is liquidated and all capital is returned.

In bringing policy, law and administrative considerations to bear in deciding the detailed design features of integration, how to treat distributed untaxed income (unfranked dividends) will be an important feature.

One approach would be to apply reductions in CGT cost bases of shares not only for distributions of contributed capital (including prior "retained" taxed income), but also for distributions of untaxed income. Thus, unfranked dividends would attract CGT cost base reductions under integration (as applies with "deferred" income under current treatment of unit trusts) instead of imputation's immediate taxation. This approach would provide simplicity because no distinction is needed between returns of capital and cash distributions of untaxed income.[64] It would also provide a better match with tax outcomes of direct investors, who immediately receive reduced tax payments from tax preferences, and unit trust investors (see discussion beneath Table A3 in Attachment A). Relative to current imputation design, however, this approach would result in delayed tax on distributed untaxed income. The timing of tax on amounts of distributed untaxed income would depend on the sale of shares or sale of company assets attracting the associated tax preferences.

The alternative approach, and that applied in this article, is to retain the immediate taxation in shareholders' hands of unfranked dividends. Familiarity with this treatment (including down the company chain) may bolster acceptability of integration, particularly as this approach would also deal with potential concerns over the tax revenue impact of delayed tax on distributed untaxed income. Retaining unfranked dividends would also mean that there is no difference in the tax treatment between interest paid on preference shares classified as debt and unfranked (or franked) dividends paid on preference shares classified as equity. Under this approach, like now, CGT cost base reductions on shares would be required only for returns of capital (including allocated/reinvested taxed income,[65] which has been converted to contributed capital and has attracted CGT cost base increases in prior

64 With allocated/reinvested taxed income attracting a CGT cost base increase, all distributions would incur a CGT cost base reduction, a design feature of integration in US Treasury (1977), op cit, US Treasury (1992), op cit and Mayo (2011), op cit.

65 As under integration design in Carter Commission, op cit.

years). Achieving complete tax balance between shareholders, sole traders and trust unitholders under this approach would require complete removal of tax preferences.

After integration design that retains unfranked dividends is successfully implemented, consideration could then be given to replacing unfranked dividends with CGT cost base reductions. Such replacement would result in integration design that could be a suitable template to apply to trusts, including superannuation funds (with zero fund earnings rate and equitable concessional treatment applied to marginal personal tax rates), which already accredit annual trust/fund taxable income to unitholders/beneficiaries.

2.3 Cash distributions and shareholder's annual tax statement

Under imputation, typically, biannual dividend slips show shareholders their franked dividends with associated franking credits and their unfranked dividends to be included in their personal tax assessments. The dividend could be out of profits from the current year or any prior year.

Under integration, after year's end, annual tax statements for the preceding year would be issued to company shareholders. The statements would be similar to current annual tax statements of fixed trusts, issued after year's end, that include distributions, taxable income and CGT cost base reductions associated with distributions of deferred (untaxed) income. Tax statements for shareholders would contain: (1) share of current-year taxed income (franked dividends) and associated company tax paid (franking credits) to be incorporated in personal tax assessments; (2) any cash distributions received for the year — and, where cash distributions exceed share of taxed income, the amount of that excess representing unfranked dividends for inclusion in personal tax assessments; and (3) required CGT cost base adjustment comprising:

- share of current-year taxed income that is not received as cash (resulting in no double tax on allocated and reinvested taxed income if shares sold); less
- distributions of contributed capital (including capital created by prior-years' allocated/reinvested taxed income).

Under integration, regular distribution reinvestment arrangements would still enable shareholders to continue to choose to reinvest any cash distributions received in return for extra shares.

2.4 Worked examples

Worked examples in Attachment A illustrate how suggested integration design maintains close links with Australia's current imputation design. Annual pre-tax investment return in the examples is 10%. The company tax rate is 30% and shareholders have a 47% personal tax rate. The (marginal) 10% pre-tax return may

be viewed as matching the opportunity cost of investing (alternative risky interest return). Then, the bringing together under integration of tax-neutral corporate investment and debt/equity financing decisions is illustrated in the examples where shareholders achieve annual post-tax returns of 5.3% — or 10% pre-tax reduced by their 47% tax rate.

The worked examples in Attachment A show the operation of integration of taxable income where a company has no foreign income and only has ordinary local shareholders with equal dividend rights whose sales of shares always occur at year's end. The examples are taken from Mayo[66] but changed to have unfranked dividends continue to attract immediate taxation rather than, as in Mayo,[67] CGT cost base reductions. The examples in Attachment A cover circumstances of full distribution of available cash, with or without annual sale of shares (Tables A2 and A3, respectively), and no cash distributions until liquidation, again with or without sale of shares each year (Tables A5 and A4, respectively).

The tax base in the examples incorporates tax preferences in the form of accelerated depreciation and CGT applied on realisation (not accrual) but with no CGT discount (either at company or individual shareholder levels). Current-year company income (commercial profit) is not therefore taxed in years prior to liquidation, but all the company income is ultimately taxed via "balancing adjustments" on sale of associated assets in the final liquidation year (the tax preferences are only "temporary"). The company's results are compared to those of an unincorporated investor directly undertaking the same investments as the company (Table A1 in Attachment A).

The examples in Attachment A illustrate how closely post-tax outcomes under suggested integration design track those under current imputation design in circumstances of full distribution of available cash — Table A2 (shares sold each year) and Table A3 (no share sales). The results under integration can be compared directly with those under imputation shown in Mayo.[68] Thus, outcomes under integration in Tables A2 and A3 in Attachment A match exactly those under imputation shown in Tables 33 and 35, respectively, in Mayo.[69]

Not surprisingly, differences between the two systems arise when integration comes into its own in circumstances of no distributions being made prior to liquidation — Table A4 (no share sales) and Table A5 (shares sold each year) in Attachment A. In those circumstances, imputation just has the company tax rate (30%) applying to the company's taxable income year by year but, as designed, integration ensures that annual taxable income of the company always attracts shareholders' 47% tax rate in the same year. Thus, $10 and $20 extra tax is paid by shareholders in years 3 and 4 in

66 Ibid, pp 215-222.
67 Ibid.
68 Ibid.
69 Ibid, pp 169-175.

Table A4 relative to imputation's outcomes under identical circumstances shown in Table 36 in Mayo.[70] The adding of the associated allocated/reinvested taxed income in years 3 and 4 (totalling $126) to the CGT cost bases of shares in Table A4 means that no double tax on retained taxed income arises under integration should shares be sold — as illustrated in Table A5. Consequently, no CGT gain or loss arises when this reinvested taxed income is distributed as a return of capital with matching cost base reduction, as it is in year 5 in Table A4. Potential share purchasers should be prepared to pay for the full value of reinvested taxed income because there are no tax effects associated with its ultimate distribution.

Imagine there are no tax preferences applying in Table A4. All current-year company income, shown in the before-tax section of the table, would be taxed in the company each year. The resulting retained annual taxed income would be allocated to shareholders, along with associated franking credits, implicitly reinvested and converted to contributed capital with matching increases in CGT cost bases (tax value) of shares. In each year, tax value of shares would match their sale value. Consequently, no CGT gain or loss would arise from any sale of shares at the end of any year or on liquidation.

In contrast, when untaxed income is retained (as in Tables A4 and A5) with consequent increase in share value, the CGT cost base of shares is not increased (as clearly shown in years 1 and 2 in Table A4). Nevertheless, people should still be prepared to pay the full value of retained untaxed income because, while they will be taxed on the associated unfranked dividends when distributed, they will receive a matching CGT capital loss. Thus, in Table A5, people pay full value for shares each year with the sellers subject to CGT on the sales. When assets are sold and proceeds distributed on liquidation in year 5, a $746 capital loss arises that matches all prior retained untaxed income subject to CGT on share sales in prior years. No net CGT revenue is realised overall but year-by-year pricing is sound and tax arbitrage stifled.

Table 37 in Mayo[71] shows the operation of imputation in identical circumstances to those in Table A5. The annual returns in the latter years of Table 37 falling below the steady 5.3% returns in Table A5 illustrate the opportunity cost to shareholders of taxed income being retained under imputation. Integration avoids these effects by having retained taxed income implicitly distributed, leaving no store of franking credits, and reinvested with associated increase in cost base of shares.

Nevertheless, overall tax revenue is the same ($570) in both Table 37 and Table A5. Under imputation when no CGT discount applies, an offsetting capital loss on liquidation removes potential double taxation from CGT applying to sales of shares after unfranked income or taxed income is retained. Tables A2 and A3 in Attachment A also show how an offsetting CGT loss similarly removes potential double taxation

70 Ibid, p 177.
71 Ibid, p 179.

of distributed unfranked income.[72] In contrast, Table 39 in Mayo[73] shows how permanent double tax can arise under imputation when a CGT discount reduces the offsetting capital loss by half. Such effects are avoided in suggested integration design by dropping the current 50% CGT discount.

3. Operational issues

Beyond the above key features of integration in vanilla circumstances, upgrading imputation to integration design raises a number of practical operational issues — even when only ordinary shareholders with equal dividend rights are involved.

