

Interest, Exempt Income and Inter—corporate Dividends

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Introduction

The tax treatment of inter—corporate dividends has been the subject of a good deal of discussion lately, particularly in the context of the proposed change from our current classical system of company taxation to a full imputation system.

This discussion often presents inter—corporate dividends, which are currently relieved of multiple layers of tax as they pass through the corporate chain by the s.46 rebate, as exempt income and suggests that the tax treatment afforded interest payments on associated debt funds should be framed accordingly. In particular, it is suggested that the interest expenses should be effectively denied deductibility at the company level by the s.46 rebate being calculated on the dividends received net of associated interest payments.

This paper analyses these issues by first considering the principles involved in the question of denying deductibility of interest on debt used to fund direct investments which give rise to exempt income. The paper goes on to look at the treatment of inter—corporate dividends in the context of both classical and imputation systems when either assessable or exempt (or tax—preferred) income underlies the dividends.

Interest Deductibility and Exempt Income

An investor is able to lend funds and obtain a 15 per cent before tax annual return. Alternatively, it costs the investor 15 per cent before tax to borrow funds to invest.

The investor is subject to income tax. Nominal interest income is assessable and nominal interest payments are

* *Department of the Treasury.* The views expressed are not necessarily those of the Treasury or the Government. This paper was presented at the Australian Tax Forum Fourth Intensive Workshop in Taxation, October 1986.

deductible. The investor faces a 30 per cent marginal rate of tax so that the investor's after tax return from lending funds is 10.5 per cent. Symmetrically, the investor's after tax cost of borrowing funds is 10.5 per cent.

Risk considerations aside, the investor is prepared to put his money into any activity, including widget production, which returns at least 10.5 per cent after tax on the total amount invested (equivalent to 15 per cent before tax with widget production fully taxable).

It does not matter whether the investor uses funds on hand to invest in widget production or whether the investor has to borrow to undertake the investment. If the investor borrows, an explicit 10.5 per cent after tax cost is incurred (just covered by the 10.5 per cent return on a marginal widget investment). If the investor puts his or her own equity funds into the investment, he or she is still incurring the 10.5 per cent opportunity cost of not putting those funds in the financial market.

The government of the day now declares that income from widget production is exempt from tax. General provisions of the income tax law consequently deny deductibility for annual operating expenses, as well as write-off allowances in respect of capital expenditure, associated with widget production.

Our investor, along with other taxable investors, suddenly find that their 15 per cent before tax return from widget investment is not reduced by tax. Investment is switched from marginal after tax investments in other activities to widget production. Previously sub-marginal investments in widget production become viable. Over time, widget production is increased (presumably the intention of the government in introducing the exempt status) until the return from a marginal widget investment matches the after tax return from fully taxed investments, including from the financial market.

Our investor and other taxable investors will not, however, find marginal widget production is made more attractive by its exempt status if they borrow to fund their investment. That is because the general provisions of the law would also deny deductibility for the interest payments on the borrowings. The denial of interest deductibility means that the 15 per cent cost of borrowing is not reduced after tax. The cost of the borrowing matches the pre-exemption 15 per cent return from widget production.

Nevertheless, the opportunity cost of equity funding remains at 10.5 per cent for our investor. Interest returns remain assessable and 10.5 per cent is still the after tax return available to our investor from investing those funds in the financial market rather than widget production. Further, with equity financing, the investor could enjoy the 15 per cent return available from exempt widget production (before other

equity investors started reducing the returns from widget production below that).

Exempting income from widget production and denying deductions on associated borrowings would, therefore, be expected to encourage investment in widget production but at the same time encourage the use of equity over debt to fund this investment. It is not surprising that the level of direct debt funding by gold producers is relatively low.

Looked at another way, the effect of the exemption is frustrated to the extent that investors finance their widget investment by debt funding. Moving from debt to equity financing provides the means around this frustration.

The bias towards equity imposed in these circumstances would be removed by allowing interest deductions on funds borrowed for widget investment despite its exempt status. Of necessity, the interest deductions would have to be claimed against income other than from widget production. Disallowance of deductions for operating expenses and write-off allowances for capital expenditure would have to remain in order that the tax system did not increase, in an ad hoc fashion depending on the amount of such expenditures for particular investments, the return of widget production above the pre-exemption 15 per cent before tax return on total investment. Allowing interest deductibility would, however, mean that the encouragement provided widget production by its exempt status would be unaffected by the tax arrangements regardless of the level of debt funding. In order to get at the 15 per cent return from widget production, the investor faces the same 10.5 per cent after tax explicit cost of debt or opportunity cost of equity funding.

