



## TECHNICAL UPDATE

# COMPANY AND SMALL BUSINESS TAX CUTS AND OTHER MATTERS

It has been widely reported in the media that the Federal Government has succeeded in securing passage of parts of its Enterprise Tax Plan, following negotiations with Senator Nick Xenophon. The main focus of the media discussions centred on the tax cuts for small and medium companies and businesses. However, legislation also contains amendments to dividend imputation and the much awaited small business threshold provisions. These amendments appear to have been accepted by the Senate as part of the arrangements with Senator Xenophon.

### Company Tax Cuts

The main focus of discussion in the media has been the passage of some of the company tax cuts. Whilst the full package of company tax cuts has not been accepted by the Xenophon Team, the tax cuts that are expected to pass through Parliament are:

A corporate tax rate of 27.5% will apply for	
Companies carrying on a business with a turnover not exceeding	Income Tax Year Ending 30 June
\$10 million	2017
\$25 million	2018
\$50 million	2019

The rate will fall to 27% for the year 30 June 2025, to 26% for the year 30 June 2026, and to 25% for the year ended 30 June 2027.

Companies that do not qualify for the lower tax rate will remain on the current rate of 30%. This means all companies with a turnover in excess of \$50 million will remain on the 30% rate, although the Government has indicated it would like to continue with its package of reforming the company tax rates. Given the current make-up of the Senate it is questionable whether these will pass in this current Parliament).

Note that under the legislation, there are flow through amendments to tax rates and taxable income scales for companies that become pooled development funds, non-profit companies, recognised medium credit unions, life insurance companies, and public trading trusts.

### SECTOR

Tax

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## Imputation Implications

Included in the package expected to pass through Parliament are amendments to dividend imputation to account for the change in the company tax rates.

The starting point for the amendments to dividend imputation is to identify which income tax rate applies to the company. This is referred to as the corporate tax rate for imputation purposes and sets the rate at which dividends may be franked. It is determined as:

- The company's income tax rate in the current year, but based on its aggregated turnover for the previous income tax year. For example, a company wishes to frank a dividend in the year ended 30 June 2018. Its turnover for the prior year was \$18 million. The tax rate that applies for the year ended 30 June 2018 to a company with a turnover of less than \$25 million is 27.5%. Therefore, its dividend can only be franked at the 27.5% rate. The actual turnover for the company for the 30 June 2018 tax year does not matter for imputation purposes and nor does the fact that it would have paid tax during the year ended 30 June 2017 at the 30% rate, or
- If the company did not exist in the previous income tax year, the prevailing rate will be 27.5%

The impact of the different corporate tax rate for imputation purposes is relevant in calculating the maximum franking credit that can be attached to a distribution. The following example is provided in the Explanatory Memorandum to the legislation:

*In the 2015-16 income year, Company A has an aggregated turnover of \$18 million. In the 2016-17 income year, its aggregated turnover increased to \$20 million.*

*Therefore, for the 2016-17 income year, Company A will have:*

- A corporate tax rate of 30 per cent (having regard to its aggregated turnover of \$20 million in the 2016-17 income year),
- A corporate tax rate for imputation purposes of 30 per cent (based on aggregated turnover of \$18 million in the 2015-16 income year), and
- A corporate tax gross-up rate of 2.33 — that is,  $(100\% - 30\%)/30\%$ .

*As a result, if Company A makes a distribution of \$100 in the 2016-17 income year, the maximum franking credit that can be attached to the distribution is \$42.86 — that is,  $\$100/2.33$ .*

*In the 2017-18 income year, Company A will work out its corporate tax rate for imputation purposes based on its aggregated turnover for the 2016-17 income year — that is, \$20 million. Therefore, for the 2017-18 income year, Company A will have:*

- A corporate tax rate for imputation purposes of 27.5 per cent, and
- A corporate tax gross-up rate of 2.64 — that is,  $(100\% - 27.5\%)/27.5\%$ .

*As a result, if Company A makes a distribution of \$100 in the 2017-18 income year, the maximum franking credit that can be attached to the distribution is \$37.88 — that is,  $\$100/2.64$ .*

### Small Business Tax Offset

The legislation also contains amendments to the Small Business Tax Offset provisions, giving effect to the changes to the offset that have been previously announced.

The small business tax offset is available for small business taxpayers who do not conduct their business through a company structure (e.g. sole traders carrying on a business, or partnerships and trusts carrying on a business where the business income is distributed to individuals). The rebate is only available where the small business income derived by the taxpayer does not exceed \$5 million.

At present, the offset is calculated as 5% of the individual's business income (not total taxable income). For example, if an individual who derives \$10,000 business income (net of allowable deductions), they would be entitled to an offset of \$500.

The available offset is capped at \$1,000.

The new offset rates will be:

Income Tax Year Ended 30 June	Rate of Offset
2016	5%
2017 to 2024	8%
2025	10%
2026	13%
2027 and later income tax years	16%

Note that the tax offset continues to be capped at \$1,000.

### Small Business Entity Threshold

Another series of amendments included in the legislation are the much anticipated changes to the small business entity thresholds. At present, the turnover threshold to be classified as a 'small business entity' is \$2 million. The amendments apply as follows:

- The amendments generally apply from the start of the income tax year ended 30 June 2017 (ie 1 July 2016)
- The amendments to small business CGT concessions apply to CGT events that occur from the start of the income tax year ended 30 June 2017
- The amendments to FBT concessions apply from the FBT year starting on 1 April 2017 and later years.

The thresholds are as follows:

- \$2 million aggregated turnover for access to the small business CGT concessions (unchanged from the current threshold as is the \$6 million asset threshold)
- \$5 million aggregated turnover for access to the small business tax offset
- \$10 million aggregated turnover for access to all other small business tax concessions including simpler depreciation and trading stock rules, immediate deductions for certain start-up expenses and certain prepaid expenses, small business restructure roll-over relief, GST compliance concessions, FBT car parking exemption and PAYG instalments based on notional tax.

## BDO Comments

Whilst it is disappointing the full package of company tax cuts did not clear Parliament in this tranche of legislation, it is positive that there is some welcome and immediate relief for small businesses. The trade-off however is the reduction in the maximum franking amount for dividends paid by companies that benefit from the tax cuts.

The greater concern from these amendments is the two-tier corporate tax rates that will prevail. Whilst big business has gained traction in the media using the term 'two-tier tax rate', nothing has been said in the media about the reduced rate only applying to companies that are carrying on a business. It is not unusual for families to use small companies to make non-business investments (such as investments in commercial property). Where these companies engage in passive investment (as opposed to carrying on a business), historically they would not have been entitled to the company tax cuts.

However, the ATO recently released draft Taxation Ruling TR 2017/D2 dealing with the central management and control test of company residency. At footnote 3 of the draft ruling, the ATO states that:

'where a company is established or maintained to make a profit or gain for its shareholders it is likely to carry on business..... This is so even if the company only holds passive investments, and its activities consist of receiving rents or returns on its investments and distributing them to shareholders.'

These comments may mean that investment companies are carrying on a business. It will be interesting to see how the ATO interprets the 'carrying on business' requirement in the context of the company tax rate reductions.

This could create compliance issues, as there will be a greater emphasis on determining whether a company is engaged in business (and is entitled to the tax cut). Clearly, there will be pressure on clients to establish companies that are carrying on a business to enable them to access the tax cut.

## MORE INFORMATION

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