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TITLE: **Paid parental leave levy doesn't add up**

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The Opposition has proposed a paid parental leave scheme that offers to replace a woman's wage if she takes time off following the birth of her child.

The payment is capped so that wages are replaced for women earning up to $150,000 per annum.

Such a policy draws the inevitable criticism that governments should not be so generous to high-income earners. To get around that, the Opposition is funding the scheme with a corporate levy. This means, in a sense, they can say the scheme is only doing what business should be doing anyway.

Tony Abbott expects to raise $3.5 billion with a 1.5 percentage point increase in the company tax rate. Given the state of the economy, this estimate may be at the optimistic end of the plausible range, but the Australian taxation system is a complicated beast and this estimate is not the end of the story - changes in the company tax rate have ramifications in the rest of the tax system.

The Australian tax system has mechanisms designed to prevent the same income being taxed twice; once in the hands of the company earning the profit and again when the after-tax profit is received by shareholders as dividend income. To do that, the Australian imputation system treats company tax as a pre-payment of tax on behalf of the ultimate taxpayer, the shareholder who receives credit for tax paid by the company. Hence, a company making dividend payments out of taxed income pays the shareholder a dividend with franking credits attached to it. The dividend recipient then includes the dividend in the tax return and can claim franking credits. An example will help.

Suppose a company earns profit of $100, pays $30 in company tax and then pays the after-tax profit of $70 to the shareholder. The shareholder then grosses up the $70 to $100 by adding back the franking credits; the shareholder is then taxed on the grossed up dividends but receives a $30 credit. So, if the shareholder is on a 45 per cent marginal tax rate, the tax on the dividend is assessed at $45. A credit of $30 is recognised and a net liability of $15 is payable to the tax office. That leaves $55 (=70+30-45) in the hands of the shareholder.

This system is significant when assessing the fiscal implications of changes in the company tax arrangements. In the above example, suppose the company tax rate is increased to 31.5 per cent. The company will now pay company tax of $31.50 and the shareholder will receive a dividend of $68.50. The shareholder now grosses up the dividend to $100 and is taxed again at

$45, but receives a credit of $31.50 for a net liability of $13.50 payable to the tax office. The shareholder is left with $55 once again (=68.50+31.50-45).

The tax office gains $1.50 in company tax, only to lose $1.50 in personal income tax. The increase in company tax has no impact on government revenues, however in practice there are two main complications.

Firstly, companies do not distribute all of their after-tax profit, which means not all potential franking credits are distributed. And second, a good deal of the dividends are distributed to entities that cannot take advantage of franking credits, in particular foreign shareholders.

This dilution of the imputation system means that not all the change in company tax revenue will be lost. Calculations based on tax office figures imply shareholders claim franking credits worth 46 per cent of company tax itself. Those figures suggest almost half of all company tax is lost in credits to individual taxpayers, superannuation funds, partnerships and the like.

The Opposition's claim to raise $3.5 billion has to be adjusted downwards to $1.9 billion, suggesting $1.6 billion is missing. To run a fully-funded scheme, the company tax rate would have to increase twice as much as what Mr Abbott is suggesting to approximately 3 percentage points - not 1.5.

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