The bias away from debt and towards equity would also be removed by allowing interest deductibility but taxing year by year the imputed interest (determined at the going 15 per cent interest rate) in respect of the capital investment - net of economic depreciation of that capital - in widget production. The after tax return on total investment in marginal widget production would be again 10.5 per cent. The exemption would be totally frustrated regardless of the level of equity involved - a result which would be applauded by those seeking to avoid the resource misallocation caused by the exemption, but not presumably by the government seeking stimulation of widget production at the expense of other activities.

The above discussion leads to the conclusion that where income from an activity is exempt, the allowance of deductibility for associated interest payments would ensure (provided sufficient other taxable income is available) that the effect of the exemption was not frustrated to the extent that investment in the activity is funded by borrowing.

This conclusion does not, however, imply that interest quarantining should not in principle be used to frustrate the effect of tax preferences in our income tax law - for example, quarantining with rental property to address the taxing of capital gains on a real rather than nominal basis - or that interest deductibility should not be denied when exempt income is involved. It does suggest that there may be bounds on the distortions introduced by the non-taxation of imputed income from owner-occupied homes when a relatively high degree of (non-deductible) debt is often involved in these investments. As discussed by Sieper¹, however, the conclusion implies that, when interest deductibility is denied, equity funding - to the extent that there are no market constraints operative - will step into the gap left by reduced debt funding to take advantage of the tax preferences.

Income 'freed' from tax by tax preferences, such as investment allowances or accelerated write-off provisions, differs from exempt income in that expenses, including interest expenses, incurred in earning that income would be deductible. Such tax-preferred income would be more common than exempt income (as distinct from non-assessable capital profits). Moreover, investments giving rise to non-assessable capital profits would invariably also be returning annual assessable income such that associated expenditure would be deductible.

Inter-corporate Dividends

In the above discussion our investor undertakes widget production in an unincorporated business. There is the question of how the investor fares under classical and imputation systems of company tax from investing in widget production indirectly by acquiring shares in Company A which undertakes the widget production. There is also the question of the effect on the investor's return of different treatments of the dividends passing to our investor through Company B which is interposed between Company A and the investor.

An analysis of these questions when income from widget production is assessable and when it is exempt should help determine the correct in-principle tax treatment of inter-corporate dividends. Numerical illustrations of the effect of tax under the various circumstances on the investor's return for a particular year are used as a basis for the analysis. The numbers used in these illustrations are purely hypothetical. The annual snapshot could, for example, be one year of widget investment with a before tax return on investment of 15 per cent.

1. E. Sieper, 'Business Tax Reform', in J.G. Head, ed., *Changing the Tax Mix* (Sydney: Australian Tax Research Foundation, 1986), at 289-92.

Tables 1 and 2 provide numerical illustrations of the outcome for a particular year under our classical system when the income from widget production is assessable and exempt respectively. Tables 3 and 4 provide parallel illustrations under the full imputation system of company taxation incorporating compensatory tax proposed in the *Treasurer's Statement* of 19 September 1985.² Tables 1 and 3 are based on examples given in *Treasury Economic Paper No. 12*.³

For ease of comparison, all the examples assume \$300 of gross income results in the year from \$2000 of capital invested in a widget-producing asset. The only expenses are \$150 of interest incurred in funding the investment, leaving a net pre-tax annual return of \$150.

Each table covers four cases. Case I is our investor investing directly in the \$2000 asset using \$1000 of equity funds and \$1000 of debt. With the going interest rate at 15 per cent, the investor's interest expenses are \$150. Case II has the investor using the \$2000 to acquire shares in Company A, which buys the widget-producing asset and passes the profits from widget production to the investor as dividends.

In Cases III and IV, the investor uses his or her \$1000 of equity to acquire shares in Company B. Company B borrows the additional \$1000 at 15 per cent and invests the \$2000 in Company A, which again purchases the widget-producing asset. The difference between Cases III and IV is in the tax treatment of the income from widget production when it passes through Company B as dividends on the way to our investor.

In both cases, the s.46 rebate does its job of ensuring that layer on layer of company tax is not imposed on income as it passes through the company chain (even when the income is exempt in the originating company as in Tables 2 and 4). In Case III, however, Company B is able to deduct its \$150 of interest expenses against its assumed non-dividend income. In other words, the s.46 rebate is calculated on the dividends received from Company A gross of the \$150 of associated interest. In contrast, with Case IV the s.46 rebate is calculated on the basis of dividends net of the \$150 associated interest, despite the availability of plenty of non-dividend income.

As illustrated in *Treasury Economic Paper No. 12*,⁴ under the compensatory tax approach to full imputation the gross s.46 treatment of Case III provides an equivalent outcome - when the company receiving the dividends is in a profitable position - to the rolling of imputation credits through the corporate chain as a method of avoiding multiple layers of company tax.

