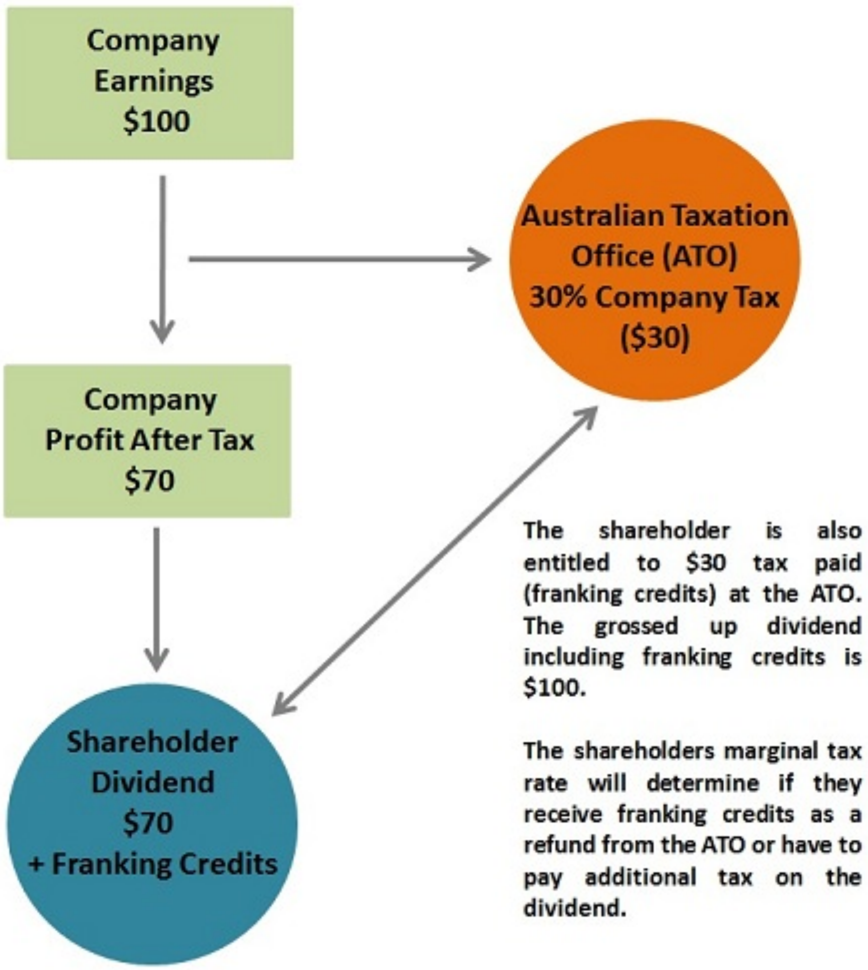
What are Franking Credits?

Franking Credits are a type of tax credit that allows Australian Companies to pass on tax paid at the company level to shareholders. These franking credits can be used to reduce income tax paid on dividends or potentially be received as a tax refund.

Basically, franking credits stop the double taxation of company profits as the tax paid at company level can be passed to the shareholder.

Sound confusing? The diagram below should make the process clearer.

Dividend and Franking Credit Cash Flow Diagram



As a company generates profit it needs to pay tax, in this example 30% of $100, which is $30. This leaves the company with $70 profit after tax. The company can either reinvest some or all this money back into the business or pay out some or all to shareholders as a dividend. In this example the company has paid a $70 dividend to shareholders.

When the shareholder receives the $70 dividend they are also entitled to the $30 franking credits at the ATO. Therefore the total assessable income or grossed up dividend is $100. The shareholders marginal tax rate will determine if they have to pay the ATO additional tax or potentially receive franking credits back as a tax refund.

Grossed up dividend?

A grossed up dividend means you are also including the franking credits. It is important you gross up dividends when comparing returns. Although in the example above you only receive a $70 dividend you are also entitled to the $30 franking credits. This makes the total assessable income $100. If your tax rate is only 30% you keep the $70 and don't have to pay tax on it as the company has already paid 30% tax on it.

When comparing a dividend to cash or term deposit interest you need to compare the **grossed up dividend** to get a like for like to return comparison. The reason is some tax is paid for you on a franked dividend, whereas no tax has been paid on interest from cash or term deposits.

45 Day Holding Rule

In order to be eligible to receive franking credits you need to hold you shares at risk for over 45 day at risk. This does not count the purchase and sale dates so in effect it is a 47 day holding period.

More information on this rule can be found on the Australian Taxation Office Website; [Australian Taxation Office Franking Credit Rules]

How do I know if I have to pay extra tax or receive franking credits as a refund?

Basically it comes down to your marginal tax rate and the franking level of the dividend. If the dividend is fully franked and your margin tax rate is below 30% you can potentially receive some the franking credits back as a refund (or all of them back if your tax rate is 0%). If your marginal tax rate is above 30% you potentially need to pay additional tax on your dividend.

When calculating assessable income a shareholder will count both the dividend and franking credits as income, however the franking credits can be used to reduce total tax due. If the shareholder has franking credits remaining and no more taxes to pay, franking credits can be returned as a tax refund to the shareholder.

Please note; we do not know your circumstances and have only provided factual information please consult your accountant or taxation adviser regarding franking credits and how the impact your taxation requirements.

Do managed funds pay franking credits?

If a managed fund has investment holdings in Australian Shares that pay fully franked dividends you can potentially receive these franking credits as the managed fund makes distributions. An international or fixed interest managed fund is unlikely to pay franking credits as it is unlikely they would hold Australian Shares.

Can I target shares that pay dividends and franking credits?

If you want to invest via direct shares you can certainly target shares that pay high dividends and franking credits.