3.1 Part-year share ownership

Absent any cash dividends paid for a year, for shares that are held for part of the year, the allocation by a company of its annual taxable income is ideally a pro rata allocation based on the period or periods of time that the shares are held by shareholders during the year. Brief periods of ownership could be ignored. With no cash distributions made by a particular company whose share price is steadily rising from a steady build-up of retained income, shareholders selling during the year would be subject to CGT on their gains. The taxable gains of these shareholders would be reduced by any increases in their shares' cost bases from taxed income allocated to them (in year-end tax statements) — as shown in years 3 and 4 in Table A5 in Attachment A. Were allocated taxed income to match capital gain, the only tax effect (extra tax or refund) would come from the taxed income itself.

Such design best meets the aim of taxing annual allocated/reinvested taxable income at the current marginal rates of shareholders. Implementing such design would be a challenging administrative task, particularly for widely held companies whose shares are constantly changing hands — but one made less demanding by technological advancements.

As explained in section 2.2, when all shareholders in a share class hold their shares all year, any annual cash distributions paid to them (potentially during the year and/or with year-end tax statements) taken in aggregate first absorb the company's current-year taxed income. Aggregate cash dividends equal to taxed income then result in fully franked cash dividends (the $661 dividend in year 5 in Table A2 in Attachment A) and cash dividends greater than taxed income result in partially franked or unfranked cash dividends (as in years 1 to 4 in Table A2). Taxed income

72 Other options for dealing with the potential double taxation of distributed tax-preferred income are discussed in Review of Business Taxation, *A platform for consultation*, "Building on a strong foundation, The taxation of entities", (J Ralph, Chairman), AGPS, Canberra (February 1999), pp 355-360.

73 Ibid, p 186.

that is greater than aggregate cash dividends is implicitly reinvested and held in the contributed capital account of that share class.

The more interesting, general design question is how to spread taxed income across cash dividends paid at varying times during a year to shareholders who may be selling out to others through the year. In circumstances of evenly spaced, equal dividend payments, aggregated cash dividends received by those holding shares at dividend cut-off dates would continue to first absorb annual taxed income. The mechanics of this may be illustrated drawing on the situation where people buy in for short periods spanning a payment of cash dividends.

Imagine, instead of retaining taxed income, the above company earning steady income pays equal cash dividends twice in a year (mid-year and year's end) that in aggregate at least equal annual taxed income (the degree of partial franking of the dividends then depends on the extent to which aggregate cash dividends end up exceeding current-year taxed income). Resident shareholder A has held shares during the year until he sells out to resident shareholder B just before the mid-year cash dividend is paid. CGT is payable by shareholder A on the cum-dividend gain in share price[74](as under imputation now), which includes the value of estimated taxed income and associated franking credits — say, $100 price gain underpinned by $70 of taxed income and $30 franking credits.

Shareholder B would be assessed on the cash dividend (revealed at year's end to be fully franked in this case). If shareholder B then immediately sells ex-dividend to resident shareholder C, shareholder B could attract a $100 CGT loss to offset the $30 company tax and any extra personal tax payable on the dividend (assuming available CGT gains)[75]. The net effect is tax at shareholder A's tax rate on the retained income producing the cum-dividend gain — potentially the same tax outcome had shareholder A not sold shares at all and received the cash dividend. Identical circumstances would arise if shareholder C subsequently held onto her shares and sold just before year-end final dividend.

The level and frequency of cash dividends may, of course, vary. Only one cash dividend may be paid, for example, during a year. Nevertheless, the simplest approach is again to have aggregate cash distributions first absorb current-year taxed income. Separate cash dividends for the year would then all be equally franked. However, this approach may enable taxed income to be channelled preferentially to particular groups of shareholders. For example, should the above company distribute only mid-year, taxed income associated with the cash dividend could be diverted to shareholder B at the expense of shareholder C.

74 Foreign shareholders generally would not face any Australian tax on the gain under current income tax law.

75 The author has Peter Swan to thank for coercing clarification of these effects.

An alternative approach could avoid excessive taxed income being channelled to particular shareholders. That approach would spread taxed income allocated to a share class across cash distributions for the year in proportion to the fraction of the year covered by the cash distribution. Where, say, a cash dividend is only paid once during the year, only a proportion of taxed income would be allotted to the cash distribution based on the fraction of the year from the start of the year to the time the cash dividend is payable. Under this approach, equal levels of cash distributions during a year could have unequal franking rates if paid unevenly across the year.

Under either of these approaches, it is always taxed income in excess of associated cash dividends that would be allocated/reinvested across shareholders in the share class (with matching CGT cost base increases) according to period of share ownership.

If tracking of part-year ownership is considered too onerous, use of a selected "day of record" (at the end, or after, a company's tax reporting year[76]) is a well-accepted alternative — see Swan,[77] Officer[78] and Benge and Robinson.[79]

Regardless of whether ownership periods were tracked or a day of record used, end-of-year statements would be sent to all shareholders who received cash dividends for the year and to those holding shares on the final cut-off date. Share ownership on the final cut-off date under either system would determine eligibility for final cash distributions (as would be the case with cut-off dates for intra-year cash distributions). And, under either system, intra-year share price would, as usual, depend on expectations of company earnings and tax on those.[80]

Under the day-of-record approach, however, only those holding shares on the day of record would receive allocations of any annual taxed income not absorbed by cash distributions. This means, where, say, a company retains all of its current-year taxed income (increasing share value) and shareholder A sells out to shareholder B just before year end (and day of record), shareholder A would attract CGT on his gain while shareholder B would be allocated a share of the annual taxed income (and offsetting credit for company tax paid), together with matching increase in CGT cost base of shares. Capitalisation into share price of the differing tax impact on

76 US Treasury (1977), op cit, p 70, has the day of record as the first day of the tax year, with accompanying unresolved issues; and US Treasury (1992), op cit, p 34, has a day of record at the end of each quarter of a company's tax year with annual taxed income allocated pro rata among each quarter's shareholders.

77 Swan (1981), op cit, p 13; and Swan (1982), op cit, p 90.

78 R Officer, "Further notes on the integration of company and personal taxation", Australian Financial System Inquiry, *Commissioned studies and selected papers*, Part 3 – Business taxation and the financing of industry, AGPS, Canberra (1982), p 155.

79 Ibid, p 75.

80 Notwithstanding this, US Treasury (1992), op cit, p 35 sees "uncertainty of tax consequences for" part-year sales of shares as "one of the significant obstacles to adoption" of integration.

buyer and seller would seem inevitable. That contrasts the preferred situation under tracked-ownership design, described earlier, where shareholder A would attract both allocation of retained/reinvested taxed income with matching CGT cost base increase and CGT on his gain (with CGT reduced, or nullified, by the cost base increase). Nevertheless, Swan[81] suggests a day-of-record approach may have some practical advantages over tracked-ownership design in circumstances where the tax years of companies and shareholders do not coincide.

3.2 Chains of companies and amendments to assessments

Given retention of immediate taxing of unfranked dividends in integration design, current treatment of inter-corporate dividends under imputation arrangements would continue to apply — though with taxed income always allocated across shareholders down each link in a company chain. Conceptually, integration requires current-year allocated taxable income and cash distributions to flow through a company chain (including company groups) for inclusion in the ultimate individual shareholders' tax assessments for that same year. That should be readily achievable in practice when tax years are aligned throughout the company chain, underpinned by arrangements that have each company providing their shareholders with annual tax statements within a specified limited period after the end of its tax reporting year. Currently, distributions of taxable income for an income year down chains of trusts operate under similar circumstances.

The flow of taxed income through a chain of companies to individual shareholders would not be much disturbed even when tax reporting years do not coincide at each stage in the chain — regardless of whether retained taxed income were allocated under a day-of-record approach or a tracked-ownership approach. Say, under either approach, a company in the chain has a tax year ending well after the coincident tax year of all other links in the chain. The result would be that the taxed income of that company, as well as of companies higher up the chain, would feed into companies and individuals further down the chain one tax year later than otherwise. Such timing shift, for retained and distributed taxed income, is minor compared to the indefinite delay currently available to retained taxed income under imputation.

Such minor timing shift, perhaps created by interposed companies with different tax years, may benefit individual shareholders on tax rates above the company rate. Nevertheless, shareholders on tax rates below the company rate would provide countervailing pressure for early access to their taxed income. Taxation authorities would be expected to be on the lookout for arrangements that used tax reporting dates for tax manipulation.

81 Swan (1982), op cit, p 92-93.

The handling of issues associated with amendments to initial returns and final assessments under integration of taxable income would presumably be similar to the handling of those issues under full imputation and fixed trust arrangements in Australia now — for example, with any change in a company's prior years' taxable income and tax payable being added to the company's assessment for the year of resolution. Taking the same approach, US Treasury[82] notes that the "adjustments would be passed through to current year shareholders". As Swan[83] explains, expected outcomes of tax audits and appeals will be reflected in share prices and unexpected outcomes are just one of the many risks faced by shareholders — with no implications at all for integration design. An unexpected tax liability that is actually higher than the price paid by existing shareholders for their shares[84] would be an extreme example of such risk.

3.3 Foreign income of local companies

Under proposed integration design, treatment of foreign income of resident companies remains unaffected.[85] Foreign income of resident companies would therefore often be in the form of untaxed income (unfranked dividends) when distributed to local individual shareholders.

