Advanced Income Tax Law

Chapter 4

Companies

Overview

Definition of a company

s.995(1) defines a company as including "***all bodies or associations corporate or unincorporated, but does not include a partnership***".

Overview

Residence of Companies

Under s.6(1) ITAA36, a company is a resident in Australia if:

- it is incorporated in Australia,

  or

- it is not incorporated in Australia, it carries on business in Australia and has either its central management and control in Australia, or its voting power is controlled by Australian resident shareholders.

Overview

Taxation of companies

A company is taxable in its own right when it is registered.

All resident companies whose total income is $1 or more must lodge a Company tax return.

Therefore, a company trading at a loss must still lodge a tax return.

Companies are taxed at a flat rate of tax (there is no tax-free threshold).

For 2019/20, the company tax rate is either 30% or 27.5%.

Overview

Taxation of companies – Base Rate Entities

From 2017/18, companies eligible for the lower company tax rate are known as **base rate entities**.

The definition of a base rate entity has changed by replacing the former *'carrying on a business'* requirement with a passive income test.

For the 19/20 income year, a company will be a base rate entity if:

- 80% or less of their assessable income is base rate entity passive income.
- they have an aggregated turnover below the $50 million turnover threshold.

Overview

Taxation of companies – BRE Passive income test

Passive income includes:

- dividends other than non-portfolio dividends.
- franking credits on such dividends.
- non-share dividends.
- interest income (some exceptions apply).
- royalties and rent.
- gains on qualifying securities.
- net capital gains.
- income from trusts or partnerships, to the extent it is referable (either directly or indirectly) to an amount that is otherwise base rate entity passive income.

Overview

Taxation of companies – Franking Credits

The maximum franking credit that can be allocated to a frankable distribution paid by a corporate entity will be equal to the maximum amount of income tax that the entity making the distribution could have paid, at their applicable corporate tax rate, on the profits underlying the distribution.

Private Companies

Certain payments made by private companies may be deemed by the FCT to be dividends and, as such, may be disallowed as deductions.

These are:

- Payments to associates
- Division 7A amounts (e.g. debts forgiven by the company)
- Excessive remuneration

Private Companies

Payments to associates

A loan or advance made by a private company to an *"associated person"* will be deemed to be a dividend if considered to represent a distribution of profits.

"associated person" means a shareholder, director, or their associates (e.g. spouse, other relatives).

The deemed dividend becomes assessable income of the recipient and is not frankable.

Private Companies

Excessive remuneration

Where the Commissioner considers that payment paid by a private company to an associated person is excessive (i.e. beyond what is “reasonable”) the excess is not allowed as a deduction.

It is deemed to be an unfrankable dividend of the company.

Calculation of Taxable Income

Income Statement compared to Taxable Income

- **Income Statement (profit/loss)**- is usually prepared according to accounting standards.

- **Taxable income** - is determined according to taxation law.

  Therefore, net profit/loss will not necessarily equal taxable income.

Tax Losses

To be able to claim a deduction for a carry forward tax loss, a company must satisfy:

- the Continuity of Ownership test,

  Or if not met,

- the Similar Business test.

Tax Losses

Continuity of ownership test

- requires that shares carrying more than 50% of all voting, dividend and capital rights must be owned at all times during the year of recoupment of the tax loss *and* during the actual loss year.

Tax Losses

Similar Business test

The similar business test replaces the same business test. This test requires that a company carry on a business of a similar type to a previous business.

If a company fails the continuity of ownership test it may still be able to claim past tax losses from the 2016 to present income years if it satisfies the similar business test criteria.

A business is of a similar type:

- where there is an element of continuity, and
- it has evolved or organically grown over time without changing its core identity or core source of income.

Similar Business Test

There are four factors that must be taken into consideration when determining whether a business remains sufficiently similar:

1. **Assets**

2. **Activities and operations**

3. **Identity**

4. **Changes**

Research & Development Tax Incentive

The Research and Development (R&D) Tax Incentive allows Australian companies incurring expenditure on scientific research and development activities to claim a tax offset on eligible expenditure.

Eligible expenditure must be incurred on or after 1 July 2011.

Research & Development Tax Incentive

Eligibility requirements

- Must be an eligible entity.
- Must be conducting eligible R&D activities.
- Must incur at least $20,000 notional deductions on those activities.

Research & Development Tax Incentive

Eligible Entities

Are also referred to as **R&D entities**.

A taxpayer is eligible if they are any of the following:

- incorporated under an Australian law
- incorporated under a foreign law but an Australian resident for tax purposes
- a resident of a foreign country which has a double tax agreement with Australia, and the entity carries on business in Australia through a permanent establishment as defined in the double tax agreement.

Research & Development Tax Incentive

Eligible R&D activities

- Core R&D activities
  - In pursuit of outcomes that can only be determined by applying a systematic progression of work based on principles of established science and proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions.
  - Conducted for the purpose of generating new knowledge (including about creating new knowledge or improved materials).

  Core R&D activities are experimental activities.

- Supporting R&D activities
  - A supporting R&D activity is one that is directly related to core R&D activities.
  - A supporting R&D activity must be undertaken for the dominant purpose of supporting core R&D activities.

