yourprivateadvisers

independent + personal + financial advice

Franking Credits. What are they ?

“Frankly my dear, I do give a damn.“

You have probably heard the term “fully franked dividend” or “franking credit” and we all know that is generally a good thing but what does it mean? Here I will try to explain how franking works to your advantage.

Companies pay 30% of their profit in “company tax”. When a company pays that tax, a “Franking Credit”, is created by the ATO equal to the amount of tax paid.

For example, if a company made $40,000, the company would pay $12,000 in company tax and the ATO sets aside a franking credit of $12,000.

In Australia, we have a system whereby you only pay tax at your rate of tax. So the franking credit that arises from the tax paid by the company is taken into consideration when you do your own tax return. The franking credit is therefore a tax credit that lowers the tax paid on any dividends or, even better, can result in you getting a cash refund.

Accordingly when you receive a fully franked dividend, it simply means that 30% tax has already been paid.

In simple terms, when you receive a franked dividend, you will pay additional tax if your marginal rate is greater than the 30%, or $0.30 in the dollar, and if your marginal rate of tax is less than 30%, you will get a tax refund for the difference.

Similarly, as super funds pay 15% tax on their income, the fund gets a net cash refund for dividends that have franking credits attached. And if your super fund is in pension mode, there is no tax payable on income, and you get the whole of the franking credit as a cash refund. All of it.

The tax office however doesn’t make things so straightforward. To work out how much tax you are to pay, or possibly get back, they add back the franking credit to arrive at the gross income before the company tax is taken out.

The table below shows an example of how dividends and franking credits apply to four different people, who each receive a $7,000 dividend and a $3,000 franking credit. Each person has a different marginal tax rate.

		Bob	Carol	Ted	Alice
		Earns $95k. Shares held personally	Earns $25k. Shares held personally	Age 50, shares held in Super Fund	In a Super Funded Pension
A	Dividend (Fully Franked)	$7,000	$7,000	$7,000	$7,000
B	Company Tax Paid	$3,000	$3,000	$3,000	$3,000
C	Taxable Income: Add the Franked Dividend to the Franking Credit(A plus B)	$10,000	$10,000	$10,000	$10,000
D	Marginal Tax Rate	37c in the dollar	19c in the dollar	15c in the dollar	Nil
E	Tax payable on the Taxable Income (C times D)	$3,700	$1,900	$1,500	Nil
F	Less the Franking Credit	$3,000	$3,000	$3,000	$3,000
G	**Net Tax Payable or Tax Refund (E minus F)**	**$700 additional tax**	**$1,100 refund**	**$1,500 refund**	**$3,000 refund**
H	**Net Cash Income (Dividend A less tax/ plus tax refund G)**	**$6,300**	**$8,100**	**$8,500**	**$10,000**

As shown in the table above;

Bob is employed full time, earns $95,000 and holds his shares personally. Bob will pay $700 tax on the dividend of $7,000 which equates to 10%, nowhere near the $2,590 ($7,000 x 37%) he would pay in tax if the dividend was not franked.

Carol works 25 hours per week, earns $25,000 and holds her shares personally. Carol gets a $1,100 refund.

Ted works full time, earns $120,000 and his shares are held in a super fund. Ted's super fund receives a $1,500 refund.

Alice is a pensioner and her shares are owned by a super fund in pension mode. Alice gets a full refund for all the franking credits received, turning a $7,000 dividend into a whopping $10,000 net cash income.

How good is that!

You can see how franking credits can add a significant boost to retirement income and to reduce tax generally. That's why we like them so much.