3.4 Tax revenue implications

Australia has already accepted the tax revenue impact of moving from classical (double) company taxation to full imputation, as well as providing resident shareholders with refunds of excess imputation credits. Moreover, retaining unfranked dividends in integration design removes a source of concern over tax revenue loss. Consequently, though there would be a range of both positive and negative influences, an unambiguously solid positive effect on tax revenue could be expected from a change from imputation to integration.

On the one hand, significant saving of tax revenue would come from: shareholders on high tax rates not being able to time the distribution of franked dividends in order to minimise tax payments and maximise refunds, including through the use of complex company/trusts arrangements and "bucket" companies; and removal of the CGT discount at least from gains and losses from the sale of shares (but preferably across the board). On the other hand, some net losses, as well as timing shifts, in tax revenue would arise from: shareholders on low tax rates accessing year-by-year refunds of

82 US Treasury (1992), op cit, p 35.

83 Swan (1982), op cit, pp 94-95.

84 A possibility raised with the author by Matt Benge.

85 This includes provisions which provide "participation exemption" or special treatment to resident companies for capital gains/losses on disposal of shares in, or for foreign source dividends received from, foreign companies in which the resident companies have a particular level of equity interest.

excess company tax; and removal of temporary double taxation of income that can arise under current imputation arrangements (see Mayo[86]) and permanent double taxation of income that can arise from current imputation arrangements coupled with the current CGT discount (see Mayo[87]).

3.5 Cash flow impact on shareholders

Integrating taxable income means taxable income of companies is included in shareholders' personal tax assessments even when that income is "retained" (allocated and reinvested) and not distributed as cash in hand. Potential annual cash flow deficiency only arises with implicit reinvestment of taxed income for those high income shareholders whose tax rates are higher than the company tax rate. Shareholders whose tax rates are less than the company tax rate would receive immediate extra tax credits with their allocated/reinvested taxed income which would reduce overall tax payable or result in a tax refund (contrasting a nil effect under imputation of retained taxed income).

Moreover, cash flow deficiency for high income shareholders should not be a problem for closely held entities that can ensure sufficient cash distributions are made to address any potential cash flow difficulties of their shareholders. Similarly, the vast majority of widely held entities would likely make sufficient annual cash distributions to cover required net personal tax payments of high-rate shareholders.

4. Multiple share classes

Changing from imputation to integration sees tax design shift from the payment under imputation of cash distributions with associated franked and unfranked dividends across different share classes to the following issues relating to multiple share classes that arise under integration from the potential separation of companies' current-year taxed income and their payment of cash distributions:

- the possible allocation of annual taxed income to one share class and payment of that income as cash to another class in subsequent years;
- the allocation of annual taxed income across share classes regardless of annual cash distributions made; and
- how cash distributions are spread across multiple share classes.

Share classes may be thought of as either having non-discretionary dividend rights or receiving cash dividend payments at the discretion of company boards (with that discretion providing obvious streaming possibilities).

86 Ibid, pp 176-182.
87 Ibid, pp 183-188.

Shares with non-discretionary dividend rights include:

- what can be regarded as "regular" ordinary shares with equal "normal" dividend (and voting) entitlements;
- ordinary shares with dividend entitlements set on a proportional basis (say double) relative to normal level of entitlement;
- preference shares attracting priority cash dividend payments over dividends to ordinary shareholders with those priority dividends set on the basis of, say, fixed or floating percentage rates to face value; and
- deferred shares which are subordinate to other classes (and have no rights to assets on liquidation) and receive cash dividends often larger than those paid on regular ordinary shares in specified circumstances (like when cash flow improves or after other share classes have received their dividends). While contributed capital of deferred shares may be consistent with that of ordinary shares, the discretionary nature of dividend payments to these shares gives them a flavour of discretionary shares.

Discretionary shares often have minimal contributed capital distributions (they may be issued at, say, $1 and be able to be repurchased at any time for the same). A company might have discretionary shares that dominate its shareholdings — like, say, a "bucket" company that only has discretionary shareholders such as family members of a family business or a discretionary trust. Other closely held companies might have minor and benign discretionary shareholdings perhaps receiving cash distributions on an intermittent ad hoc basis for, say, performance remuneration.

4.1 Different shareholders attracting allocated taxed income and associated cash distributions

Even when all shareholders are only ordinary shareholders with equal dividend rights, a particular concern might be the prospect of one group of shareholders paying tax on allocated/reinvested taxed income in one year and another group of shareholders later receiving cash distributions of that previously "retained" income. Shareholders in one year when, say, no cash distributions are made are allocated all the taxed income for that year (along with matching increases in CGT cost bases of their shares). Shareholders who buy into the company in the ensuing year or years then receive cash distributions of that prior reinvested taxed income — though in the form of return of capital (like the $126 of contributed capital returned in year 5 in Table A5 in Attachment A, where shares are sold each year but no cash distributions are made until liquidation in year 5).

That situation is, however, no different from current circumstances where shareholders sign up to DRPs under which they include the gross dividend and associated imputation credits in their personal tax returns without receiving the cash dividend in hand. The cash dividend is reinvested and those shareholders have no idea whether they will still be shareholders when this reinvested income is ultimately distributed

or which new future shareholders may receive it. The shareholders know that the reinvested income adds to company value and they can always sell out if they want to access that value. Table A5 in Attachment A illustrates how integration plus CGT with no discount results in those selling out at the end of each year receiving, and being taxed on, all the company's income (taxed and untaxed) for the year.

Similarly, the use of different classes of share might be seen as problematic if taxed income earned, allocated to, and reinvested on behalf of, ordinary shareholders in one year (increasing company value) could be distributed in cash to, say, preference (or deferred or discretionary) shareholders in a subsequent year. The cash distribution (reducing company value) might occur in a later year when there is insufficient cash flow to pay dividends to ordinary (original or new) shareholders. Remaining original ordinary shareholders might then be able to sell out and realise a capital loss for CGT purposes (a loss matching the original taxed income allocated to them with its associated increase in CGT cost base) while the preference shareholders — perhaps superannuation funds — are taxed on the distributed income. As a result, it might be thought that, ultimately, tax could be paid on the original income at the tax rates of the preference shareholders, not the rates of the original ordinary shareholders.

Such an outcome, one raised as a possibility by Benge and Robinson,[88] would cut across the key rationale for integration, having annual company income taxed at shareholders' tax rates in the same year, and would, indeed, be a fatal problem.

Under suggested integration design, however, taxed income that has been allocated and reinvested (with accompanying share cost base increases) is no longer treated as retained earnings. The integration design treats these deemed reinvestments as new contributed capital — as illustrated in Tables A4 and A5 in Attachment A. The potentially fatal problem can therefore be pre-empted by requiring each share class to have a separate contributed capital account, payments from which (with accompanying share cost base reductions) can only be made to shareholders of that same class.

The desired treatment could be given effect by requiring companies to maintain a separate contributed capital account for each class of share for tax purposes — instead of relying on share capital accounts which, under the corporations law, may include capitalised profits. The Review of Business Taxation recommends such arrangements (recommendation 12.9 (a)[89]) and provides associated rules in accompanying draft exposure legislation. Taxed income allocated to a share class and implicitly reinvested would be added to the contributed capital account for that share class. Payment out of the contributed capital account of one share class to holders of a different class of shares would attract appropriately penal tax treatment. To ensure consistency of treatment of allocated/retained taxed income across income tax and corporations

88 Ibid, p 78.
89 Ibid, p 441.

laws, including parallel treatment of voluntary DRPs and retained taxed income that is compulsorily reinvested, changes may be necessary to the corporations law.[90]

The US Treasury[91] sees the maintenance of a separate capital account for each class of share as a necessary feature of integration design despite the extra complexity involved. Absent separate capital accounts, US Treasury argues "the corporation could allocate tax liability without regard to the economic substance of the capital structure"[92] and sound "division of liquidation proceeds"[93] may not result, emphasising the importance of appropriate allocation of company losses (not passed through to shareholders) across capital accounts of share classes.[94]

4.2 Allocation of annual taxed income across multiple share classes

The overarching aim and challenge of integration of taxable income is to spread annual taxed income across a company's various share classes so that this income attracts the right balance of tax rates across all the company's shareholders — taking into account varying dividend entitlements across different classes, including classes that potentially have shareholders with identical or proportional dividend rights.[95]

Rules are required for the allocation of taxed income for a year across different share classes independent of any cash distributions. Those rules need to recognise, however, that cash distributions are a characteristic of some share classes, like preference shares, deferred shares and discretionary shares.

Attempting to specify rigid rules in this article for the allocation of taxed income across share classes has been resisted absent the benefit of the expertise of Australia's taxing authorities. Much expertise has developed within Australia's taxing authorities for dealing with related issues, like multiple classes of units in unit trusts, and the channelling of franking credits to shareholder groups who can benefit most from them. This expertise is behind Australia's recently introduced attribution rules for managed investment trusts, rules with similarities with suggested integration design — like CGT cost base reductions when cash distributions exceed taxable income (the

90 The author is indebted to Rick Krever for this important point.

91 US Treasury (1992), ibid.

92 US Treasury (1992), op cit, p 32.

93 US Treasury (1992), op cit, p 33.

94 US Treasury (1992), op cit, footnote 24, p 202, provides an example of the allocation of a company's tax loss between capital accounts for preferred stock with a liquidation preference and common stock followed by the company's liquidation; and US Treasury (1992), op cit, p 33, refers to the transitional issue of companies having "to seek shareholder approval to provide for … the maintenance of capital accounts".