2. *Reform of the Australian Taxation System*, Statement by the Treasurer (Canberra: AGPS, 1985).

3. Department of the Treasury, *Some Economic Implications of Takeovers* (Canberra: AGPS, 1986), Appendix C3.

4. *Id.*, at 49.

The annual outcome would be different, however, if the company receiving the dividends is in a loss position. The two methods would, nevertheless, equal out over time as the company uses up imputation credits attaching to the dividends received for the purpose of offsetting compensatory tax on dividends paid. Because of this equivalence, only the gross s.46 method is discussed here.

In each table, a 49 per cent company tax rate is assumed and our individual investor retains his 30 per cent personal tax rate.

CLASSICAL SYSTEM

Table 1: Classical System - Assessable Income

Gross Investment Income	\$300.00			
Interest Bill	\$150.00			
Company Tax Rate	49%			
Personal Tax Rate	30%			
	CASE I	CASE II	CASE III	CASE IV
COMPANY A	\$	\$	\$	\$
Investment Income		300.00	300.00	300.00
Company Tax		-147.00	-147.00	-147.00
Dividend Distribution		153.00	153.00	153.00
COMPANY B				
Interest Bill			-150.00	-150.00
Tax Saving			73.50	
Dividend Distribution			76.50	3.00
INDIVIDUAL				
Investment Income	300.00			
Interest Bill	-150.00	-150.00		
Taxable Income	150.00	3.00	76.50	3.00
Personal Tax	-45.00	-0.90	-22.95	-0.90
After-tax Income	105.00	2.10	53.55	2.10
Total Tax Paid	45.00	147.90	96.45	147.90

Table 2: Classical System - Exempt Income

Gross Investment Income	\$300.00			
Interest Bill	\$150.00			
Company Tax Rate	49%			
Personal Tax Rate	30%			
	CASE I	CASE II	CASE III	CASE IV
COMPANY A	\$	\$	\$	\$
Investment Income		300.00	300.00	300.00
Company Tax				
Dividend Distribution		300.00	300.00	300.00
COMPANY B				
Interest Bill			-150.00	-150.00
Tax Saving			73.50	
Dividend Distribution			223.50	150.00
INDIVIDUAL				
Investment Income	300.00			
Interest Bill	-150.00	-150.00		
Taxable Income		150.00	223.50	150.00
Personal Tax		-45.00	-67.05	-45.00
After-tax Income	150.00	105.00	156.45	105.00
Total Tax Paid	0.00	45.00	-6.45	45.00

Table 1 (Case I) shows that with widget production taxable our individual investor attracts tax at his or her 30 per cent marginal tax rate on the gross income from widget production less the associated interest expenses. Tax of \$45 is payable on the \$150 of net income.

With the s.46 rebate applied on a gross basis (Case III) the \$150 of net income is subject to the double taxation imposed by the classical system: once at the 49 per cent company rate and again at the 30 per cent personal rate. Each \$100 of net income is reduced to \$51 by company tax and this \$51 is reduced to \$35.7 by the personal tax rate - an overall double tax rate of 64.3 per cent. Thus, the \$150 of net income is reduced by \$96.45 of tax. The gross s.46 treatment effectively allows the \$150 of interest expenses to be deducted at the same 64.3 per cent double tax rate that applies to the gross income from widget production.

Thus, the s.46 rebate applied on a gross basis meets the conceptual requirements of the classical system. That is, that gross assessable income less expenses - regardless of whether those expenses are incurred in the company chain or by the individual shareholder - is subject to double tax: once at the company rate and again at the shareholder's personal rate.

With the s.46 rebate applied on a net basis (Case IV) the \$150 interest expense of Company B must be deducted from the after-company tax dividends received from Company A rather than from non-dividend gross income of Company B. The effect of this for our individual investor is that the \$300 gross income from widget production is taxed at the 64.3 per cent double tax rate but the \$150 of associated interest is deductible only at the investor's 30 per cent rate. Case IV has \$51.45 more tax payable than Case III which corresponds to deducting the \$150 of interest at 30 per cent and not 64.3 per cent.

The overall effect of the net s.46 rebate treatment is to subject the \$150 of net income from widget production to more than the double taxation required by the classical system. It does not matter whether the individual investor borrows funds to invest or whether Companies A or B borrow on his behalf: the net income which belongs to the investor remains at \$150.

Case II, where the investor does undertake the borrowing, results in more than double taxation the same as Case IV. The investor can only deduct the interest costs at the 30 per cent personal rate, and cannot avoid having the \$300 gross income taxed at 64.3 per cent double tax rate. The gross income less associated expenses is again effectively taxed at more than the 64.3 per cent rate.

