

batallion legal

keepin' it simple

company tax - an overview

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overview

- meaning of “company”
 - mutuality principle
 - income tax at company level
 - income tax at shareholder level
 - imputation system
 - transactions involving shares
 - treatment of company losses
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meaning of “company”

- a separate legal entity (*Corporations Act* s 124)
 - for tax purposes, “company” includes:
 - ◆ a body corporate
 - ◆ an unincorporated association or body of persons
 - ◆ does not include a partnership (*ITAA 1997* s 995-1(1))
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mutuality principle

- one cannot derive income from oneself: *The Bohemians Club v Acting Federal Commissioner of Taxation* (1918) 24 CLR 334 at 337
 - *Sydney Water Board Employees' Credit Union Ltd v FC of T* (1973) 129 CLR 446: Loans made up of member contributions made to individual members, at interest
Held: Since only a class of members paid interest and other members could not gain from payment of interest, interest was income of credit union
 - *North Ryde RSL Community Club Ltd v FC of T* [2002] FCA 313: Keno receipts of RSL club from members did not count as contributions, since interposed entity collected receipts
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mutuality principle (cont)

- *Coleambally Irrigation Mutual Co-Operative Ltd v FC of T* 2004 ATC 4835: mutuality only applies if members can gain back own contributions
 - for non-profit associations: amounts that are income under *Coleambally* principle are non-assessable non-exempt income (ITAA 1997 s 59-35)
 - co-operative companies (ITAA 1936 Pt III Div 9)
 - ◆ co-operatives must conduct at least 90% of business with members (ITAA 1936 s 117)
 - ◆ mutuality principle does **not** apply to receipts of co-operatives from members
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taxation of companies

- separate taxable entity (ITAA 1997 s 4-1)
 - company calculates assessable income like individual (ITAA 1997 s 4-15)
 - taxed at flat rate of 30% (*Income Tax Rates Act 1986 s 23*)
 - public officer must be appointed (ITAA 1936 s 252) - can be liable to penalties on default by company
 - director liability: under ITAA 1936 for failure to remit PAYG withholding, pay an estimate or abide by payment arrangement (ITAA 1936 Pt VI Subdiv 9-B)
 - new provisions allow director liability for company's GST defaults (*Taxation Administration Act 1953 Sch 1 s 444-15*)
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dividend assessability

- assessable income of resident shareholder includes dividends paid out of profits of company
 - 5 conditions
 - ◆ **company** must pay dividend
 - ◆ **shareholder** must receive dividend
 - ◆ **dividend** must be received
 - ◆ **paid**
 - ◆ **out of profits**
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conditions 1 & 2 - company & shareholder

- condition 1 - **company**
 - ◆ a company must pay dividend
 - ◆ includes corporations, corporate limited partnerships, corporate unit trust and public trading trust (ITAA 1997 s 995-1(1))
 - condition 2 - **shareholder**
 - ◆ a shareholder must receive dividend
 - ◆ shareholder must be registered (*Patcorp Investments v FC of T* (1976) 140 CLR 247)
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condition 3 - dividend

- distribution must constitute a dividend
 - a “dividend” is a distribution to shareholders, whether in cash or property; and any amount credited to shareholders in that capacity (ITAA 1936 s 6(1))
 - *DFC of T v Black* 99 TC 4600: mere debt forgiveness is not a crediting. Also, it was not a benefit to shareholders in their capacity as such
 - “dividend” includes dividends paid to holders of shares that fail debt/equity test under ITAA 1997 Div 974
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condition 4 - paid

- dividend must be paid
 - “paid” includes “distributed” or “credited”
 - *Brookton Co-Operative Society Ltd v FC of T* (1981)
147 CLR 441: mere recording of “interim dividend” not “crediting”. Shareholder must be able to call for dividend and this must be irrevocable
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condition 5 - out of profits

- dividend must be paid out of “profits” of company
 - “profits”: interpreted according to accounting meaning
 - *Re Spanish Prospecting Co Ltd* [1911] 1 Ch 92:
“profits” requires a comparison between state of business at beginning and end of income year
 - *FC of T v Slater Holdings Ltd* (1984) 156 CLR 447:
“profits” include capital gains and gifts
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condition 5 - out of profits (cont)