95 A formal definition of "class of share" that accords with these requirements is in recommendation 12.9(b) of Review of Business Taxation (July 1999), op cit, p 441.

alternative design for unfranked dividends under integration in section 2.2) and CGT cost base increases when taxable income exceeds cash distributions (consistent with integration design in section 2.1). These attribution rules allow trusts with multiple classes of units to elect to have each trust treated as a separate trust for the purpose of attributing taxable income. Australia's expertise and experience with such issues is one of the reasons behind its being uniquely positioned to consider upgrading imputation to integration.

That expertise would be heavily drawn on in the determination of allocation rules for spreading taxed income across multiple share classes when integration design is being developed under the integrated tax design process — a process instituted in light of recommendations of the Review of Business Taxation[96] to bring policy, law and administration considerations together early in tax design. If the desire for a world-first, major improvement in company income taxation is strong enough, integration issues associated with different classes of share become challenges to be addressed in the integrated design process, rather than fatal problems.[97]

Short of proposing specific rules for the allocation of current-year taxed income across share classes, following is a range of considerations that could be drawn on in the integrated tax design process for non-discretionary and discretionary classes, respectively.

4.2.1 Non-discretionary classes

(1) Allocation of taxed income across non-discretionary share classes is unaffected by cash distributions made to the individual classes. Otherwise, cash distributions to one class could simply channel taxed income away from other classes. Thus, for example, priority access to cash distributions by preference shareholders (reflecting companies' commitments to pay specified returns to these shareholders) does not influence the allocation of taxed income across non-discretionary share classes (and therefore the shareholder tax rates applying to that income). Similarly, paying no cash dividends in a year to deferred shareholders does not interfere with the allocation of that year's taxed income to those shareholders.

(2) Within a non-discretionary share class, individual shares attract a share of the taxed income allocated to the class according to dividend rights — for example, pro rata for equal dividend rights. Any cash distributions made to the class first absorb current-year allocated taxed income (the simpler option in section 3.1). Only the excess of taxed income over cash distributions made is spread across shareholders in that class on the basis of periods of share ownership.

96 Ibid, pp 95-98.

97 The flavour of this important practical point was given to the author by Matt Benge.

(3) Allocations of taxed income cannot simply follow how a company's governing instruments might allocate taxable income to different non-discretionary share classes. As US Treasury[98] notes, that would allow companies to allocate taxed income without regard to "the economic substance of the capital structure". Consequently, US Treasury[99] argues that allocation of taxed income across share classes requires "some capital account mechanism".[100]

(4) Current-year taxed income could therefore be spread across all non-discretionary shares such that an equal percentage of taxed income is achieved across share classes based on market value of the respective share classes (providing the same return to each class). A practical variant of this might replace market value with aggregate face value for preference shares classed as "equity",[101] with the amount allocated limited by 100% franking of interest payments on the preference shares. The value of preference shares is likely little affected by a company's overall level of current-year taxed income other than via reduced default risk. For ordinary and deferred shares, market value might be replaced by aggregate contributed capital plus total annual taxed income because the level of taxed income does affect share value (and annual taxed income is soon to be added to contributed capital if reinvested).

(5) After the allocation process, for preference shares classified as equity, if percentage of taxed income to face value happened to be equal to, or less than, their rate of interest to face value, the interest payments would be fully, or partially, franked, respectively. In either case, there would be no net CGT cost base adjustments (with interest payments on the shares always absorbing all the shares' allocated current-year taxed income). Nevertheless, consequent practical treatment of allocated taxed income and cost base adjustments would be required, say, if a company has annual taxable income but is unable to make cash payments to preference shareholders.

(6) A franking rate equivalent can only be determined for a non-discretionary share class until taxed income has been allocated across share classes at year's end. The rate is necessarily 100% if no cash dividends are paid (with distributions of allocated taxed income deemed to have occurred, followed by implicit reinvestment) and stays at 100% until cash dividends exceed taxed income and become partially franked.

---

98 US Treasury (1992), op cit, p 32.

99 US Treasury (1992), op cit, p 33.

100 US Treasury (1992), op cit, pp 32-33 refers to the possibility of subjecting the allocations to a simplified form of the "substantial economic effect" requirement of US tax law that then applied to income allocation rules for partnerships.

101 If preference shares were classed as "debt", the payments would not be allocated any taxed income and would be taxed as regular interest.

4.2.2 Discretionary classes

(1) Cash distributions and taxable income are necessarily linked with discretionary shares, as with preference shares. Like preference shares also, annual taxed income has little influence on the value of discretionary shares given cash distributions to them are at the discretion of boards. Unlike preference shares, however, the minimal cost base of discretionary shares does not provide a potential basis for a percentage allocation of taxed income to these shares separate from their associated cash distributions.

(2) For a minority discretionary share class, the allocation of taxed income could be achieved by applying the same franking rate as the franking rate that regular ordinary shares end up attracting — though continued use of dividend streaming provisions would be required to guard against the diversion of taxed income away from other share classes. Those provisions would, however, need to recognise that, under integration, for ordinary and deferred shares, while the level of cash distributions in excess of allocated taxed income is still relevant, allocated taxed income itself is also a distribution, albeit one which is then reinvested. While potentially somewhat circular, taxed income allocated to such a discretionary share class would need to be subtracted from the allocation across non-discretionary share classes.

(3) For discretionary shares (held by, say, a discretionary trust or family members) that dominate a company's shareholdings, sufficient cash distributions could be required to be made (or reinvestment arrangements instituted) to absorb the company's current-year taxable income. Beyond this overall allocation of taxed income comes issues relating to the use of such discretionary shares (including so-called dividend access shares) to channel distributions and associated taxed income selectively to different taxpayers on a year-by-year basis — issues similar to those associated with discretionary trusts.

4.3 Cash distributions across non-discretionary share classes

There is not a lot of flexibility under suggested integration design in the allocation of current-year taxed income across non-discretionary share classes. In addition, distributions of contributed capital are restricted to the non-discretionary class that provided the capital (including via allocated/reinvested taxed income). This inflexibility regarding the distribution of taxed income and returns of capital puts a focus on the possible tax advantages of channelling cash distributions to non-discretionary share classes, potentially along with associated unfranked dividends.

Cash distributions might usually be expected, however, to be spread across non-discretionary share classes broadly in line with underlying capital structure. Moreover, there are a number of integration design features that militate against the streaming of unfranked dividends to particular non-discretionary share classes:

- retention of immediate shareholder taxation of unfranked dividends (rather than replacing these dividends with CGT cost base reductions);
- the availability of refunds of excess franking credits that lessens the attraction of unfranked dividends to low- or zero-rate resident shareholders;
- the potential separation between the making of cash distributions for a year and determining after year's end the amount of annual taxed income for that year (though no doubt final distributions will often be held back until the time of end-of-year tax statements); and
- no CGT discount on share sales, which addresses the incentive to sell out to particular shareholder groups just before a distribution is made — the seller of shares being taxed on untaxed company income and the purchaser of shares potentially paying full value for that income because of the treatment of the income when distributed (see section 2.4).

Nevertheless, deferred shares deserve particular attention because of the flexibility they provide over cash distributions. They have both non-discretionary and discretionary characteristics. At directors' discretion, they currently enable ordinary shareholders to receive cash dividends (with the applicable level of franking) ahead of deferred shareholders.[102] Benge and Robinson[103] are concerned at such design on the basis that, if "corporate profits were attributed to holders of both classes of shares", it "could be advantageous for low-rate taxpayers to hold the deferred dividend shares" to access refunds of franking credits despite all cash distributions having been distributed to resident "high-rate holders of ordinary shares".

There should be no concern, however, if, say, all corporate profit for a year were taxable income and cash distributions going only to ordinary shareholders matched the amount of taxed income allocated to them. Ordinary shareholders would simply be receiving their allocated franked dividends as cash. The taxed income retained by the company and allocated to deferred shareholders would, as usual, be implicitly distributed to, and reinvested by, these shareholders with matching CGT cost base increases and addition to their segregated contributed capital account. Any extra cash distributed to ordinary shareholders would strictly be a return of their capital.

At the other extreme, annual corporate profit might not be taxable at all. Cash dividends paid preferentially only to ordinary, perhaps non-resident, shareholders would comprise unfranked dividends. This situation, reflecting current circumstances, is not affected by suggested design for the integration of taxable income. Channelling current-year unfranked dividends to ordinary over deferred shareholders could logically be choked off, if desired, by provisions that mirrored the allocation of taxed income across these classes. Streaming provisions could require cash distributions to

102 Design in this article addresses the potential channelling of franked dividends in this way to ordinary shareholders by seeking to have taxed income allocated to both ordinary and deferred shareholders according to their respective capital bases, regardless of cash distributions made.