Compared to the \$105 annual profit that would be available to the investor from producing widgets directly - corresponding to the 10.5 per cent overall return, referred to in the previous section, on the investor's \$1000 equity - the investor would only have a \$2.1 annual profit from borrowing to invest directly in a widget-producing company. Limiting the tax to double taxation only by having an interposed company do the borrowing with s.46 applying on a gross basis lifts the annual profits to \$53.55.

An important point to emphasise here is that the income being 'freed' of further tax in the company chain in Cases III and IV is not exempt income. It has already been subject to tax in the originating company. The in-principle requirement for gross s.46 treatment is clear in these circumstances. It results in double taxation of the net income, not something more than that.

If however, the government of the day exempts income from widget production as speculated earlier, the outcome would be as illustrated in Table 2. With the investor producing widgets directly (Case I), the annual untaxed profit would be \$150 - reflecting the initial 15 per cent return on the investor's equity from exempt widget production.

Investing in a widget-producing company, either directly (Case II) or via an interposed company with the net s.46

treatment applying (Case IV), returns the individual investor \$105. Forty-five dollars tax is payable at the investor's 30 per cent rate on the \$150 of net profits, as in Case I of Table 1. A single layer of tax at the investor's marginal tax rate applies to net profits from widget production despite the exemption. That is because company profits distributed as dividends are taxed in the hands of shareholders (although differences arise here under current law if some capital profits are retained until liquidation). Again, we are no longer strictly dealing with exempt income. The s.46 rebate applied on a net basis would, in this situation, effectively result in the \$150 of interest being deducted at the investor's 30 per cent rate, corresponding appropriately to the rate of tax on the associated gross income.

Under the classical system when income is exempt at the company end and therefore taxed only once at the individual shareholder's marginal tax rate, expenses associated with that income should also only be deductible at the individual shareholder's rate of tax. That will ensure that the gross income less associated expenses - regardless of whether the expenses are incurred in the company chain or at the individual shareholder end - is taxed once at the individual shareholder's tax rate (in contrast with the case involving assessable income where net income should be subject to double tax).

With widget production exempt at the company end, however, applying s.46 on a gross basis effectively allows the \$150 of interest to be deducted at the 64.3 per cent 'double tax' rate while the \$300 of associated gross income is taxed only at the 30 per cent personal rate. Case III in Table 2 again has \$51.45 less tax payable than Case IV corresponding to the \$150 being deducted at 64.3 per cent rather than 30 per cent.

This is totally different from the situation covered in the previous section where allowing the deductibility of interest - at the investor's marginal personal tax rate - associated with exempt income would avoid frustrating the effect of exemption. Interest expenses are attracting deductibility at a much higher rate than the investor's tax rate attracted by the associated gross profits. In addition, interposed companies could perhaps be used to attempt to achieve the same effect with non-interest operating expenses associated with the exempt income - by separating the gross exempt income and associated operating costs in different companies. With exempt income under the classical system the net treatment of the s.46 rebate has attractions.

While, in practice, tax exempt income may not be all that significant overall - gold mining income being the only activity paralleling the hypothetical exemption applied here to widget production - similar effects would be possible in the

case of income 'freed' from tax by tax preferences and in the case of non-assessable capital profits.

IMPUTATION SYSTEM WITH COMPENSATORY TAX

Many of the distortive influences and ambiguities of the classical system reflected in the above results would be removed by a full imputation system incorporating compensatory tax payments at the rate of \$49 for every \$51 of cash dividends distributed by resident companies. Any ambiguity over the net or gross basis of the s.46 rebate disappears completely.

Table 3: Full Imputation System - Assessable Income

Gross Investment Income	\$300.00			
Interest Bill	\$150.00			
Company Tax Rate	49%			
Personal Tax Rate	30%			
	CASE I	CASE II	CASE III	CASE IV
COMPANY A	\$	\$	\$	\$
Investment Income		300.00	300.00	300.00
Company Tax		-147.00	-147.00	-147.00
Dividend Distribution		153.00	153.00	153.00
COMPANY B				
Interest Bill			-150.00	-150.00
Tax Savings			73.50	
Dividend Distribution			76.50	3.00
INDIVIDUAL				
Grossed-up Dividends		300.00	150.00	5.88
Investment Income	300.00			
Interest Bill	-150.00	-150.00		
Taxable Income	150.00	150.00	150.00	5.88
Personal Tax	-45.00	-45.00	-45.00	-1.76
Imputation Credit		147.00	73.50	2.88
Net Credit		102.00	28.50	1.12
After-tax Income	105.00	105.00	105.00	4.12
Total Tax Paid	45.00	45.00	45.00	145.88

