Australian Accounting Standards Board

Proposed Agenda Rejection Statement

Recognition of Franked Dividend Revenue

(November 2007)

The Issue

Australian Accounting Standards do not presently specify whether an entity should recognise franked dividend revenue on a:

- net basis – that is, by recognising only the amount of the dividend as revenue (e.g. if a fully franked dividend of $70 is received, dividend revenue would be $70); or

- gross basis – that is, by recognising the sum of the dividend and any franking credit attached to the dividend as revenue (e.g. if a fully franked dividend of $70 is received, dividend revenue would be $100, being the sum of $70 and the franking credit of $30).

Because certain taxpayers are entitled to refunds for their excess imputation credits and other taxpayers are able to convert excess franking credits into tax losses rather than the excess being forgone, some constituents have suggested that the treatment of franked dividend revenue should be reconsidered. In addition, some constituents suggest that the treatment of franked dividend revenue should also be reconsidered in light of adopting IFRSs from 2005.

Reasons for Not Adding the Issue to the AASB's Agenda

The AASB has not observed evidence of divergence in practice and considers that franked dividends should continue to be recognised on a net basis because revenue typically is measured at the fair value of the consideration received or receivable, which does not take into account entity-specific tax implications.

Australian Accounting Standards Board

Issue Proposal

Recognition of Franked Dividend Revenue

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2. Background

This issue has previously been considered in Australia under the 'pre-2005' suite of Australian Accounting Standards.

In January 1997, it was considered by the UIG. At that time, the UIG decided that "the dividend received should be recognised as revenue without the addition of any franking credits and agreed that since this approach was currently applied in practice it would not add the issue to its work program".

In February 1999, and in relation to the development of AASB 1020 *Income Taxes*, the issue was considered by the AASB. The Board confirmed the UIG's decision to not require franked dividend revenue to be grossed up for any imputation credits. This decision was reflected in paragraph 13.3.1 of AASB 1020 commentary, which states:

> "… Dividend revenue recognised by an entity that receives franked dividends is not grossed up for the imputation credit. Information about imputation credits is disclosed as part of the reconciliation required by paragraph 13.2(b)".

Subsequent to these decisions, on 1 July 2002, the simplified imputation system replaced the previous imputation regime in the *Income Tax Assessment Act 1997*. Changes made by the simplified imputation system included the removal of the tax offset for unfranked inter-corporate dividends, converting excess franking credits into tax losses for resident companies, and the refunding of excess imputation credits for certain resident shareholders, such as individuals, complying superannuation funds and life insurance companies.

Particularly because certain taxpayers are now entitled to refunds for their excess imputation credits and other taxpayers are able to convert excess franking credits into tax losses rather than the excess being forgone, some constituents have suggested that the treatment of franked dividend revenue should be reconsidered. Other constituents have suggested that the treatment should be reconsidered in light of adopting IFRSs from 2005.

At its 30 August 2005 meeting, the UIG Agenda Committee considered the issue of the recognition of franked dividend revenue and concluded that franked dividends should continue to be recognised on a net basis as revenue typically is measured at the fair value of the consideration, which does not take into account entity-specific tax implications. The UIG Agenda Committee and the AASB generally supported net treatment, but agreed that the position or views in New Zealand (which has franked dividend arrangements similar to those in Australia) should be considered before deciding on further action on this issue.

AASB staff contacted New Zealand Financial Reporting Standards Board (FRSB) staff in October 2007 and New Zealand FRSB staff indicated that the FRSB agrees with the AASB view as expressed in the proposed agenda rejection statement dated November 2007. The issue was addressed by the FRSB at its April 2006 meeting and the following is an extract from the April 2006 *FRSB Alert*:

> **"Recognition of dividends with imputation credits attached**
> The FRSB concurred with the view that dividends received with imputation credits attached should be recognised net of the imputation credits in accordance with NZ IAS 18 *Revenue*".

3. Consideration of alternative approaches of revenue recognition

When the Board considered this issue in February 1999, three approaches for the recognition of franked dividend revenue were identified:

- a net basis;
- a gross basis; and
- a partial gross basis, whereby dividend revenue is grossed up to the extent of the benefit that can be derived by the recipient entity (shareholder).

3.1 Net approach

The net approach recognises only the dividend receipt as part of pre-tax revenue. If the entity receiving the dividend (e.g. resident company) pays tax at the same rate as the company from which the dividend has been received there is no net effect on the income tax expense line as the benefit derived from the imputation credit effectively offsets the tax payable on the grossed up dividend. If the entity receiving the dividend (e.g. compliant superannuation fund) pays tax at a different rate from the company from which the dividend has been received the benefit derived from the imputation credit will either offset tax payable on other revenue or be refunded to the entity. When an entity is entitled to a refund for excess imputation credits, the refund is recognised as a current tax asset. The corresponding journal entry is to recognise income tax revenue. In contrast, if all or part of the imputation credit benefit had been recognised as part of pre-tax revenue, this income tax benefit would have already been recognised as an amount of pre-tax revenue and would need to be offset by an amount of income tax expense (equivalent to the pre-tax revenue). Therefore unlike the other approaches (see below), any imputation credit is treated as a tax-related amount and remains as part of 'income tax expense' line item.