103 Ibid, p 78.

be made consistent with the capital structure underlying the ordinary and deferred share classes. That approach would render the use of deferred shares ineffectual.[104]

Absent such a strident approach, general anti-streaming and anti-avoidance provisions (which would need to recognise that allocations of retained taxed income are deemed distributions) would be available. Those provisions could seek to address the use of different share classes to channel cash distributions with unfranked dividends to shareholders, like non-resident shareholders, who can benefit more from them than other shareholders. Anti-streaming provisions under imputation focused on the channelling of franking credits to particular share classes could be superseded by streaming provisions under integration which focus on the channelling of cash distributions with associated unfranked dividends to selected share classes — particularly if immediate taxing of unfranked dividends were ultimately replaced under integration by CGT cost base reductions.

4.4 Illustration of integration's operation across multiple share classes

Four types of shares with very different dividend rights are used in Table 1 to illustrate the operation of integration, particularly in relation to the allocation of annual taxed income and payment of cash distributions across shares with differing dividend rights: preference shares; ordinary shares with equal dividend and voting rights; deferred shares which receive dividends in particular circumstances; and discretionary shares, restricted in the table to shares only able to attract a minor proportion of taxed income paid on an ad hoc basis (say, as a performance bonus).

Table 1 uses the four typical share types to describe how integration design would operate in following three different situations:

(1) *cash dividends only to ordinary shareholders* (company has no preference shareholders) with cash constraints or company retention policy resulting in taxed income being greater than total cash distributions to the ordinary shareholders, so that the franking rate of ordinary shareholders (both on cash and reinvested amounts) is 100% and deferred shareholders receive only allocated taxed income with implied 100% franking rate;

(2) *cash distribution only to preference shareholders* with cash constraints or company retention policy resulting in taxed income being greater than total cash distributions so that franking rate of interest payments is capped at 100%, increasing taxed income allocated to other classes; and

104 And again require coordination between corporations and income tax laws.

(3) *distributions to all shareholders* with taxed income less than total cash distributions in each share class. Dividends are partially franked across all share classes.

Table 1: Distributions and allocated taxed income across different share classes

Distributions during income year	**(1) Cash distributions only to ordinary shareholders**	**(2) Cash distributions only to preferred shares**	**(3) Cash distributions across all share classes**
Amount of taxed income versus cash distributions	**(1) Taxed income *more than total cash distributions to ordinary shareholders***	**(2) Taxed income *more than total cash distributions***	**(3) Taxed income less *than total cash distributions for each share class***
Preference shares tax treatment	Company has issued no preference shares.	Franking rate of interest payments capped at 100% (increasing taxed income allocated to other classes).	Interest payments' partial franking rate depends on percentage of allocated taxed income to face value versus interest rate on shares.
Ordinary shares tax treatment (held all year)	Franking rate 100% both on cash distribution of franked income and amount of allocated/reinvested taxed income with cost base increases.	Allocated taxed income reinvested (equivalent to 100% franked) with matching cost base increases.	Percentage of franking depends on extent to which cash distribution exceeds allocated taxed income. No cost base increases.
Deferred shares tax treatment	Franking rate an implied 100% on allocated taxed income (all implicitly reinvested).	As with ordinary shares.	As with ordinary shares – with provisions ensuring that unfranked dividends not streamed with tax benefit to ordinary shares.
Minority discretionary shares tax treatment	Company has no discretionary shares.	With no cash distribution made, no allocation of taxed income.	Taxed income allocated so that cash distribution is partially franked at rate of ordinary shareholders. Passes anti-streaming rules.
Comment	Current shareholder tax rates apply to taxed income with low-rate shareholders eligible for franking refunds on deferred shares.	Current year shareholder rates apply to taxed income except for discretionary shareholders.	Current year shareholder rates (including discretionary shareholders) apply to taxed income.

Situation (1) in the table illustrates the operation of integration in circumstances where priority over cash distribution is afforded ordinary shareholders ahead of deferred shareholders (as is often the case in practice now). This does not affect allocation of taxed income between the two share classes. Moreover, because cash distributions in situation (1) are less than the taxed income allocated to ordinary shareholders, the deferred shareholders can be viewed as reinvesting all their taxed income (into their segregated contributed capital account) and ordinary shareholders not reinvesting all theirs.

In contrast, situation (3) in the table potentially provides the opportunity for ordinary (perhaps non-resident) shareholders to access current-year cash distributions and associated unfranked dividends ahead of deferred (perhaps low-rate) shareholders who access refunds of franking credits on their allocated taxed income. As noted, to address this situation, design may specifically require cash distributions to ordinary versus deferred shareholders to be based on the capital structures of these two share classes — or, at a minimum, require well-designed general streaming provisions. In this situation (3), tax outcomes across all shareholdings would likely closely align with those under current imputation arrangements (as illustrated by Tables A2 and A3 in Attachment A).

Table 1 assists in a general appreciation of the significant degree of similarity between imputation and integration outcomes, underpinned by the ability of DRPs under imputation to equate with the retention of taxed income under integration. For example, circumstances similar to situation (2) in the table and where cash payments to preference shareholders turn out to be fully franked could be mirrored under imputation where again all payments to preference shareholders are franked dividends and fully franked dividends are distributed to, and reinvested via DRPs by, ordinary and deferred shareholders.

5. Non-resident shareholders

5.1 Dividend withholding tax

Under imputation arrangements, franked dividends and associated franking credits plus unfranked dividends flow with biannual dividend advice, perhaps through chains of domestic companies, out to individual domestic shareholders and non-resident shareholders. Any unfranked dividends going to non-residents attract dividend withholding tax (DWT) — subject to any special arrangements designed to provide DWT relief, say, on foreign income flowing through domestic companies and out to foreign shareholders ("conduit" income).

Abolition of DWT could be contemplated under suggested integration design (which includes no CGT discount) on the basis that unfranked dividends often result from the income of companies' assets being only temporarily freed from company tax by

accelerated depreciation and delayed tax on accrued capital gains. In this situation, when such assets are sold by a company, the temporarily delayed tax is paid, enabling payment of franked dividends, even though tax has already been paid on related prior unfranked dividends (income tax and DWT by resident and non-resident shareholders, respectively). Recompense for resident shareholders for the double tax paid is available via CGT losses when the asset sale proceeds are distributed with associated franked "dividends" (which reduce the amount of capital in the distribution) and either shares sold or the company liquidated (producing the $692 capital loss in Table A3 in Attachment A). Depending on CGT design in their home country, however, there may be no recompense for non-resident shareholders for DWT paid on the prior unfranked dividends paid to them. More than a single layer of tax at the company rate could therefore be paid overall on income from these assets distributed to non-residents.

Nevertheless, not all tax preferences are temporary. In addition, the CGT discount applying to Australian resident shareholders on the sale of their shares may not be abolished. Moreover, the treatment of DWT under integration may be best left for consideration in the context of any negotiations with other countries regarding implementation of integration.

5.2 No refunds to non-residents of Australian tax credits

Under imputation, when dividends are paid to non-residents, it is up to tax authorities in the non-residents' countries to determine what credits they might provide for company tax underlying dividends received by their residents (shown by the imputation franking credits on dividend slips) and DWT. The countries of the non-residents decide the extent of any foreign tax crediting arrangements (which invariably exclude credit against home country tax for extra foreign taxes paid beyond what is payable on the dividends in the non-residents' countries). This is not, however, an issue to concern a country running an imputation system, or an integration system.

There is no economic justification for the country running either an imputation or integration regime to provide non-residents refunds for franking credits, just as there is none for a country running a classical company tax system to provide refunds to non-residents for DWT and underlying company tax associated with dividends from that country. Providing refunds to non-residents would diminish Australia's "ability to tax income generated in Australia by overseas investment on the basis of its Australian source".[105]

Countries like the United States, however, have argued that non-discrimination articles in double tax treaties require their countries' shareholders to access the same imputation credits provided to residents of a country running an imputation system.

105 Swan (1982), op cit, p 98.

Nevertheless, beyond the range of arguments that oppose this view, like those above and in Swan[106] and Taylor,[107] Australia successfully introduced full imputation in 1987 without providing refunds of imputation credits to non-residents — no doubt buttressed by design that exempts non-residents' franked dividends from DWT. Prior to the introduction of integration in Australia, other countries could be advised that, consistent with current imputation arrangements, no refunds for Australian company tax would be provided by Australia in relation to their residents' Australian shareholdings.

5.3 Effect of integration on non-resident shareholders

Suggested integration design could affect non-resident shareholders of Australian companies differently depending on whether their Australian dividends attract exemption or foreign tax crediting arrangements in their home countries.

5.3.1 Dividend exemption

A widening group of countries exempt repatriated dividends from home country tax — including those running "territorial" tax arrangements designed to tax only income earned in their home countries. Residents of such countries would immediately feel the increased cash flow from dividend payments resulting from any removal of DWT under integration design in Australia. Their share of unfranked dividends in the annual cash distributions in Table A2 (Attachment A) would, for example, no longer be diluted by DWT. They would also immediately benefit from any reduction in Australia's company tax rate that stems from the introduction of integration.