Table 4: Full Imputation System - Exempt Income

Gross Investment Income	\$300.00			
Interest Bill	\$150.00			
Company Tax Rate	49%			
Personal Tax Rate	30%			
	CASE I	CASE II	CASE III	CASE IV
COMPANY A	\$	\$	\$	\$
Investment Income		300.00	300.00	300.00
Compensatory Tax		-147.00	-147.00	-147.00
Dividend Distribution		153.00	153.00	153.00
COMPANY B				
Interest Bill			-150.00	-150.00
Tax Savings			73.50	
Dividend Distribution			76.50	3.00
INDIVIDUAL				
Grossed-up Dividends		300.00	150.00	5.88
Investment Income	300.00			
Interest Bill	-150.00	-150.00		
Taxable Income		150.00	150.00	5.88
Personal Tax		-45.00	-45.00	-1.76
Imputation Credit		147.00	73.50	2.88
Net Credit		102.00	28.50	1.12
After-tax Income	150.00	105.00	105.00	4.12
Total Tax Paid	0.00	45.00	45.00	145.88

Of the situations illustrated in Tables 3 and 4, including those when income from widget production is exempt, all but three result in our individual investor obtaining the \$150 net profits less \$45 tax on that at the investor's 30 per cent personal tax rate. Two of those exceptions are the Case IV situation with the s.46 rebate applying on a net basis.

With a net s.46 rebate applying, \$73.5 of tax savings are lost by Company B both when the income from widget production is taxable and when it is exempt. Dividends in the year are reduced by that amount along with \$70.62 of attached imputation credits. The net result is that \$100.88 excess tax is payable in that year.

Conceptually, s.46 applying on a gross basis is unambiguously the appropriate treatment under the compensatory tax approach to full imputation.

The third of the three cases which does not result in one layer of tax at 30 per cent applying to the \$150 net profit is, of course, the case where the investor produces exempt widgets directly (Case I, Table 4). The \$150 of net profits is not diluted at all by tax. (If the interest payments were to be

deductible from the investor's non-widget income in this unincorporated case, in order to remove the bias to equity discussed in the first section, the difference between the unincorporated and incorporated outcomes would be exacerbated.)

If full integration was to operate and not full imputation, our investor would also receive an undiluted \$150 by acquiring the shares in a company producing exempt widgets or by investing via an interposed company. The compensatory tax approach to full imputation means that these forms of investment in exempt widgets attract tax at the investor's personal tax rate on the net profits (Cases II and III, Table 4), as in all cases under imputation - except the net 46 rebate case - when widget production is taxable (Cases I, II and III, Table 3). The same result obtains under the classical system when the widget income is exempt for corporate investment Cases II and IV (Table 2).

It is important to note that, the case of tax exempt and non-resident shareholders aside, the \$147 compensatory tax paid by Company A in Table 4 does not represent an additional layer of tax imposed by the proposed full imputation arrangements on tax exempt or tax-preferred profits. Under the current classical system such profits are taxed in the hands of shareholders at shareholders' marginal tax rates when distributed as dividends.

The same result can be achieved for resident taxable shareholders under the imputation system - with the dividend cheque reduced commensurately by payments of compensatory tax. The dividend payments attract compensatory tax but the resident shareholder obtains a full credit for that in his or her assessment. So long as the shareholder's cash dividend plus attached imputation credits at least equal the dividend payment under the classical system (and the shareholder can take full advantage of the available credits) the shareholder is no worse off under imputation. This may be seen, for example, by comparing Case II in Tables 2 and 4.

Alternative Imputation Systems

'INTEGRATION' SYSTEM

An outcome where net profits from exempt or tax-preferred income received by individual shareholders attract the same treatment as the profits earned by the shareholders investing directly would require a move from full imputation (with compensatory tax applying) to full integration. An intermediate step in that direction towards full integration

would be the 'qualifying dividends' approach to full imputation of Benge and Robinson.⁵

Under Benge and Robinson's qualifying dividend approach to full imputation, no compensatory tax applies and effectively only dividends out of profits which have attracted company tax have imputation credits attaching to them. Exempt income or non-assessable profits effectively flow through untaxed to individual shareholders and remain non-assessable in their hands. Table 3 doubles as an illustration of the treatment of assessable income under this system. Apart from the taxation at the individual shareholder end, Table 2 illustrates the treatment of exempt income. For taxable individual shareholders able to obtain the full benefit of available imputation credits, the effect with full distribution of after tax profits - or with bonus issues out of those profits if the bonus issues were treated for tax purposes as dividends followed by immediate re-investment - would be the same as if the shareholders invested directly. (This full integration outcome would not, however, obtain in the absence of refunds for excess credits where assessable income was involved and the shareholders were tax exempt or could not enjoy the full benefit of available credits.)

