Note on ATO staff response to AER staff inquiries about Hathaway's 2013 report on imputation credit redemption

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AER staff made enquiries with ATO staff regarding Neville Hathaway usage of taxation data in a 2013 report by him on imputation credit redemption.[1] This was in response to a 2017 note from Hathaway that discusses the reliability of several estimates in his 2013 report. [2] The 2017 note was provided to the AER by the Energy Networks Australia as part of the current Rate of return guideline review process.

AER staff corresponded with staff in the ATO's Public Groups & International branch with regard to these enquiries. AER staff received information in response to its enquiries prepared by staff in the ATO's Revenue analysis branch.

The response from the ATO staff, as outlined below, suggest that there are certain limitations in relying on taxation data as an analytical tool in the calculation of imputation credits.[3] The details of the AER's enquiries can be found in *Attachment 1.*

Issues noted by ATO revenue analysis branch in response to the AER enquiries:

1. Net tax in the tax statistic publication is calculated using unpublished data and is not analogous to 'tax payable'.

2. ATO staff identified issues with assumptions made by Hathaway with regard to the net credits distributed. They indicated the labels overestimate the amounts of franking credits recycled as the labels include a variety of tax offsets, not just franking credits:
    a. Label C – "Rebates/tax offset"

    Total of actual rebates and tax offsets available (Not the amounts giving rise to those tax offsets)

    - Entrepreneurs tax offset
    - Allowable franking tax offsets for the year – the amount claimed here should include the share of franking credit included in gross distributions from partnerships/trusts, the amount recorded at 7J Franking credits and 7C Australian franking credits from a new Zealand company
    - Tax offsets for bonuses and certain other amounts under short-term life insurance policies
    - Tax offsets for interest on government/semi-government securities
    - Tax offsets to approved resident lenders

    None of the above tax offsets will be refunded

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[1] Hathaway, Imputation Credit Redemption ATO data 1988-2011: Where have all the credit gone?, Sept 2013

[2] Hathaway, Response to questions from Energy Networks Australia, 12 Dec 2017.

[3] Information provided from the ATO Revenue Analysis Branch via AER correspondence with the ATO's Public Groups & International branch.

b. Label Z – "Other refundable credits"
   - Share of credit from PTR/TRT for tax withheld no-ABN
   - Credit for tax paid by trustee
   - Life insurance: refundable franking tax offsets to the extent they relate to franked distribution. Paid on equity interests held on behalf of policy holders
   - Franking credits for endorsed income tax exempt entities and DGRs entitles to claim a refund of excess FC
   - Total amount of entitlement to film tax offset Dive 376 ITAA 1997
   - Any refundable amount of the NRAS (rental affordability) tax offset

3. A limitation in the analysis exists due to the dynamic nature of the tax system as a whole. The analysis proceeds on the basis of a closed system where companies are fixed, all company tax generates franking credits, and all franking credits are enclosed and disclosed in the tax system etc. This does not take into account situations such as consolidation, where a company has a franking account balance (FAB) associated with a consolidated group but then leaves that group and takes the FAB with it. This limitation will be accentuated over longer time periods.

4. The analysis does not account for non-resident companies paying company tax in Australia which do not generate franking credits. Although this proportion may appear to be small at first glance, it adds to the report's inability to reconcile the imputation system using aggregate data.

5. Mergers and acquisitions – companies who merge or take over other companies and who either do not report the aggregate FAB or for whatever reason are not able use the FAB from the acquired company will skew the data.

6. There is a reporting issue with the FAB label itself. As it is only an informational label and not used in the calculation of tax payable, the integrity of the label can be considered low.

Attachment 1: AER's enquiries to the ATO[4]

Enquiry 1: Reconciling the net tax paid figures with franking accounts distributed and the FAB balance from Company Tax Table 1

To check if the ATO numbers in Table 1 are reliable, Hathaway (2014) did the following check:

Imputation credits (IC) created (Hathaway used "net tax") = IC distributed (ATO dividend data) + IC retained in the FAB (ATO FAB data)

The right hand side of the equation should be equal to the left hand side of the equation if the ATO tax data used in the analysis is reliable and relevant (the analysis is confined to the period 2004-2011).

For IC created during 2004-2011, Hathaway used net tax from Company Tax Table 1 and summed up Net Tax (row 339) for the period 2004-2011 to arrive at $421.5bil. (We also question whether the "net tax" figure can be regarded as IC created for that year?)

