Franking Deficit

The Franking deficit occurs when a company's franking credit account has a negative balance. This situation arises when the franking debits (e.g., dividends paid with attached franking credits) exceed the franking credits (e.g., tax payments and refunds) in the account. In other words, the company has distributed more in franked dividends than it has in franking credits from taxes paid.

Consequences of a Franking Deficit

1. **Franking Deficit Tax:**

The company may be liable to pay franking deficit tax (FDT), which is imposed to cover the shortfall in the franking account. This tax ensures that the company does not benefit from distributing more credits than it has earned.

2. **Interest Charge:**

The company might also incur an interest charge on the franking deficit tax to discourage companies from maintaining a franking credit deficit.

How to Solve a Franking Deficit

1. **Pay Franking Deficit Tax (FDT):**
    - **Calculation:** The FDT is calculated based on the deficit amount in the franking account at the end of the company's income year.
    - **Payment:** The company must pay the FDT to the ATO, usually along with its annual income tax return. This payment effectively clears the deficit in the franking account.
2. **Adjust Future Dividend Payments:**
    - **Monitor Franking Credits:** Carefully manage and monitor the franking credits available before declaring and paying dividends.
    - **Reduce Franking Percentage:** If the franking account is running low, consider reducing the franking percentage on dividends or pay unfranked dividends to avoid further debits to the account.
3. **Increase Tax Payments:**
    - **Prepay Taxes:** If feasible, make additional tax payments to increase the franking credits in the account before the end of the income year.
    - **Timely Tax Payments**: Ensure timely payment of taxes to maintain a healthy balance in the franking account.
4. **Carry-Back of Franking Deficit Tax:**
    - **Tax Offset:** If the company pays FDT, it can claim a tax offset in the subsequent income year for the FDT paid. This offset helps in reducing the company’s tax liability in the next year, effectively reimbursing the FDT over time.

Example:

Let's illustrate the steps with an example:

i. **Identify Deficit:**

Opening Balance: $10,000
Credits: Tax Payment ($7,000)
Debits: Dividends Paid ($7,000 + $11,000)
Closing Balance: $10,000 + $7,000 - $18,000 = -$1,000 (deficit)

ii. **Pay Franking Deficit Tax:**

Calculate FDT based on the $1,000 deficit.
Pay the FDT to the ATO.

iii. **Adjust Future Dividend Payments:**

Monitor the franking credits before declaring dividends.
Consider reducing the franking percentage or issuing unfranked dividends.

iv. **Increase Tax Payments:**

Prepay additional taxes if possible, to cover the deficit.
Ensure timely tax payments to maintain a positive balance.

Managing and Avoiding Franking Deficit

To avoid a franking credit deficit, companies should:

- Regularly review and reconcile the franking account.
- Plan dividend distributions in line with available franking credits.
- Maintain clear communication with tax advisors to ensure compliance and optimal tax planning.

By carefully managing the franking account and taking proactive steps, companies can avoid the financial and administrative burden of a franking credit deficit.