- *Sun Alliance Investments Pty Ltd (in liq) v FC of T [2004] FCAFC 11*: unrealised capital gains are counted as profits
 - exception to “out of profits” requirement: non-share dividends under debt/equity tests in Div 974, which do not have to be paid out of profits.
 - returns of share capital: not “out of profits” - covered by CGT rules
 - distributions upon liquidation: not “out of profits” unless distribution is made from income of company
 - **bonus share distribution**: if compulsory and not for consideration, then not a dividend (ITAA 1936 s 6AB)
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imputation system

- ITAA 1997 Pt 3-6
- companies liable to tax at 30% on taxable income (ITAA 1997 s 4-5)
- individual shareholders liable to tax at marginal rate on dividends under ITAA 1936 s 44
- imputation system gives shareholders a credit for tax paid on income at company level

(Note: “profits” other than income are not taxed at company level, but only at shareholder level).

imputation - example

- company has \$100 in profits
 - at company level, tax applies at flat rate of 30%, leaving \$70 after tax
 - company has to credit its “franking account” with \$30 tax paid
 - upon distribution of \$70, a franking credit of up to \$30 can attach to dividend
 - shareholder can claim tax offset of \$30 on dividend
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franking account

- formally records amount of tax paid by company, and thus franking credits available to a company for crediting distributions
 - all corporate entities must keep a franking account (ITAA 1997 s 205-10)
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franking account - credits

- ITAA 1997 s 205-15 lists 5 situations where franking account is credited:
 - ◆ when PAYG instalment is paid
 - ◆ when company pays income tax
 - ◆ when franked dividend is received from another company
 - ◆ when franked dividend is received via interposed entity
 - ◆ when franking deficit tax is paid
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franking account - debits

- ITAA 1997 s 205-30 lists 9 situations where franking account is debited, including:
 - ◆ when company makes a franked distribution to its shareholder
 - ◆ when company receives a tax refund
 - ◆ when company has underfranked a distribution
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franking dividends

- dividend is frankable except to extent it is specifically made unfrankable (ITAA 1997 s 202-40 and 202-45)
 - distributions are grossed up with a franking credit upon distribution to shareholders
 - formula for maximum franking credit (currently 30%) (ITAA 1997 s 202-60(2))
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distribution statements

- distribution statements must be provided with distribution to shareholder (ITAA 1997 s 202-75(1)).
 - required content:
 - ◆ name of company
 - ◆ date
 - ◆ amount distributed
 - ◆ amount of franking credit on distribution
 - ◆ franking percentage
 - ◆ withholding tax (if foreign shareholder)
 - ◆ other relevant information (ITAA 1997 s 202-80(3))
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benchmark rule

- all frankable distributions in given franking period must be credited to same extent, i.e. “benchmark franking percentage” (ITAA 1997 s 203-25)
 - “benchmark franking percentage” is percentage credited to first franked distribution of franking period (ITAA 1997 s 203-30)
 - “franking period” is now aligned to income year for a private company (ITAA 1997 s 203-45)
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breach of benchmark rule

- **franking too high**
 - ◆ over franking tax is payable (*NBTS (Over-Franking Tax) Act 2002 s 4*)
 - **franking too low**
 - ◆ a franking debit arises - company must debit franking account according to formula in ITAA 1997 s 203-50
 - ◆ changes in benchmark - must notify Commissioner (ITAA 1997 s 204-75)
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franking deficit tax

- franking deficit tax is imposed if company ends franking period with franking account in deficit (ITAA 1997 s 205-45)
 - tax equals amount by which account is in deficit
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imputation - direct distribution

- imputation only applies if shareholder is Australian resident (ITAA 1997 Subdiv 207-C)
 - assessable income of shareholder is grossed up by amount of franking credit on distribution (ITAA 1997 s 207-20(1))
 - shareholder is entitled to tax offset equal to gross-up (ITAA 1997 s 207-20(2))
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imputation - indirect distribution