5.3.2 Foreign tax crediting – ideal response to integration

Countries running foreign tax credit systems that provide credit for underlying company tax on repatriated cash dividends would continue to do so under integration. Thus, credit would be available for the $11 and $283 of Australian company tax underlying any share of cash distributions in years 4 and 5 in Table A2 (Attachment A) going to non-residents of such countries. These shareholders would also benefit from any removal of DWT and reduction in the company tax rate: they would no longer need to seek credit at home for DWT and would be less likely to exceed limits placed on total credit available on foreign dividends.

Under suggested integration design, however, countries running foreign tax crediting systems would be faced with the challenge of their residents saying they have received end-of-year statements telling them that Australian company tax has been paid on

106 Swan (1982), op cit, p 97.

107 Ibid, p 44. Taylor says "the better view was that denial of an imputation gross up and credit to a nonresident shareholder technically did not breach the non-discrimination article" of the OECD Model Double Tax Convention.

deemed dividends that have been reinvested in their Australian companies. It could be that some countries are familiar with similar circumstances through their own attribution rules applying to some accrued foreign income of their own residents (like the attribution rules in Australia applying to controlled foreign corporations) or from their residents' participation in DRPs of Australian companies (which is legal in New Zealand, for example). Prior experience or not, ideally, such countries would provide their resident shareholders of Australian companies with immediate credit for underlying Australian company tax against home country tax on their residents' share of allocated/reinvested taxed income.

To illustrate, such countries would ideally provide credit for their residents' share of the $18 and $36 Australian company tax in years 3 and 4, respectively, underlying the $60 and $121 of taxable income in those years (or $42 and $85 of taxed income) in Table A4 in Attachment A. For Australian tax purposes, there has been a distribution but it has been reinvested and retained as capital, not retained earnings. Any non-resident shareholders who receive such credit from their tax authorities should not then expect to get duplicate credit for Australian tax when, in year 5, they get cash payments for their share of the $42 and $85 of taxed income ($126 with rounding) previously allocated and reinvested in years 3 and 4. This $126 of taxed income allocated/reinvested in years 3 and 4 is flagged as a return of capital in the final liquidation distribution in year 5. Foreign jurisdictions would ideally deal with that contributed capital just as they do now with returns of capital on Australian shares. The only creditable Australian tax underlying the final distribution in year 5 should be the non-residents' share of the $310 paid by the company on its $1,033 of year 5 taxable income.

Such ideal outcomes would likely result if the foreign jurisdictions themselves saw the benefits to worldwide resource allocation and decided to implement matching integration arrangements applied to worldwide income of their residents. In those circumstances, foreign tax authorities' recognition of cost base increases on shares held by their residents for allocated/retained taxed income of Australian companies would ensure no double tax from the foreign jurisdictions' taxing of any sale of those shares (consistent with the tax-neutral 5.3% return to Australian residents each year in Table A5). Those cost base increases would be matched by cost base reductions when the prior reinvested taxed income was distributed as contributed capital — with no additional tax implications (consistent with the nil CGT effect shown for Australian residents in Table A4 when the $126 of reinvested taxed income is distributed as a return of capital). Moreover, dividends (cash or deemed) flowing from country to country (including through countries as conduit income) would accumulate tax credits potentially ready for passing through to the ultimate individual shareholders, as described by Mayo.[108]

108 Mayo (2013), op cit, pp 270-271, under what is termed a "Simplicity" policy option.

5.3.3 Foreign tax crediting – practical integration design

Universal integration is but a pipe dream, of course. Consequently, significant practical issues[109] arise from the fact that other countries may not be prepared to treat allocated/reinvested taxed income as deemed dividends and may view the later associated return of capital as dividends for tax and corporate law purposes. Just because Australian company tax on deemed distributed/reinvested taxed income (as usual, clearly specified on dividend slips) deserves to be recognised for tax purposes — just like company tax underlying cash distributions — by countries running foreign tax crediting systems, it does not mean that it will be. It would also no doubt be a step too far to expect foreign tax jurisdictions to provide cost base increases on shares in Australian companies held by their residents for allocated/reinvested taxed income of those companies (like the accumulated $126 increase in tax value in year 4 in Table A4).[110]

These issues are diminishing in importance the more countries move from foreign tax crediting to exemption arrangements (including the United States). Nevertheless, an Australian solution to these issues is important, prior to introduction of integration. That solution comes from extension of the design feature in section 4.1 involving the maintenance of a separate contributed capital account for each class of share. For local companies with (or the potential to have) non-resident shareholders, this extension would see each class of share have a "regular" contributed capital account plus a contributed capital account for the accumulation of allocated/reinvested taxed income, perhaps termed "allocated contributed capital account".

For Australian resident shareholders: additions to the allocated contributed capital account would be reflected as usual as taxable income and franking credits in dividend slips (along with increases in share cost bases); and distributions from either of these two accounts would have the same effect (reductions in share cost bases). For non-resident shareholders, however:

- additions to the allocated contributed capital account would have no tax implications — matching the status quo before integration for retained taxed income; and
- distributions from the allocated contributed capital account would be flagged as distributions of prior retained taxed income. The non-resident shareholders and their tax authorities could then determine an appropriate amount of Australian company tax to be allowed for foreign tax crediting purposes.

109 Issues stressed by Rick Krever and also by an anonymous referee who emphasised the importance of an Australian response to them.

110 Carter Commission, op cit, p 62, notes that "… the usual approach in other countries is to tax corporations as separate entities and, accordingly, it would be impossible to extend to non-residents on a reciprocal basis a treatment comparable to" the Commission's integration proposal.

Such design, essentially maintaining pre-integration status quo for non-resident shareholders,[111] puts focus on well-designed dividend slips suitable for both resident and non-resident shareholders. Possibilities here are indicated by current dividend slips of Australian companies that show the imputation credits that their New Zealand shareholders can claim at home (reflecting New Zealand income tax paid on the companies' operations in New Zealand).

Moreover, countries like New Zealand that allow their residents to participate in Australian companies' DRPs (which have close affinity with integration) could be ready candidates to sign up to the above ideal treatment under integration for their residents who are shareholders in Australian companies. Again, well-crafted dividend slips would make clear which non-resident taxpayers were participating directly in Australia's integration arrangements.

With only Australian companies subject to integration, non-resident investors operating in Australia through permanent establishments, including branches of non-resident companies, should be little affected by integration. Subject to income tax at the company tax rate, they would face no immediate tax effect from taxed income associated with their shareholdings in Australian companies being allocated and reinvested under integration rather than retained under imputation. Changed cost base adjustments under integration for their shares held in Australian companies would best be accommodated, however.[112]

In addition, with treatment of inter-corporate dividends and foreign income of local companies essentially unchanged under integration, current dedicated tracking of conduit foreign income should also not be affected by integration.

6. Conclusion

This article has tried to present a workable design that integrates the annual taxable income of Australian companies directly into the personal tax assessments of their local shareholders, even when that taxed income is retained by the companies. Currently, under Australia's full imputation system of company tax, costly effects arise from indefinite retention by companies of their taxed income, exacerbated by the rate(s) of company tax falling well below the top personal tax rate and refunds of excess imputation credits. Integration of taxable income addresses those effects

111 US Treasury (1992), op cit, p 36, considers, in relation to its integration prototype, that "… foreign shareholders making investments in the United States should not receive, by statute, the benefits of integration received by U. S. shareholders".

112 CGT liability on sale of shares in Australian companies aside, it may not be necessary for a branch of a non-resident company to lodge an Australian tax return if the only Australian sourced income of the branch comprises franked dividends (cash or allocated/reinvested) and unfranked dividends from which any applicable DWT has been withheld.

by rendering the rate of Australian company tax irrelevant for resident shareholders regardless of degree of retention of taxed income. For these shareholders, their personal tax rates always apply to their local companies' current-year taxable income.

If all resident companies had only local ordinary shareholders with equal dividend rights, questions over the implementation of integration would focus on the admittedly challenging, but likely feasible, tasks of tracking part-year ownership of shares and minimising delays down chains of companies so that company tax statements to individual shareholders can be finalised in reasonable time after year's end.

Beyond such administrative issues, it is the complications posed by non-resident shareholders and multiple share classes that often have been seen as insurmountable barriers to integration.

In relation to different classes of share, there are two key design issues to focus on.

First, there is the potential for companies to attribute to one class of share a particular year's retained taxed income and distribute that income in later years as cash to other share classes. Should that potential be realised, the whole rationale for integration is undermined. The original retained taxed income could ultimately be taxed at the tax rates of shareholders in the class receiving the income in later years, not the tax rates of shareholders originally receiving the allocation of current-year taxed income.

However, integration design that treats retained taxed income as reinvested contributed capital (a close parallel with dividend reinvestment plans under imputation) lends itself neatly to tax treatment that ensures that the contributed capital of one class of shareholder is not given later to another class of shareholder. Specifically, the tax law would require companies to maintain a separate, segregated contributed capital account for each class of share for tax purposes to which annual taxed income not distributed as cash would be added — and appropriate penal provisions would apply to payments from the contributed capital account of one share class to shareholders of a different share class.

Second, soundly based attribution of annual taxed income across different share classes, necessarily independent of any cash distributions made, is a crucial requirement and one that is not insurmountable. Discretionary shareholders aside, there are practicable methodologies that would spread taxed income across share classes in a manner that recognises the economic substance of their underpinning capital bases. While taxed income attribution and cash distributions are generally not linked under suggested integration design (contrary to imputation design), tax outcomes for shareholders would often match those under imputation for high dividend paying companies.

