On track for a company tax rate reduction?

28 April 2017

In brief
Although almost one year has passed since the Federal Government announced its ten-year plan to progressively reduce the company tax rate to 25 per cent, it is currently only partly on track to achieve the promised rate cuts, which for now look certain to apply to small and medium companies with aggregated turnover of up to $50 million.

At 30 per cent, which is the current tax rate applying to the majority of companies in Australia, Australia’s corporate tax rate is well above the 23 per cent average for OECD member states, so any tax cut, even if limited to smaller companies in the short-term, is a step in the right direction. We welcome the Government’s statements that it still intends to continue to pursue its full ten-year plan to reduce the company tax rate to 25 per cent for all companies.

In detail
On 31 March 2017, the Senate passed amendments to the Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016 to limit the reduction in the corporate tax rate to companies with aggregated turnover of less than $50 million. Under the revised proposals, the tax rate will immediately drop to 27.5 per cent for small business companies with aggregated turnover of up to $10 million. This rate will then progressively apply to companies with aggregated turnover of less than $50 million, with the rate then decreasing to 25 per cent by the 2026-27 income year. Table 1 below sets out the tax rates applying to all companies under the proposed amendments.

With Federal Parliament to resume on 9 May 2017, no doubt one of the first priorities will be for the House of Representatives to agree to the amendments that were made in the Senate to the Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016 so as to enable the company tax rate reforms agreed upon in the Senate to be enacted as soon as possible.

Once the Bill is enacted, it will clear the way for small business taxpayers to reap the full benefits of the plan for the current income year. However, in a welcome move, in the interim, the Australian Taxation Office (ATO) has confirmed that for Pay As You Go (PAYG) Instalment purposes, it will administer the law in anticipation of these changes.
Table 1: Table of tax rates applying under the current proposed amendments

<table>
<thead>
<tr>
<th>Company type</th>
<th>Tax Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2016-17</td>
</tr>
<tr>
<td>Company with aggregated turnover of up to $10m</td>
<td>27.5</td>
</tr>
<tr>
<td>Company with aggregated turnover of up to $25</td>
<td>30</td>
</tr>
<tr>
<td>Company with aggregated turnover of up to $50m</td>
<td>30</td>
</tr>
<tr>
<td>All other companies</td>
<td>30</td>
</tr>
</tbody>
</table>

The reduced rates first apply to the 2016-17 income year. Accordingly, the first income year may already have ended for early balancers (for example, for a December earlier balancer, the reduced rate first applies to the year from 1 January 2016 to 31 December 2016). Until the law is enacted, that ATO will continue to assess companies at the higher rate. However, it has indicated that it will subsequently identify and amend those tax returns to reflect the lower rate and pay interest on overpayments of tax.

The reduction in the corporate tax rate in this limited and phased-in manner presents a number of opportunities and challenges for small and medium businesses. Some of these are highlighted below.

### Determining eligibility for the lower rate

There are broadly two aspects to the test for eligibility for the lower corporate tax rate:

1. The company must carry on a business.
2. The company’s “aggregated turnover” (a specifically defined term) is less than the specified threshold for the year.

In relation to the requirement to carry on a business, although this is a question of fact and degree, no specific guidance has been provided by the ATO to assist potentially affected companies. However, previous experience with the small business concessions is likely to be relevant. Companies that carry on purely passive investment activity may not be eligible for the reduced rate.

The aggregated turnover test requires the company to aggregate its turnover with that of entities that are ‘connected’ or ‘affiliated’ with it, as defined in the tax law. This will generally pick up controlled entities, those that control the company, and entities that are controlled by the same entity (using a 40 per cent voting power or right to receive income/capital ‘control’ threshold) and other entities that act, or could reasonably be expected to act, in accordance with the directions or wishes of the company or in concert with the company. The turnover of a company for this purpose is its income according to ordinary concepts derived in the ordinary course of carrying on a business.