He then used "Class C Franking Account Balance" in Table 1 to work out how much IC was created for the period 2004-2011 but hadn't been distributed. It is calculated as the 2011 value of 'Class C Franking Account Balance' (row 213) in Company Tax Table 1 minus the 2003 value.

To get the IC distributed for that period, he used Franked Dividend (row 207)/0.7*0.3 for 2004-2011, and got $270bil. He then took away the imputation credits resulted from the dividend recycled (e.g. Company A pays Company B dividend) from the total IC distributed $270bil. He also adjusted for dividend paid to Life office. He then got $204.7 for IC distributed for the period 2004-2011.

Theoretically, if we add up IC distributed ($204.7bil) and IC hasn't been distributed ($122.3bil, retained in the FAB) that would be equal to IC created. But the number we got from Table 1 for IC created (we assume that is net tax) is $421.5, reflecting an $87.5bil discrepancy between these two numbers.

Enquiry 2: Calculation of credits redeemed and its reliability as a measure of the actual credits utilised.

With regard to the $66bil of recycled credits (Hathaway, 2014), as franking credits can be received directly via franked dividend income or indirectly as a share of distributions from partnerships and trusts, to calculated the total franking credits received by companies (or franking credits recycled) Hathaway added up 'Other Refundable Credits' (row 322) and 'Rebates/Tax Offsets' (row 328) to get $72.3bil. (The franking credits received directly by companies can be calculated from 'Franking Credits' (row 116) in Company Tax Table 1 to get $56.9bil.) He then adjusted for franking credits received by Life office. It is unclear to us how he got the figure of $6.4bil for the franking credits received by Life Office. It would seem that Hathaway estimated it with reference to the level of direct franking credits received by funds and the Life Office share of the total fund holding of Australian equities ($6.4bil implies 26% share of the total fund is owned by Life Office). The level of direct franking credits received by funds can be calculated from 'Dividend Franking Credit' (row 41) of Super Funds Table 1 (APRA regulated) plus 'Dividend Franking Credits' (row 30) of Super Funds Table 2 (SMSF) (See para 93 of Hathaway's 2014 report). Hence we got net IC recycled which is about $66bil rounded (72.3-6.4). He then got $204.7 (270.7-66) for net IC distributed for the period 2004-2011.

[4] The AER also provide ATO staff Hathaway's 2013 report and 2017 note and links to the relevant data during this correspondence.

The $127.6 bill credits redeemed is the sum of the franking credits redeemed by each class of investor: $7 (Companies) + $81.2 (Persons) + $36.2 (Funds) + $3.2 (Charities)

- Companies $7bil- ‘Other Refundable Credits’ (row 322) of Company Tax Table 1
- Persons $81.2bil- ‘Dividends Franking Credit’ (row 91) of Individual Tax Table 1 $58.9bil (received directly) + ‘Share Of Franking Credit From Franked Dividends’ (row 283) same table $22.3bil (received indirectly)
- Funds $36.2bil- ‘Dividend Franking Credit’ (row 41) of Super Funds Table 1 (APRA regulated) $12.16bil + ‘Dividend Franking Credits’ (row 30) of Super Funds Table 2 (SMSF) $12bil + ‘Credits Received Indirectly By Super Funds’ $12bil (this is calculated by: ‘Credit: Refundable Franking Credits’ (row 164) minus ‘Dividend Franking Credit’ (row 30) of Super Fund Table 2 (SMSF) plus the total of 2008 to 2011 of ‘Trust Distributions Franking Credit’ (row 53) plus the total of of 2004 to 2007 of ‘Credit: Refundable Franking Credits’ (row 175) minus the total of 2004 to 2007 of ‘Dividend Franking Credit’ (row 41) from Super Fund Table 1 (APRA))
- Charities $3.2bil- Total (row 14) in Charities Table 1

In a previous correspondence with the ATO, it was noted that not all payments of company tax liabilities give rise to franking credits, for example, credits cannot arise for a company that is not a ‘franking entity’” as defined in section 202-15 or for one that does not satisfy the “residency requirement” test in section 202-20 of the ITAA97. But we are unsure of how material this could be. If the total tax payments made by non-residency companies is large, it could help explain the discrepancy.