- when an entity is interposed between the company and the individual shareholder
 - interposed partnership or trust - the net income of partnership or trust is grossed up with franking credit (ITAA 1997 s 207-35)
 - offset is at level of individual who is ultimately taxed
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transactions involving shares

- tax consequences may arise in following transactions:
 - ◆ issue of new shares by company
 - ◆ sale of share interests
 - ◆ capital reduction
 - ◆ termination of shares
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issue of shares for cash

- subscribers for new shares can contribute cash in return for shares
 - no CGT consequences for company despite CGT event D1 happening (ITAA 1997 s 104-35)
 - shareholder acquires a CGT asset (ITAA 1997 s 109-5)
 - cost base includes either money paid for share or market value of share if:
 - ◆ there has been no expenditure
 - ◆ expenditure by shareholder cannot be valued; or
 - ◆ dealing was not at arm's length (ITAA 1997 s 112-20)
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issue of shares for assets

- if capital assets are exchanged for shares (whether newly created or not), CGT will normally apply to disposal of asset
 - however, special rules apply where company is wholly owned by shareholder who is issued shares
 - allotment of shares for trading stock: if shareholder contributes items of trading stock to a wholly owned company in exchange for shares, ITAA 1997 s 70-90 deems shareholder to receive market value of stock
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issue of shares for assets (cont)

- if shareholder contributes capital assets to wholly owned company in exchange for shares, CGT rollover relief under ITAA 1997 Div 122 may apply
 - market value of shares must be substantially same as of assets (ITAA 1997 s 122-20(3) and (4))
 - effect of CGT rollover in Div 122 is:
 - ◆ effects of CGT events A1, D1 or D2 are ignored
 - ◆ cost base is presumed to equal transferor's (ITAA 1997 s 122-40)
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sale of shares

- if shares are sold by shareholders, then CGT event A1 happens (ITAA 1997 s 104-5)
 - however, this depends on character of shares as capital assets
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capital reduction

- CGT event G1 applies to capital portion of capital reduction payout (ITAA 1997 s 104-135)
 - cost base reduced by income portion of payout
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termination of shares

- termination of shares takes place in each of following situations:
 - ◆ cancellation of shares
 - ◆ share buybacks
 - ◆ liquidation
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termination of shares - cancellation

- occurs when there is a complete return of capital
 - CGT event C2 applies (ITAA 1997 s 104-25)
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termination of shares - liquidation

- when company is wound up:
 - ◆ company ceases to exist
 - ◆ shares are terminated
 - ◆ amounts are distributed to shareholders
 - amounts are deemed to be dividends (assessable to shareholder) to extent they represent income of company
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termination of shares - share buyback

- share buybacks can be on-market or off-market
 - if on-market, then always entirely capital in nature
 - if off-market, then is treated as a dividend, except to extent that company share capital account has been debited to make payment (ITAA 1936 Div 16K)
 - CGT event C1 applies to capital portion
 - ITAA 1936 s 4 applies to dividend portion
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company losses

- add up expenses deductible in current income year
 - subtract total assessable income
 - subtract net exempt income
 - balance remaining equals tax loss for year and may be carried forward (ITAA 1997 s 36-15)
 - two alternative tests for carrying forward losses - change of ownership test and same business test
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continuity of ownership test

- more than 50% continuity during ownership test period for voting power, rights to dividends and rights to capital distributions (ITAA 1997 s 165-12)
 - some exceptions for ASX listed companies (ITAA 1997 Div 166)
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same business test

- if continuity of ownership test is failed, same business test can be applied (ITAA 1997 s 165-210)
 - company must be carrying on “same business” in current income year as before ownership changed
 - *Avondale Motors (Parts) Pty Ltd v FC of T* (1971) 124 CLR 97: “same” business requires actual identity, not mere similarity
 - test failed as business was carried on under a different name, with different management, from different premises and with different plant and stock
 - TR 1999/9: mere expansion of business does not itself cause a failure of test (paragraph 13)
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conclusion

- many issues arise from Australian company taxation
 - we have looked at:
 - ◆ the definition of “company” and mutuality principle
 - ◆ taxation at company and shareholder levels
 - ◆ imputation system
 - ◆ transactions involving shares
 - ◆ treatment of company losses
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any questions?

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