Discretionary shares (usually having minimal contributed capital) attract cash distributions at the discretion of company boards. Cash distributions and taxable income are then necessarily linked. For discretionary shares (of, say, a discretionary

trust or family members) that dominate a company's shareholdings, sufficient cash distributions would have to be made — or reinvestment arrangements instituted — to absorb current-year taxed income. For minority discretionary shareholdings, taxed income could be allocated on the basis of equal franking rates with ordinary shares. Excessive cash distributions to such minority holdings could, nevertheless, easily divert taxed income from other share classes. Thus, anti-streaming provisions both in the corporations and tax laws would remain of crucial importance.

More generally, given tight allocation of taxed (franked) income across share classes and no store of franking credits in franking accounts, streaming provisions in the tax law focused on the channelling of franking credits under imputation would likely morph into provisions more focused on streaming of cash distributions beyond taxed income (with accompanying unfranked dividends) to targeted share classes.

In relation to non-resident shareholders, integration design should not be of any significant concern to foreign tax jurisdictions.

No refunds of Australian company tax would be provided by Australia to non-resident shareholders consistent with how, under its imputation system, Australia already only provides credits and refunds to local shareholders. Nevertheless, consistent with deliberations that underpinned that outcome, the treatment under integration of remaining DWT on dividends paid to non-resident shareholders could be an issue for discussion with other countries.

In the ever-growing range of countries that exempt repatriated dividends from home country tax, non-resident shareholders would benefit from any removal of DWT and reduction in Australia's company tax rate accompanying integration. For the diminishing number of countries running foreign tax crediting systems, the status quo for their residents holding shares in Australian companies can be maintained after integration in relation to taxed income that is retained (allocated/reinvested) and later distributed by their Australian companies. That can be achieved by earmarking that part of the segregated contributed capital account of each share class that is filled by allocated/reinvested taxed income of local companies — and clearly explaining on non-resident shareholders' dividend slips the source of those earmarked amounts when distributed.

Countries could, nevertheless, be offered the opportunity to sign up to the efficiency benefits that would flow from their residents, who are shareholders of Australian companies, receiving credit for company tax in the year that the companies' taxed income is retained, rather than when it is later distributed as cash.

Overall, it is hoped the framework in the article encourages Australia to make the most of its unique corporate taxation circumstances and at least give serious consideration to upgrading its full imputation system so that current-year taxable income of Australian companies is always integrated with their shareholders' tax assessments.

Attachment A: worked examples of integrating taxable income

The following assets are involved in these worked examples:

- an appreciating asset (land), acquired in year 0 for $1,000, that increases in value by 10% a year;
- a depreciating physical asset (widget-producing machine), again acquired in year 0 for $1,000, that first produces net receipts in year 1 and its value declines at 15% a year (reflecting declining annual net receipts); and
- a regular bank account, which provides compounding interest income at the rate of 10% pa, should the direct investor or company retain cash from widget production.

Direct investment

Table A1 shows aggregate pre- and post-tax cash flows of someone on a 47% tax rate investing directly in the depreciating asset and associated land for widget production. The investor has a post-tax 5.8% pa return, instead of a tax-neutral 5.3% pa, as a result of tax preferences of 30% declining balance depreciation on the machine and capital gains on the land not taxed until sold. Tax losses are carried forward (the same assumption made for simplicity in the following company analyses).

Table A1: Direct investment in widget production with 100% realisations CGT applying ($)

Year	Buy/sell price (a)	Net receipts (a)	Change in value (a)	Value (a)	Income (b)	Tax value (c)	Taxable income (d)	Loss carry-forward	Tax at 47% (e)	Post-tax cash flow (f)
0	–2000			2000		2000				–2000
1		250	–50	1950	200	1700	-50	0	0	250
2		213	–18	1932	195	1490	3	0	0	213
3		181	13	1945	193	1343	34	0	0	181
4		154	41	1986	195	1240	51	38	17	136
5	2054	131	68	2054	199	2054	945	945	444	1741
Total					982		982		461	
Return		10% pa			5.3% pa (g)					5.8% pa

(a) Aggregated pre-tax figures for land and widget-producing machine.

(b) Net receipts plus change in value.

(c) $1,000 tax value of land plus tax value of machine declining at 30% a year until $2,054 sale price of both in year 5.

(d) Net receipts plus change in tax value.

(e) 47% x taxable income (net receipts plus change in tax value) with tax losses ($50 in year 1) carried forward. $461 total tax matches 47% × $982 aggregate annual income.

(f) Pre-tax cash flow less tax paid.

(g) Post-tax return if annual income taxed at 47% tax rate (10% pre-tax then reduced by 47% to 5.3%).

Table A1 shows that if annual income (commercial profit) were taxed each year at the investor's 47% tax rate, pre-tax 10% return of investment would be cut by the tax in proportion to the tax rate to 5.3%. The available temporary tax preferences (accelerated depreciation and capital gains taxed on realisation) push the post-tax return to 5.8% (before any second-round effects on prices and costs).

Investment via company under integration of taxable income

The following tables show indirect investment by 47% shareholders in the widget-producing activity via a company subject to integration of taxable income — in varying circumstances of retention or distribution of cash and sales of company shares.

Full distribution of cash and sale of shares each year

Table A2 has the company distributing all cash each year and shareholders selling out to others each year (after distributions are made). A (tax-neutral) 5.3% post-tax return is achieved by shareholders selling out each year, as well as shareholders at the time of liquidation. Overall tax payable ($461) is the same as for the direct investor in Table A1.

Table A2: Practical integration: widget-producing company with full distribution of cash and sale of shares each year ($)

Year	0	1	2	3	4	5
			Widget-producing company			
BEFORE TAX (a)						
Cash flow	–2000	250	213	181	154	2185
Return pa						10.0%
AFTER TAX (b)						
Company's taxable income		0	0	0	37	945
Tax paid at 30%		0	0	0	11	283
Post-tax cash flow	–2000	250	213	181	143	1901
Return to company					Post-tax return pa	7.4%
			Investor shares in company			
Sell shares		Sell	Sell	Sell	Sell	
Retain/distribute cash		Dist	Dist	Dist	Dist	
Value (a)	2000	1950	1932	1945	1986	0
Tax value of shares (c)	2000	1950	1932	1932	1945	746

Table A2: Continued...

Year	0	1	2	3	4	5
Taxed income in dist (d)		0	0	0	26	661
Unfranked dividend (e)		200	195	181	117	0
Return of capital (f)	–2000	50	18	0	0	1240
Tax on distribution (g)		94	92	85	61	161
CGT base (h)		0	0	13	41	–746
CGT at 47%		0	0	6	19	–351
Post-tax cash flow (i)	–2000	2106	2053	2035	2048	2091
Return to shareholder pa (j)		5.3%	5.3%	5.3%	5.3%	5.3%
Accumulated overall tax		94	186	276	368	461

(a) As in Table A1.

(b) As in Table A1 but with company subject to tax at 30%.

(c) Prior-year tax value of shares (here prior-year value of company assets because shares are sold at end of prior year, eg $1,986 in year 5) plus company's current-year taxed income (not distributed as cash) less return of capital ($1,240 in year 5).

(d) Company's taxable income less company tax paid on it.

(e) Amount of income (Table A1) distributed that is not in taxed income. This is included in shareholders' tax assessments.

(f) Distributions beyond company income, as well as all of the franked distribution in year 5 which reduces capital return in that year. In year 5, of the $1,901 cash distribution, $661 is franked (including amounts taxed earlier as unfranked dividends), leaving $1,240 return of capital (taxable income of $945 in year 5 plus $37 in year 4 matches the $982 of total company income in Table A1).

(g) Company's taxable income (taxed income grossed up by company tax payable) times shareholders' 47% tax rate less company tax paid plus shareholders' 47% tax rate on unfranked dividends.

(h) Sale value of shares less tax value. On liquidation, tax value is $746: year 4 $1,986 sale price less $1,240 contributed capital in year 5. Thus, with zero sale value on liquidation, shareholders have a CGT loss of $746 (ensuring no double tax on income previously taxed as unfranked dividends or, when untaxed income is retained in years 3 and 4, via CGT). Alternatively, –$746 year 5 CGT base equals $1,240 year 5 return of capital less $1,986 year 4 tax value of shares acquired.

(i) After initial $2,000 capitalisation of company, sale value plus distribution less tax paid on distribution and CGT (CGT savings in year 5).

(j) Tax-neutral 5.3% return (10% pre-tax reduced by 47% tax) each year because pre-tax income — or net receipts plus annual change in asset values (eg $200 in year 1) — is taxed at 47% each year.

Full distribution of cash but no sales of shares

Table A3 has the company distributing all cash each year but original shareholders holding on to their shares until liquidation. Pre- and post-tax cash flows of the company are as in Table A2.