Research & Development Tax Incentive

Eligible Notional Deductions

Eligible notional deductions are available for:

- Expenditure incurred on R&D activities (e.g. labour, contractors).
- Decline in Value of assets used for R&D.
- Balance adjustments for assets used only for R&D.
- Expenditure in relation to goods and materials transformed or processed for R&D purposes. (feedstock expenditure)
- An earlier year associate R&D expenditure
- Monetary contributions under the CRC program.

Research & Development Tax Incentive

Eligible Notional Deductions

Eligible expenditure (<$20,000):

The entity is still able to obtain the R&D tax offset for:

- expenditure incurred to a RSP for services within the RSP's registered field, where that RSP is not an associate of the entity;
- expenditure incurred as a monetary contribution under the Co-operative Research Centre (CRC) program.

  The CRC program is a government program that supports Australian industries' ability to compete and produce.

Research & Development Tax Incentive

Ineligible Expenditure

Types of expenditure that are not notional deductions under the R&D tax incentive:

- Interest expenditure (within the meaning of interest in the withholding tax rules)
- Expenditure that is not at risk
- Core technology expenditure
- Expenditure included in the cost of a depreciating asset
- Expenditure incurred to acquire or construct a building (or part of a building or and extension, alteration or improvement to a building).

Research & Development Tax Incentive

R&D tax offset eligibility

- Since 1 July 2014, a $100 million threshold applies to the R&D expenditure for which companies can claim a concessional tax offset under the R&D Tax Incentive.
- For any R&D expenditure amounts above $100 million, companies will still be able to claim a tax offset at the company tax rate.
- To be eligible for the R&D tax offset, eligible R&D expenditure of a company must exceed $20,000.
- R&D expenditure of less than $20,000 in the year of income is deductible.

Research & Development Tax Incentive

R&D tax offset

Smaller companies

A 43.5% refundable tax offset is available to small companies with an annual aggregate turnover of less than $20 million.

These companies can receive an uncapped fully refundable offset if they are in tax loss.

Research & Development Tax Incentive

R&D tax offset

Larger companies

Since 1 July 2014 a 38.5% non-refundable tax offset has been available to companies with an annual aggregate turnover of $20 million or more.

Capital Gains and Losses

The CGT Discount method does not apply to companies.

Capital losses are subject to the continuity of ownership and same business test provisions.

A company may transfer current year net capital losses to another resident company in a wholly owned group but only if both companies were part of the same owned group at all times.

Reconciliation

A company's net profit/loss normally will not correspond to its taxable income due to a variety of factors such as:

- expenses not allowed as deductions
- franking credits
- capital gains
- Past year tax losses
- Special tax incentive deductions
- grossing up of foreign income

Therefore, must reconcile net profit/loss to taxable income.

Imputation System

Franking account

A company that pays franked dividends must keep a *franking account* for tax purposes.

A franking account is an account maintained to keep track of the income tax credits that a company can pass on to its members.

Franking accounts are basically a running total of all franking credits and franking debits.

Imputation System

Franking account

- If franking debits > franking credits

= ***franking deficit*** (i.e. debit balance).

- If franking debits < franking credits

= ***franking surplus*** (i.e. credit balance).

Imputation System

Franking credits

A franking credit arises when a corporate tax entity:

- makes a payment of a PAYG instalment or income tax;
- receives a franked distribution from another company; or
- incurs a liability for franking deficit tax.

Imputation System

Franking debits

A franking debit arises when a corporate tax entity:

- receives a refund of income tax.
- makes a franked distribution.
- underfranks a distribution (i.e. the corporate tax entity makes a distribution with a franking percentage that is less than the entity's benchmark franking percentage for the franking period).

Imputation System

Franking debits

- ceases to be a franking entity (to eliminate any franking surplus in the franking account).
- makes a linked distribution;
- issues tax-exempt bonus shares (instead of making a distribution).
- streams imputation benefits to members most able to benefit from them.
- buys back a share on-market.

Imputation System

Benchmark rule

- requires that a corporate tax entity must frank all frankable dividends made during a franking period at the "benchmark franking percentage".

The benchmark franking percentage is the same as the franking percentage for the first frankable distribution made by the entity within the franking period.

Imputation System

Benchmark rule

Over-franking tax

- If the actual franking percentage of a frankable distribution exceeds the benchmark franking percentage over-franking tax arises.

- The formula to calculate over-franking tax is:

Franking % differential x Amount of franked distribution x $^{\text{corporate tax rate}}/_{\text{100\% - corporate tax rate}}$

Imputation System

Benchmark rule

Under-Franking debit

If the actual franking percentage of a frankable distribution is less than the benchmark franking percentage an under-franking debit entry arises.

The amount of under-franking debit is calculated on the same basis as over-franking tax.

Imputation System

Franking Deficit Tax (FDT)

Franking deficit tax will arise only where the company has a franking deficit at the end of the year (i.e. a debit balance which means that franking debits > franking credits).

The FDT amount is the same as the deficit balance of the franking account.

Payment of Tax

Companies pay their tax under the PAYG system either in a single lump sum or in quarterly instalments.

Under the PAYG instalments system tax payments are made throughout the year of income to which they relate.

Such payments will be made in conjunction with the lodgement of a Business Activity Statement (BAS).