A perceived shortcoming of the net basis for recognising dividend revenue may be that, unlike the gross approaches, it does not enable users to readily ascertain the use of imputation credits by a reporting entity. However this information can be obtained through the entity disclosing a reconciliation of tax expense and accounting profit, as required by paragraph 81(c) of AASB 112.

3.2 Gross approach

The gross approach recognises the benefit of an imputation credit as revenue and displays it as part of pre-tax revenue. The benefit of the imputation credit is recognised in revenue without regard to whether the entity is actually able to fully utilise the benefit. Consequently, opponents of this approach argue that it is inconsistent with the AASB 118 *Revenue* definition of 'revenue' whenever an entity is unable to fully utilise the franking credits that attach to dividends they receive. This is because the unutilised portion of the franking credit would not be an inflow that results in an increase in equity.

Under the gross approach, the entity must also recognise an amount of tax expense equal to the imputation credit. This results in both the entity paying the dividend and the entity receiving the dividend recognising tax expense that is associated with a single economic gain.

3.3 Partial gross approach

The partial gross approach is similar to the gross approach except that only the benefit from the imputation credit that is able to be utilised will be recognised as revenue and income tax expense.

By only recognising imputation credits that will be utilised, the partial gross approach should satisfy the definition of revenue in AASB 118. However it is unclear whether the fair value of the consideration received/receivable (for the dividend) would equate to the revenue recognised under the partial gross approach. This is because fair value is primarily a market-based measure whereas partial gross approach is an entity-specific measure.

Like the gross approach, the partial gross approach would also result in both the entity paying the dividend and the entity receiving the dividend recognising the income tax expense (at least partially) that is associated with a single economic gain.

These three approaches are still considered to be the alternatives available, although the partial gross approach is not relevant to entities that are entitled to a refund for excess imputation credits. This is because those entities should always be able to fully utilise their imputation credits. Reporting entities that are taxed at 30% (e.g. companies) and that are in a taxable profit position would generally be expected to be able to utilise all the imputation credits that attach to dividends they receive. However, a partial gross approach could be relevant to these entities at times when they are in a tax loss or marginal tax profit position and their excess imputation credits are converted into tax losses but it is not probable that those converted tax losses will be able to be utilised in the foreseeable future.

4. Treatment of franked dividends under post-2005 Australian Accounting Standards

AASB 118 and AASB 112 both provide some guidance on the treatment of dividends – but neither provides specific guidance on the recognition of franked dividend revenue. However, AASB 112 provides guidance on the treatment of unused tax credits and the recognition of deferred tax assets arising from the presence of unused tax credits.

4.1 AASB 118 *Revenue*

AASB 118, paragraph 30(c), indicates that dividend revenue is to be recognised when the shareholder's right to receive payment is established. Other relevant, but general, guidance can be found in:

- paragraph 9 – which requires revenue to be measured at the fair value of the consideration received or receivable; and

- the definition of 'revenue' – which is defined as "the gross inflow of economic benefits during the period arising in the course of ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants" (paragraph 7).

4.2 AASB 112 *Income Taxes*

Treatment of Dividends

Other than an example that illustrates how to calculate the tax base of a dividend receivable (AASB 112.7, example 4),[1] AASB 112 does not provide guidance on the treatment of franked dividends.

Guidance is provided on the tax consequences of dividends, but this guidance is not relevant to this issue. Paragraphs 52A and 52B only discuss dividends in the context of determining the tax rate that should be used to measure current and deferred tax and whether the current and deferred tax is to be recognised in profit or loss. Of slightly greater interest, paragraph 65A indicates that withholding tax on dividends paid by the entity on behalf of its shareholders that will receive the dividend is to be charged to equity as part of the dividends. However, the AASB considers that an imputation credit is not akin to a withholding tax payment.

Treatment of Unused Tax Credits

As discussed above, from 1 July 2002 corporate tax entities have been able to convert excess franking credits to tax losses.

The franking credit on a dividend received is in the nature of an unused tax credit, the treatment of which is outlined in paragraphs 34 to 37. Paragraph 34 states that "a deferred tax asset shall be recognised for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised".

Paragraphs 35 and 36 discuss the likelihood of the entity being able to use the tax credit in the future. In particular paragraph 37 specifies criteria that an entity should consider in assessing the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised.

If, after applying these criteria, an entity decides that it is probable that taxable profit will be available against which the unused tax losses (arising from the unused franking credit) are able to be utilised in a later accounting period, the entity is required to recognise a deferred tax asset. In such circumstances, disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition is required (refer paragraphs 81(g) and 82). Paragraph 81(e) requires disclosure of unused tax credits for which no deferred tax is recognised in the balance sheet.

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[1] This example states that the dividends to be received are not taxable. Receipt of a fully franked dividend by a company is akin to the dividend not being taxable, and so this example is considered to have some relevance to the treatment of franked dividends. However the example is not sufficiently detailed to provide guidance on whether the carrying amount of the dividend receivable should be calculated net or gross of any franking credit.

5. Current Practice

The changes to the imputation system in the *Income Tax Assessment Act 1997* that took effect in 2002 and the adoption of IFRSs in 2005 has not changed practice. Australian practice is still to recognise dividend revenue net of any franking credits that attach to the dividend.

6. Dimensions of the issue in Australia

This issue has relevance to all reporting entities that receive (partly or fully) franked dividends, affecting the reporting of dividend revenue and current tax expenses or income.