The appropriate treatment of inter-corporate dividends would be essential to achieve the full integration outcome for the taxable shareholders. For dividends out of assessable income, the gross s.46 rebate (or rolling imputation credits) is again unambiguously the appropriate treatment as illustrated in Table 3.

For dividends out of exempt income, the required treatment of inter-corporate dividends depends directly on which of the two treatments, discussed in the first section, of interest associated with the exempt income applies to unincorporated investments - that is, whether interest expenses associated with the exempt income are deductible or not (with associated non-interest expenses remaining non-deductible).

If interest expenses are not deductible, as is assumed in the unincorporated case (Case I) in Tables 2 and 4, the net s.46 rebate is the appropriate treatment of inter-corporate dividends. Case IV in Table 2 shows how the net s.46 rebate under this qualifying dividends approach would allow the \$300 of exempt income from widget production less the \$150 of associated interest flow through to the individual shareholder. The shareholder would receive a tax free net return of \$150, the same as a direct investment in widget production (Case I, Table 2).

On the other hand, if interest expenses are deductible (perhaps with a view to keeping a balance between debt and

5. M. Benge and T. Robinson, *How to Integrate Company and Shareholder Taxation* (Wellington: Victoria University Press, 1986), at 93-100.

equity, as discussed earlier, along with the widget exemption), calculating the s.46 rebate gross of associated interest expenses is the appropriate treatment of inter-corporate dividends. This is illustrated in Table 5.

Table 5: 'Integration' System - Exempt Income

Gross Investment Income	\$300.00			
Interest Bill	\$150.00			
Company Tax Rate	49%			
Personal Tax Rate	30%			
	CASE I	CASE II	CASE III	CASE IV
COMPANY A	\$	\$	\$	\$
Investment Income		300.00	300.00	300.00
Company Tax				
Dividend Distribution		300.00	300.00	300.00
COMPANY B				
Interest Bill			-150.00	-150.00
Tax Savings			73.50	
Dividend Distribution			223.50	150.00
INDIVIDUAL				
Investment Income	300.00			
Interest Bill	-150.00	-150.00		
Tax Savings	45.00	45.00		
Reduced Net Credit			-28.50	
Net Income	195.00	195.00	195.00	150.00

The \$45 tax savings provided by the deductibility of the \$150 of interest at the investor's 30 per cent tax rate increases the investor's annual return to \$195 if the investor borrows to produce widgets directly (Case I) or to buy shares in a widget-producing company (Case II). Investing in widget production through the interposed Company C, which does the borrowing on behalf of the investor, results in only a \$150 net return with the s.46 rebate calculated on a net basis (Case IV).

However, with the s.46 rebate calculated on a gross basis (Case III), the net return to the investor is again \$195 - the same as for unincorporated investment. The \$150 interest expense incurred by Company C is deductible against the other assessable income of that company at the 49 per cent company tax rate, resulting in a \$73.5 tax saving at the company end which is passed on to the shareholder by way of higher dividends. Under the qualifying dividend approach, the \$73.5 reduced tax at the company end means \$73.5 less imputation credits at the shareholder end. In addition, because of the

interest payments there is \$150 less grossed up assessable company income to be assessed in the hands of the shareholder, resulting in \$45 less personal tax assessed. The \$73.5 extra dividends resulting from the gross s.46 rebate treatment are, therefore, reduced by \$28.5 less net imputation credits (that is, \$73.5 - \$45). Thus, the gross s.46 rebate increases the \$150 return under the net s.46 rebate by \$45, giving the investor the required \$195 return. In other words, even though the \$150 of interest is initially deducted at the 49 per cent company rate, the effect of the gross s.46 rebate in conjunction with this qualifying dividends approach is for the \$150 to be deducted at the shareholder's 30 per cent rate.

These observations highlight some of the practical difficulties involving inter-corporate dividends that would be associated with this qualifying dividend approach to full imputation. In principle, calculating the s.46 rebate gross of associated interest and non-interest expenses would be required when assessable profits were involved, as well as when tax-preferred income was involved as interest and non-interest expenses associated with the tax-preferred income would be deductible for the direct unincorporated investor. With exempt income, however, if associated interest expenses were not deductible for the unincorporated investor, the s.46 rebate should ideally be calculated on a net basis for both interest and non-interest expenses.

A range of other practical difficulties would be involved, not the least of which would be the fact that, if accompanied by the abolition of dividend withholding tax, implementation of these qualifying dividend arrangements would have to involve an acceptance that tax exempt and tax-preferred profits of foreign subsidiaries could be repatriated as dividends, or capitalised into bonus shares, with no Australian tax being paid on them - a result mainly to the benefit of foreign treasuries.

