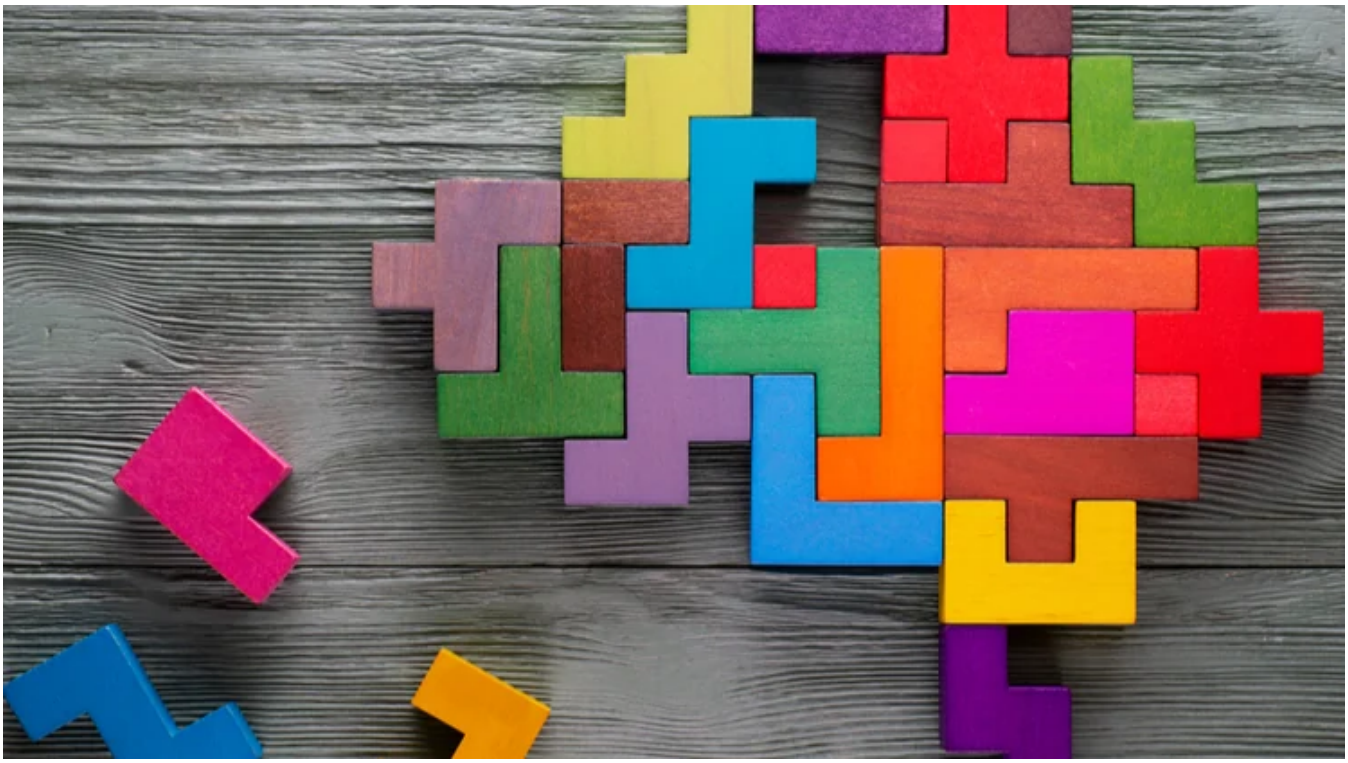
Perpetual Equity Investment Company Limited

# Perpetual knowledge bank series: franking credits

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Franking credits are a type of tax credit that can be paid by companies to their shareholders. This credit is attached to any dividend and represents the amount of tax paid by the company. It works as a mechanism to prevent double taxation on the income derived by the company

and then paid on to investors as a dividend. By definition, a franked dividend has a tax credit attached to it while an unfranked dividend does not.

In Australia, when a company pays out profits to its investors in the form of a franked dividend, it means the company has already paid tax on earnings at a corporate level. This is generally at the current Australian company tax rate of 30% but in some cases will be at the lower corporate rate of 27.5% or 26%, depending on the financial year and the company's taxable income.

All Australian resident investors are entitled to receive franking credits attached to the dividend of the listed company they hold shares in, but the final amount will depend on their marginal tax rate. If an investor's marginal tax rate is below the corporate tax rate of 30% (or the lower rate, if applicable), they will generally receive a refund from the Australian Taxation Office (ATO) for the difference. However, if an investor's marginal tax rate is above the corporate tax rate, the investor will have to pay the difference between their marginal tax rate and the tax already paid by the company. Franking credits are therefore typically seen as more valuable to investors on lower tax rates who benefit most.

**Case study**

If a company in Australia makes $100 profit and pays $30 of tax to the ATO (assuming a corporate tax rate of 30%), it has $70 of profit remaining after tax. Depending on the company's dividend policy and other factors, the company could theoretically pay out the whole $70 to investors in the form of a fully franked dividend together with a $30 franking credit. An investor that is an Australian resident for tax purposes will include in their taxable income the "grossed up" amount of the dividend, ie the dividend of $70 and the franking credit of $30. Where an investor has a tax rate of 0% – such as a pensioner – they will receive a full refund of the franking credits attached to the dividend.

On the other hand, an investor with a marginal tax rate of 47% would need to pay tax on the difference between their personal tax rate (47%) and the corporate tax already paid (30%), which would be 17% on the $70 fully franked dividend and $30 franking credit, a total of $17. This example underlines the value of fully franked dividends and franking credits to investors with a low marginal tax rate, especially retirees searching for additional income in today's historically low interest rate environment.

**Perpetual Equity Investment Company (PIC) – investing for income**

PIC operates as a listed investment company (LIC). A key feature of the LIC structure is the ability for the Board to declare and pay franked dividends.

PIC can earn franking credits through tax paid on realised gains in the portfolio, franked dividends received from Australian listed securities or tax paid on unfranked dividends and

dividends received from global listed securities. Given the active management style of the company, the Manager can generally find numerous opportunities throughout the year to realise gains in the portfolio. This generates franking credits for the company once tax is paid on the realised gain.

As a LIC, PIC is able to retain earnings where a profit is made and reinvest them into the portfolio or pay dividends out of profits. Where a LIC can build up both its profits and its franking credit balance, it can provide the opportunity for the Board of the company to 'smooth' dividends and declare more consistent dividend amounts to investors. This can also include the ability to pass on franking credits to investors so they will receive the value of the dividend itself plus the additional value associated with the franking credits attached to the dividend.

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