Table A3: Practical integration: widget-producing company with full distribution of cash, no sale of shares each year ($)

Year	0	1	2	3	4	5
		Investor shares in company				
Sell shares						
Retain/distribute cash		Dist	Dist	Dist	Dist	
Value (a)	2000	1950	1932	1945	1986	0
Tax value of shares (b)	2000	1950	1932	1932	1932	692
Taxed income in dist (a)		0	0	0	26	661
Unfranked dividend (a)		200	195	181	117	0
Return of capital (a)	–2000	50	18	0	0	1240
Tax on distribution (a)		94	92	85	61	161
CGT base (c)		0	0	0	0	–692
CGT at 47%		0	0	0	0	–325
Post-tax cash flow	–2000	156	121	96	81	2006
Shareholder return pa (d)						5.32%
Accumulated overall tax		0	0	0	17	461

(a) As in Table A2.

(b) Prior-year tax value of shares (eg $1,932 in year 5) less return of capital ($1,240 in year 5).

(c) Sale value of shares less tax value. On liquidation, tax value is $692. Thus, with zero sale value on liquidation, shareholders have a CGT loss of $692 (ensuring no double tax on income previously taxed as unfranked dividends). Alternatively, –$692 year 5 CGT base equals $1,240 year 5 return of capital less $1,932 year 4 tax value of shares acquired.

(d) Overall return is close to a tax-neutral 5.3% pa result because when net receipts distributed exceed annual income (which they do, or go close to doing, each year), the company's annual income is taxed at 47%.

Table A3 shows one important effect of retaining unfranked dividends under integration rather than replacing them with CGT cost base reductions.

Unfranked dividends in years 1 to 4 effectively tax company income that is not in taxable income because of accelerated depreciation and the exclusion of accrued capital gains. That income is taxed again in the company when the company sells its

land and machine, but double tax is neatly offset by a full $692 capital loss (matching the total of prior unfranked dividends) on liquidation. Absent liquidation, the same offsetting CGT loss would result on distribution of asset sale proceeds (and associated franked dividends, which again reduce the amount of capital returned, increasing CGT loss) and sale of shares.

In contrast, were unfranked dividends replaced by CGT cost base reductions, no tax would be paid on distributions out of accelerated depreciation and accrued gains in years 1 to 4 and no capital loss would be realised on liquidation in year 5. Overall, shareholders would earn 5.8% pa post-tax return over the five years (again, with overall tax payable of $461). That is the same as that realised by the direct investor in Table A1. Mayo[113] shows that result under integration with unfranked dividends replaced by CGT cost base reductions.

Retention of annual cash flow and no sale of shares

Table A4 has the company retaining post-tax cash flow and again original shareholders holding on to their shares until liquidation. Overall income and overall tax of $570 are higher than in Tables A1, A2 and A3 because of the 10% interest earned on retained income. The 5.72% pa return achieved and tax paid would be the same for the direct investor if the investor deposited annual post-tax cash flow in a 10% bank account until year 5.

Because taxable income is delayed and relatively low in years 3 and 4, the 5.72% pa return only incorporates a small effect under integration of no delay in the application to taxable income of the shareholders' 47% tax rate — relative to imputation where only the 30% company rate would apply to taxable income in those years.

Table A4: Practical integration: widget-producing company with no cash distribution or sale of shares each year ($)

Year	0	1	2	3	4	5
			Widget-producing company			
BEFORE TAX (a)						
Value net assets	2000	2200	2420	2644	2872	2940
Net receipts		250	238	229	223	219
Change in value		–50	–18	13	41	68
Income		200	220	242	264	287
Cash flow (b)	–2000	0	0	18	36	3160
Return				Pre-tax return pa		10.0%
AFTER TAX (a)						

113 Ibid, p 218 (Table 51).

Table A4: Continued...

Year	0	1	2	3	4	5
Tax value of assets (c)	2000	1950	1978	2042	2126	2940
Change in tax value (d)		–300	–210	–147	–103	814
Taxable income (e)		0	0	60	121	1033
Tax paid at 30%		0	0	18	36	310
Post-tax cash flow	–2000	0	0	0	0	2850
Return to company (f)				Post-tax return pa		7.3%
			Investor shares in company			
Sell shares						
Retain/distribute cash		Retain	Retain	Retain	Retain	
Value (g)	2000	2200	2420	2644	2872	0
Tax value of shares (h)	2000	2000	2000	2042	2126	0
Taxed income in dist (i)		0	0	0	0	724
Unfranked dividends		0	0	0	0	0
Return of capital (j)	–2000	0	0	0	0	2126
Tax on taxable income (k)		0	0	10	20	176
CGT base (l)		0	0	0	0	0
CGT at 47%		0	0	0	0	0
Post-tax cash flow	–2000	0	0	–10	–20	2674
Return to shareholder pa						5.72%
Accumulated overall tax		0	0	28	85	570

(a) The pre-and post-tax flows at the company level differ from those of Table A3 only because post-tax cash is retained in the company's bank account each year.

(b) Because of retained post-tax cash, the only positive cash outflow before liquidation is that required to pay company tax.

(c) Includes tax value of company's bank account that holds retentions.

(d) 30% declining balance tax depreciation on machine until year 5.

(e) Net receipts plus change in tax value (if negative, carried forward to following year).

(f) The 7.3% pa post-tax return is higher than 7.0% (pre-tax 10% reduced by 30% tax rate) because of accelerated write-off of machine and no tax on accrued capital gains (despite loss carry-forward).

(g) Value of shares equals value of widget-producing machine, land and bank account (pre-tax value of net assets) but not any retained credits for company tax paid because those credits are allocated to shareholders along with taxable income).

(h) Prior-year tax value ($2,126 in year 5) plus allocated/reinvested taxed income (not distributed as cash) until year 5 when return of capital is also subtracted.

(i) The $724 of taxed income on liquidation equals the company's $1,033 year 5 taxable income less the $310 company tax paid on that. $1,033 plus prior taxable income ($60 and $121 in years

3 and 4, respectively) equals $1,214, the aggregate amount of both pre-tax income and taxable income.

(j) $2,126 return of capital in year 5 comprises $2,000 original contributed capital plus $126 of allocated and reinvested taxed income in years 3 and 4.

(k) Company's annual taxable income (annual taxed income grossed up by company tax paid) times shareholders' 47% tax rate less company tax paid. $206 extra tax, equal to 17% of aggregate taxable income of $1,214 across all years, is paid by shareholders because their 47% tax rate is higher than the 30% company tax rate applied to taxable income in the company.

(l) The $2,126 tax value of shares in year 4 (increased from original $2,000 by retained taxed income) matches exactly the $2,126 return of capital in year 5, so no CGT gain or loss arises on liquidation.

Retention of annual income and annual sale of shares

Table A5 has the company retaining post-tax cash flow and shareholders selling out to others each year (after distributions are made). Pre- and post-tax cash flows of the company are as in Table A4. With annual sale of shares, shareholders make a (tax-neutral) 5.3% return each year. Integration design (and no CGT discount) ensures no temporary or permanent double taxation (in contrast to current imputation and CGT arrangements). As with Table A4, the $570 of overall tax is higher than the $461 in Tables A1, A2 and A3 because of the 10% interest earned on retained income.

Table A5: Practical integration: widget-producing company with no cash distribution but sale of shares each year ($)

Year	0	1	2	3	4	5
		Investor shares in company				
Sell shares		Sell	Sell	Sell	Sell	
Retain/distribute cash		Retain	Retain	Retain	Retain	
Value (a)	2000	2200	2420	2644	2872	0
Tax value of shares (b)	2000	2000	2200	2462	2728	746
Taxed income in dist (c)		0	0	0	0	724
Unfranked dividends		0	0	0	0	0
Return of capital (c)	–2000	0	0	0	0	2126
Tax on taxable income (c)		0	0	10	20	176
CGT base (d)		200	220	182	144	–746
CGT at 47%		94	103	86	68	–351
Post-tax cash flow	–2000	2106	2317	2548	2784	3025
Return to shareholder pa (e)		5.3%	5.3%	5.3%	5.3%	5.3%
Accumulated overall tax (f)		94	197	311	435	570

(a) Value of shares equals value of widget-producing machine, land and bank account (pre-tax value of net assets in Table A4). Unlike under full imputation arrangements, there are no retained credits for company tax paid to add to value.

(b) Prior-year tax value of shares (here prior-year value of company's assets because shares are sold at end of prior year — eg $2,872 in year 5) plus allocated/reinvested taxed income (not distributed as cash) less return of capital in year 5.

(c) As in Table A4.

(d) Sale value of shares less tax value. On liquidation, tax value is $746: $2,872 purchase price in year 4 less $2,126 return of capital. Thus, with zero sale proceeds on liquidation, there is a $746 CGT loss to shareholders (ensuring no double tax on unfranked income previously taxed via CGT). Alternatively, –$746 year 5 CGT base equals $2,126 year 5 return of capital less $2,872 year 4 tax value of shares acquired. The $746 matches the total income from widget production that is not in taxable income prior to liquidation and taxed to shareholders by CGT in years 1 to 4.

(e) Tax-neutral 5.3% return (10% pre-tax reduced by 47% tax) each year because retained pre-tax income or net receipts plus annual change in asset values (eg $200 in year 1) taxed at 47% each year.

(f) Same overall $570 of tax paid (47% of $1,214 aggregate company income) as in Table A4.