AUSTRALIAN QUALIFYING DIVIDENDS APPROACH

Details of the full imputation system to commence in Australia from 1 July 1987 were announced on 10 December 1986.⁶ No compensatory tax is to apply and, as in the above Benge and Robinson's qualifying dividends approach, effectively only dividends out of profits which have attracted company tax will have imputation credits attached. Unlike the Benge and Robinson approach, however, dividends out of exempt income or non-assessable profits (including tax-preferred income) are effectively to continue to be taxed in the hands of resident shareholders at their marginal rates. Consequently, dividend

6. *Business Tax Reform: Ending the Double Tax on Company Dividends*, Treasurer's Press Release No. 135, 10 December 1986.

withholding tax will continue to apply to dividends paid to non-residents 'out of untaxed profits' (but not to dividends 'out of taxed profits').

This system ensures that imputation credits are matched by tax payments at the company end while achieving a single layer of Australian tax on company profits - with that layer applying at individual shareholders' tax rates when the profits are either distributed directly or distributed indirectly by bonus issue. The current double layer of tax is removed from dividends out of taxed profits distributed to either resident individuals or non-residents while the present single layer of tax on such distributions out of untaxed profits remains unchanged.

The dropping of the originally announced compensatory tax approach in favour of this type of qualifying dividends approach therefore achieves all the aims of the original full imputation system but ensures that non-resident shareholders, as well as resident shareholders who are either tax exempt or have low non-dividend incomes, are not adversely affected by the effect of compensatory tax on dividends paid out of untaxed profits, in particular tax-preferred income. Further, the proposed qualifying dividends approach has the same advantage as the compensatory tax approach in terms of unambiguously requiring the s.46 rebate to apply to gross inter-corporate dividends out of assessable or tax-preferred income and not to those dividends net of associated interest payments. (In contrast to the compensatory tax approach rolling imputation credits are not a substitute for the s.46 rebate as they would effectively result in tax being paid on dividends out of untaxed profits received by the first company in the company chain.) The Treasurer's Statement⁷ explains that the law is to be amended to make clear that the s.46 rebate will operate under the imputation regime on a gross basis for both public and private companies.

Again Table 3 doubles as an illustration of the appropriateness of the gross s.46 rebate treatment under this qualifying dividends approach for dividends out of assessable income. Table 6 compares the gross s.46 rebate treatment under the classical system and both the compensatory tax and proposed dividend qualifying approaches to full imputation. This comparison is made using the earlier situation where \$300 of income derived by Company A is tax-preferred and therefore not assessable and the dividends from Company A pass to the individual shareholder through Company B which incurs \$150 of associated interest expenses. As illustrated earlier, the current classical system does provide a tax advantage through the \$300 of income being taxed once at the

7. *Id.*, at 8.

shareholder's 30 per cent tax rate but the \$150 of associated interest being effectively deductible at the 64.3 per cent double tax rate of the classical system.

Table 6: Investment through Interposed Company - Tax-preferred Income

Gross Investment Income	\$300 tax-preferred		
Interest Bill	\$150		
Company Tax Rate	49%		
Personal Tax Rate	30%		
	Classical System	Imputation System	
		Compensatory Tax Approach	Qualifying Dividends Approach
	\$	\$	\$
COMPANY A			
Investment Income	300	300	300
Compensatory Tax		-147	
Dividend Distribution	300	153	300
COMPANY B			
Interest Bill	-150	-150	-150
Company Tax Savings (a)	73.5	73.5	73.5
Dividend Distribution	223.5	76.5	223.5
INDIVIDUAL			
Grossed-up Dividends		150 (b)	150 (c)
Taxable Income	223.5	150	150
Personal Tax	-67.05	-45	-45
Imputation Credit		73.5	-73.5
Net Credit		28.5	-118.5
After-tax Profit	156.45	105 (d)	105 (d)
Total Tax Paid	-6.45	45	45

(a) Savings resulting from the s.46 rebate being calculated on gross dividends received by Company B and the \$150 of interest being deducted against non-dividend income of Company B.

(b) Cash dividends of \$76.5 plus associated imputation credits of \$73.5 (that is, $\$76.5 \times .49/.51$, or the net company tax borne by the distribution, $\$147 - \73.5).

(c) Grossed-up dividends are as usual the cash dividends (\$223.5) plus the associated imputation credits, negative in this case (-\$73.5) reflecting the \$73.5 less imputation credits available because of the \$73.5 reduced tax paid at the company level through the write-off of the \$150 of interest.

(d) The sum of cash dividends plus the net imputation credit. Again, as for the case of assessable income (Table 3), a single layer of tax at the shareholder's rate applies to the \$150 of net profits under either full imputation system.