The company’s aggregated turnover for an income year determines which tax rate applies for that year. As noted below, however, the aggregated turnover for the previous year is relevant for the purposes of determining the maximum franking percentage for a dividend.
Franking

A company that is subject to a lower tax rate will also have to re-consider its franking policies.

A small business company that had aggregated turnover of less than $2 million and was subject to a corporate tax rate of 28.5 per cent for an income year starting on or after 1 July 2015, on the payment of a franked dividend, was able to attach franking credits at a rate of 30 per cent. This will not be the case under the new rules where the maximum franking credits able to be attached to a dividend will have regard to the reduced corporate tax rate.

There may be a mismatch between the rate at which a company franks its dividends during a year and the tax rate applicable on its taxable income for that year. This can arise because, for franking purposes, a company will determine the applicable tax rate for the year assuming it will have the same aggregated turnover as it did for the previous income year. The tax rate ultimately applying to the company’s taxable income for a year, however, will depend on the company’s aggregated turnover for that year.

Furthermore, a company eligible for the reduced tax rate may receive franked dividends from other companies that continue to be taxed at 30 per cent. In such a case, the small business company will be able to apply the 30 per cent franking credit from the received dividend against its own tax payable, but noting that companies cannot receive a refund from any excess franking credit offsets (instead, excess franking credits convert to tax losses that can be utilised in future years, subject to complex loss integrity rules). This will also have the potential to create added complexity.

It is also important to note that in spite of the fact that a company may have accumulated franking credits in the past based on paying taxes and receiving dividends at a rate of 30 per cent, there is no transitional rule to enable an eligible company to pay dividends with a 30 per cent franking credit. Furthermore, as the company rate progressively reduces over the next 10 years, a similar outcome arises. This will have the effect that there will be some lost (or trapped) franking credits.

PAYG instalments

Once the measures are enacted, to the extent that a company is eligible for the lower tax rate, that should be reflected in any PAYG instalment rate issued by the ATO and by taxpayers seeking to vary their PAYG instalments.

For any period for which the proposed measures are not yet law, in relation to PAYG instalments, the ATO has indicated:

For Pay As You Go Instalment purposes, we can decide to anticipate the passage of a tax rate reduction. Accordingly, for activity statements that have not yet issued, we will incorporate the lower (27.5%) tax rate where applicable as soon as possible.

Those companies that currently have an activity statement that does not reflect the reduction in the corporate tax rate can vary their instalment rate or amount to reflect the reduction if they believe they are eligible.

Companies that choose to vary to reflect the rate reduction will not be subject to a variation penalty.

Tax accounting implications

Companies will also need to take into account the reduced tax rate for tax accounting purposes once the measures are substantively enacted. This may include, for example, forecasting aggregated turnover and when losses will be utilised in the future to determine deferred tax balances.
Other concessions for small business entities

Once enacted, the new $10 million threshold for small business entities will also be relevant for determining eligibility for other small business concessions, including the simplified capital allowances regime for small business, and the instant asset write-off concession which allows an immediate deduction for depreciable asset purchases costing less than $20,000 until 30 June 2017. It does not, however, extend to the small business CGT concessions - the $2 million aggregated turnover test remains relevant.

The takeaway

A multi-rate corporate tax system will no doubt create complexity not only for companies potentially affected by a phased-in reduced tax rate, but also for shareholders when it comes to understanding their franking entitlement from dividends.

Time will tell whether the Government can deliver on its promise of broader company tax rate cuts. The Government has stated that it remains committed to implementing the rest of its ten-year plan and will re-introduce the relevant legislation when Parliament resumes on 9 May 2017.

While a company tax rate reduction currently only for small business entities is a step in the right direction, the biggest economic benefits will be achieved when Australia has lower tax rates applicable to all businesses. With more favourable tax rates in the United States, United Kingdom, Europe and Asia, Australia needs to reduce tax costs to attract foreign investment, grow GDP and drive improvements in real wages.

Let’s talk

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