TECHNICAL UPDATE

EXTRA TAX FOR SHAREHOLDERS RECEIVING 27.5% FRANKED DIVIDENDS OUT OF 30% TAXED PROFITS

If companies on the 27.5% tax rate pay dividends out of 30% taxed profits, the combined tax paid by the company and shareholders will be greater than if the company remained at the 30% tax rate.

The recent company tax cut for SME business companies can result in franking credits trapped in the company, which can be an overall tax increase for the company and shareholders. The extra overall tax can happen when the company becomes entitled to the lower tax rate because of the increase in the turnover threshold for the 27.5% tax rate so that they can only frank dividends at 27.5% even if the profits were taxed at the 30% rate. Unless the company can find some non-taxed income (e.g. non-portfolio foreign dividends or foreign active branch income) the trapped franking credits is a real tax cost for the shareholders as it will increase the top up tax they have to pay. The combined overall tax paid by the company and the shareholder will be higher than the situation if the company remained at the 30% tax rate.

This problem first affected companies with less than $10 million turnover that became entitled to the 27.5% tax rate on 1 July 2016. But going forward it will continue to be a problem as the 27.5% threshold increases to $25 million on 1 July 2017 and $50 million on 1 July 2018.

There is nothing that can be done about the companies that became entitled to the 27.5% rate on 1 July 2016 so those trapped franking credits are likely to remain in those company. However, for the other companies that will become entitled to the 27.5% rate on 1 July 2017 and 1 July 2018, they may want to consider paying out their 30% taxed retained earnings and current year profits before 1 July 2017 and 2018 respectively so they can frank the dividends at 30%, unless the company needs or wants to keep the funds in the company.

However, care needs to be taken with paying the dividends before 1 July as the top-up tax that needs to be paid on the dividend will be paid earlier than it would have been if the dividends are not paid until after 1 July. In addition, for dividends paid before 1 July 2017 an additional factor to be considered is the removal of the 2% budget repair levy from 1 July 2017. The top up tax on the dividend paid before 1 July 2017 will be at 49% (at top marginal rates), whereas if the dividend is paid on or after 1 July 2017 the top-up tax will be 47% (at top marginal rate). This may mean that in these circumstances, combined with the earlier payment of the top-up tax, it may not be worthwhile paying the dividend before 1 July 2017 even though the company may have trapped and unusable franking credits if they don't pay dividends by 1 July 2017.

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Below is an example that illustrates the issues.

EXAMPLE

Flintstone Quarries Pty Limited (FQ Pty Ltd) is a company that, in the 2015/16 income year, had a turnover of $9 million. It was taxed at the rate of 30% on its 2015/16 taxable income. In the 2016/17 income year, the company had a turnover of $9.5 million. Because of the change in the law, it became entitled to be taxed at the 27.5% tax rate for the 2016/17 income year.

FQ Pty Ltd had taxable income of $1 million for the year ended 30 June 2016 and on 15 November 2016 (during the 2017 income tax year), the directors of FQ Pty Ltd resolved to pay a fully franked dividend of its 2015/16 retained earnings to its shareholder, Fred (franked with 27.5% franking credits).

Assuming Fred is on the highest marginal tax rate of 49% for the year ending 30 June 2017, the overall tax paid by FQ Pty Ltd and Fred is $507,586 (51% of the $1,000,000 taxable income of FQ Pty Ltd). This compares with overall tax payable of $490,000 (49%of $1,000,000) if FQ Pty Ltd had remained taxed at the 30% rate. This is illustrated in the table below:

	FQ P/L TAXED @27.5%		FQ P/L TAXED @ 30%	
	Tax Calculation	Tax Paid	Tax Calculation	Tax Paid
FQ Pty Ltd 2015/16 taxable income	1,000,000		1,000,000	
Tax at @30% on $1,000,000	(300,000)	300,000	(300,000)	300,000
Retained earnings Y/E 30 June 2016	700,000		700,000	
FQ Pty Ltd Franking account credit and balance for Y/E 30 June 2016	300,000		300,000	
Franked dividend paid by FQ Pty Ltd on 15 November 2016	700,000		700,000	
Franking Account debit (700,000/(1-tax rate/tax rate))	265,517		300,000	
Franking account balance 30 June 2017	34,483		0	
Fred's assessable dividend for Y/E 30 June 2017	700,000		700,000	
Add Franking credit on the dividend	265,517		300,000	
Total Taxable	965,517		1,000,000	
Tax on total @49%	473,103		490,000	
Less franking offset	(265,517)		(300,00)	
Top-up tax		207,586		190,000

Total Tax Paid		**507,586**		**490,000**
Overall tax rate on $1,000,000		**51%**		**49%**
Extra tax paid		**17,586**		

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