This mismatch in the rate of assessability of the preferred income and the rate of deductibility of the associated interest expense does not arise under either the compensatory tax or qualifying dividends approaches to full imputation - the \$150 of net profits are taxed once at the shareholder's tax rate even though preferred income is involved (see Table 6). The \$300 of preferred income is taxed at the shareholder's 30 per cent tax rate and the \$150 of interest deductions is effectively deducted at the same 30 per cent rate. That is achieved under the compensatory tax approach by the compensatory tax effectively imposing company tax on the \$300 of preferred income as it is distributed by Company A - so the outcome is the same at each level as for Case III in Table 3.

The qualifying dividends approach, together with the s.46 rebate operating on a gross basis, achieve the same result through the \$73.5 of tax savings in Company B (that is, the \$150 interest bill offset against taxable income of Company B) being balanced by a loss of \$73.5 of imputation credits at the shareholder end, together with \$45 less of shareholder tax on \$150 less of grossed-up dividends being passed through to the shareholder because of Company B's interest payments (see Table 6). Looked at another way, the \$300 gross income is effectively taxed at the shareholder's 30 per cent rate and the qualifying dividends approach (in the way illustrated in Case III of Table 5) ensures that the \$150 of interest is effectively deducted at the same 30 per cent rate.

In contrast to the classical system, because only one layer of tax applies under full imputation, the worst assessability/deductibility mismatch possible under imputation when tax-preferred income is involved would be where interest on borrowings by companies attracts deductibility at the company rate while the associated gross income is taxed at the shareholder's rate. Nevertheless, the proposed qualifying dividends approach ensures that with full distribution, deductibility also applies at the individual shareholder's rate.

Potentially, problems under the proposed qualifying dividends approach with the s.46 rebate calculated on a gross basis could arise in relation to genuinely tax exempt income (and non-assessable capital profits) and tax exempt or non-resident shareholders. As discussed previously, under general provisions in the law, expenses (including interest) associated with exempt income are not deductible. Interposed companies could be used to separate the exempt income from the expenses and achieve deductibility of the expenses in that way. Nevertheless, as noted, there will be little exempt income around in the imputation and foreign tax credit era and the amount of non-assessable capital profits will be reducing over time. Further, dividends out of exempt income or non-assessable capital profits will continue to be taxed in the hands

of resident individual shareholders and even were interest deductibility achieved by interposing companies, the overall tax outcome would be as illustrated in Table 6 with the exempt income taxed and the associated interest deducted at shareholders' marginal tax rates.

Tax exempt and non-resident shareholders could attempt, by interposing companies, to get the benefit of tax savings from the write-off of expenses associated with tax-preferred income (that is, to achieve \$223.5 rather than the net profits of \$150 by interposing Company B in Table 6). Nevertheless, this possibility is not a result unique to the gross s.46 rebate treatment - the same effect could result if the company deriving tax-preferred income also had sufficient other taxable income against which to offset fully the expenses associated with the tax-preferred income.

Conclusions

The main conclusions may be summarised by the following points:

- operating costs and capital write-off allowances can be viewed differently from interest expenses when exempt income is involved - the difference is that the denial of deductibility of the interest expenses will frustrate the effect of the exemption to the extent that debt finance is used and will introduce a bias towards equity funding. This has little relevance to the question of the appropriate tax treatment of inter-corporate dividends under our classical and proposed full imputation systems;
- under the classical system, when assessable income is involved the s.46 rebate should be calculated on dividends gross of any associated interest deductions in order to ensure that only double tax applies to taxable income. When tax exempt or tax-preferred profits are involved the s.46 rebate calculated on a gross basis could provide excessive generosity through associated interest payments being effectively deducted at a higher rate than the rate of tax applying to the gross profits at the individual shareholder end;
- under the compensatory tax approach to full imputation, the s.46 rebate applied on a gross basis is, in principle, unambiguously the appropriate treatment, which would result in profits in the corporate chain - whether assessable or not - net of associated interest payments being taxed once at individual shareholders' marginal rates of tax;
- a 'qualifying dividends' approach to full imputation, in principle, requires the s.46 rebate to be calculated on

dividends gross of associated interest expenses when assessable or tax-preferred income is involved, but only if interest expenses are deductible to direct unincorporated investors when exempt income is involved; and

- . under the proposed Australian qualifying dividends approach to full imputation, it is appropriate, in principle, that the s.46 rebate is to be determined on the basis of gross dividends (without any netting off of associated expenses). There are no significant tax advantages associated with gearing by companies that could be appropriately addressed by applying the s.46 rebate on a net basis and the net basis would impose major distortions through excessive taxation.