LOWE LIPPMANN
Chartered Accountants & Business Advisors

MAY 2017
TAX ALERT: SMALL BUSINESS ENTITIES REDUCED TAX RATES & IMPUTATION RULES

Introduction

The Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016 was introduced into Parliament on 1 September 2016 and contains a number of changes to progressively reduce the corporate tax rate for small business entities and the franking of dividends which apply from 1 July 2016.

It is important to note that these changes apply to “small business entities” (or SBEs), which are corporate tax entities which satisfy two requirements: (a) carrying on a ‘business’[1]; and (b) having aggregated turnover below the ‘aggregated turnover threshold’.

Table 1 below provides a summary of how the progressive reduction in the corporate tax rate will apply.

<table>
<tr><th>Income Year</th><th>Aggregated turnover</th><th>Company tax rate</th></tr>
<tr><td>2016</td><td>< $2 million</td><td>28.5%</td></tr>
<tr><td>2017</td><td>< $10 million</td><td rowspan="8">27.5%</td></tr>
<tr><td>2018</td><td>< $25 million</td></tr>
<tr><td>2019</td><td rowspan="9">< $50 million</td></tr>
<tr><td>2020</td></tr>
<tr><td>2021</td></tr>
<tr><td>2022</td></tr>
<tr><td>2023</td></tr>
<tr><td>2024</td></tr>
<tr><td>2025</td><td>27%</td></tr>
<tr><td>2026</td><td>26%</td></tr>
<tr><td>2027 & Later</td><td>25%</td></tr>
</table>

Table 1: SBE reduced tax rates

While a reduction in the tax rate will clearly benefit companies, be aware that consider the profits earned by the company will eventually be paid to shareholders in the form of dividends, and it is necessary to consider the taxation of these dividends when determining the total tax paid on company profits.

Prior year rules from 1 July 2015

From 1 July 2015, small business companies (with turnover less than $2 million) pay tax at a rate of 28.5%. However, the franking rate remained at 30%. This means that a company can frank dividends at a higher rate than the rate at which it paid tax.

This difference in rates may cause the company’s franking account to be temporarily in debit. If a franking account is in debit at 30 June, the company will be required to pay franking deficit tax in order to bring the franking account back to nil.

[1] Subsection 995-1(1) of the *Income Tax Assessment Act 1997* defines ‘business’ as follows: “includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee”.

Level 7 616 St Kilda Road Melbourne
Victoria Australia 3004
(PO Box 130 St Kilda Vic 3182)
T 61 (03) 9525 3777
F 61 (03) 9537 1104
E office@lowelippmann.com.au
W www.lowelippmann.com.au

Current rules from 1 July 2016

From 1 July 2016, these changes aim to link the maximum franking rate to the corporate tax rate at which each company pays tax.

To determine the appropriate franking rate in a particular year, the company will use its turnover in the previous year to determine the tax rate in the current year.

Taxation of dividends at Shareholder level

These changes will be significantly important for small to medium companies which have a small number of shareholders, in particular if they are all members of the one family.

A reduced franking credit rate may lead to a higher personal income tax liability, or reduced franking credit refund for these investors.

Table 2 below provides a comparison between the old imputation rules (before 2016-17) and the new changes to the imputation rules (from 2016-17), and highlights the difference in the overall taxes paid on the same amount of corporate profit under the old and new provisions.

	Old Rules: Underlying profit taxed at 30% & dividend with imputation at 30%	New Rules: Underlying profit taxed at 30% & dividend with imputation at 27.5%
FY 2015-16		
Company before-tax profit (A)	\$100.00	\$100.00
Corporate tax rate (B)	30.0%	30.0%
Company income tax (C=A*B)	\$30.00	\$30.00
Company after-tax profit (D=A-C)	\$70.00	\$70.00
FY 2016-17		
Franked dividend paid to Shareholder (E=D)	\$70.00	\$70.00
Corporate tax rate (F)	30.0%	27.5%
Corporate tax rate for imputation purposes (G)	30.0%	27.5%
Franking credits attached to dividend paid (H=E*G/(1-G))	\$30.00	\$26.55
Grossed-up dividend (I=E+H)	\$100.00	\$96.55
Individual resident Shareholder's marginal tax rate (J)	49.0%	49.0%
Tax on dividend income at individual Shareholder's level (K=I*J)	\$49.00	\$47.31
Franking credits received by individual Shareholder (L=H)	\$30.00	\$26.55
Net tax payable on dividend income by individual Shareholder (M=K-L)	\$19.00	\$20.76
Summary		
Total taxes paid on the original company profit of \$100 (N=C+M)	\$49.00	\$50.76
Effective tax rate on the original company profit of \$100 (combined corporate and individual shareholder levels) (P=N/A)	49.0%	50.76%

Table 2: Comparison of tax rates & imputation system under old rules (before 2016-17) and new rules (from 2016-17).

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As shown above in *Table 2*, starting from a company profit of $100 being taxed at 30% in 2015-16, this after-tax underlying profit when distributed to a resident shareholder in 2016-17 will result in different net tax payable amounts required from that individual shareholder under the old and new imputation rules.

Due to the shortfall of franking credits distributed to the shareholder, under the new imputation rules, the effective rate of total taxes paid on the original company profit for the individual resident shareholder is 50.76% which is 1.76% higher than the effective rate under the old set of rules.

Wastage of franking credits

With the progressive reduction of the company tax rates, it will be common that companies will have retained profits which they have paid tax on at 30%, but can only be franked at the 27.5% company tax rate.

Where a company has no further retained profits to declare a dividend, and the company has a credit balance in their franking account, the company will not be able to pass the benefit of these franking credits on to its shareholders – these franking credits may be wasted.

Per the example in *Table 2,* we note that under the new imputation rules, while $30 of company tax paid in 2015-16 is credited to the franking account, this balance is only reduced by an amount of $26.55 being franking credits distributed to the resident shareholder. This results in a credit of $3.45 remaining in the franking account, which could result in these franking credits being wasted.

Conclusion

While the reduction in the tax rate appears to be a good thing for businesses, it is necessary to consider the eventual payment of dividends, and the tax paid by the shareholders when determining the overall benefit.

Without any changes to the individual tax rates, the reduction in the company tax rate will merely provide a deferral of tax until such time as the dividend is declared and is taxable in the hands of an individual taxpayer.

Companies with significant retained profits should consider the impact of the reduction in the level of franking credits and the additional tax that may be payable by the shareholders.

Companies with a turnover less than $10 million do not have much time to plan for dividend distributions – to avoid wasting franking credits – whereas larger companies have more time to review their dividend policies to make the most use of any undistributed franking credits.

Please do not hesitate to contact your Lowe Lippmann Relationship Partner if you wish to discuss any of these matters further.

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