PITCHER PARTNERS
ADVISORS PROPRIETARY LIMITED

Level 19
15 William Street
Melbourne
Victoria 3000

Level 1
80 Monash Drive
Dandenong South
Victoria 3175

Postal Address:
GPO Box 5193
Melbourne Vic 3001
Australia

Tel: +61 3 8610 5000
Fax: +61 3 8610 5999
info@pitcher.com.au
www.pitcher.com.au

EXECUTIVE DIRECTORS
J BRAZZALE
M W PRINGLE
D A THOMSON
M J LANGHAMMER
S SCHONBERG
S DAHN
A R YEO
P W TONER
D R VASUDEVAN
B J BRITTEN
K L BYRNE
S D WHITCHURCH
D J HONEY
G J NIELSEN
N R BULL
A M KOKKINOS
G A DEBONO
F V RUSSO
M R SONEGO
S J DALL
D W LOVE
A SULEYMAN
D R DOHERTY
R RIGONI
G M RAMBALDI
D A KNOWLES
M C HAY
V A MACDERMID
P A JOSE
M J HARRISON
T SAKELL
G I NORISKIN
A T DAVIDSON
C D WHATMAN
A E CLERICI
P MURONE
A D STANLEY
D C BYRNE
P B BRAINE
R I MCKIE
T G HAIR
A T CLUGSTON
M G JOZWIK
B POWERS
K J DAVIDSON

Ref: AMK:gc:eh:cd

23 September 2016

Committee Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

Email: economics.sen@aph.gov.au

Dear Secretary

Re: Inquiry into Treasury Law Amendment (Enterprise Tax Plan) Bill 2016

Thank you for the opportunity to provide comments on the Treasury Law Amendment (Enterprise Tax Plan) Bill 2016 ("**the Bill**").

Pitcher Partners Advisors Proprietary Limited ("**Pitcher Partners**" or "**we**" or "**us**") is an accounting and advisory firm that specialises in advising taxpayers in what is commonly referred to as the middle market, which we have proudly done for over 25 years.

The measures contained in the Bill are very much welcomed by small and medium sized corporate taxpayers. The measures, especially those dealing with the reduction of the corporate tax rate, will help to provide much needed additional working capital to these businesses to fund their operations. In turn, this will help to ensure that small and medium sized businesses, so often and aptly referred to as the "engine room" of the economy, will continue to prosper and contribute to the nation's economic growth.

Accordingly, we fully support the staged reduction of the corporate tax rate from 30% to 25% and the increase of the small business turnover threshold from $2 million to $10 million.

However, we are concerned that the Bill's current drafting will lead to inequitable imputation outcomes for shareholders, especially those in the middle market.

At present, the Bill provides that as the corporate tax rate reduces, so too does the maximum imputation credit that can be attached to dividends.

Broadly, this means that retained profits that have been taxed at the current corporate tax rate of 30% may be subject to a reduced imputation rate (i.e. 27.5% until the year ended 30 June 2024) rather than the corporate tax rate actually paid. This will result in shareholders

Liability limited by a scheme approved under Professional Standards Legislation ACN 052 920 206

Pitcher Partners is an association of independent firms
Melbourne | Sydney | Perth | Adelaide | Brisbane | Newcastle

paying a higher amount of "top-up" tax on dividends paid by the company. As private companies generally retain profits for working capital, this results in a disproportionate cost to small and middle market taxpayers when they finally release their profits that were taxed at the higher rate.

By way of example, if a small company had been in business for ten years and derived after tax profits of $70,000 each year (which has been retained for working capital purposes), the company would have generated $700,000 of after-tax profits. In doing so, the business would have paid $300,000 in tax over the ten year period and would have a franking account balance of $300,000. If the company then transitions to a lower corporate tax rate at 1 July 2016, a payment of a dividend from retained earnings existing at 30 June 2016 (i.e. $700,000) will only be frankable to 27.5%. This will mean that the shareholder (i.e. owner) of the small business will not receive a credit for 2.5% of tax already paid and thus, the shareholder will have to pay additional tax at marginal rates.

Conversely from a shareholder's perspective, we estimate that this will, in effect, mean that a shareholder currently receiving an annual dividend of $100,000 (being subject to a tax rate of 41%), will be subject to an effective tax rate increase of 2.03% to 43.03% as a result of not being able to obtain the full benefit of imputation credits at the 30% rate of tax, at which the distributed profits were subject at the company level. This will result in the shareholder being penalised when the dividends are eventually paid from retained earnings existing at the transition time. Per Appendix A, this would equate to an additional tax cost of $20,345 over a seven year period, which is not an insignificant cost to a small or medium business owner. Furthermore, a shareholder subject to the highest marginal tax rate[1] will face an effective tax rate increase of 1.76% from 49% to 50.76%[2].

This outcome is set to be repeated each time the corporate tax rate is decreased (i.e. there may be further discrepancies between the corporate tax rate paid and the imputation rate as the corporate tax rate decreases to 27%, 26% and 25%).

At present, small and medium sized companies, with a turnover of less than $10 million, have an approximate combined franking account balance of approximately $107 billion[3]. Should the Bill be enacted in its current form, effectively 11.5% of those franking credits will be permanently retained by the government if profits are distributed to shareholders once the 27.5% corporate tax rate applies[4], representing a permanent cost to those small and medium sized corporate taxpayers. Whilst this balance includes corporate taxpayers that do not carry on business (and thus would not qualify for the rate reduction), we highlight that even a small percentage of this balance represents a substantial franking account balance for small and medium sized corporate taxpayers that would be impacted by the proposed change.

---

[1] For example, a shareholder may be subject to the 49% tax rate where the entirety of a company's retained earnings are paid out.

[2] See Appendix B.

[3] See Appendix C - As calculated based on the Australian Taxation Office's 2013/14 taxpayer's statistics for companies published by the Australian Government on data.gov.au: https://data.gov.au/dataset/taxation-statistics-2013-14/resource/5c1ea391-043c-463a-9a36-3383516a58f3?view_id=66c46110-af7e-411a-8887-08106b7c476d .

[4] We estimate that up to 11.5% of the franking credits currently within the imputation regime eligible to be attached to distributions of profits by companies may be permanently retained by the revenue. We calculate this percentage on the assumption that a company's retained earnings are referable to its franking account balance – i.e. for every $30 of franking credits, it will have $70 to pay out as a dividend. This will result in 11.5% of franking credits being 'left behind' where the company tax rate is 27.5% rather than 30%. This can be expressed in the following equation which compares the corporate tax gross-up rates at 30% and 27.5% ((72.5/27.5)+(70/30)) x (70/30) = 11.5%.

The Bill proposes that the corporate tax rate reduction and the associated impact on imputation will be retrospective for small and medium sized corporate taxpayers, as many will transition at 1 July 2016 without appropriate warning. As such, many small and medium sized companies will be unable to minimise the impact of the new measures on their franking account balances.

In contrast, larger corporate taxpayers are not as disadvantaged as small and medium sized corporate taxpayers as they will not transition into the new tax rate until a later time. This means that they may be able to reduce their retained earnings prior to their transition time to mitigate some of the ill-effects of the imputation rate change.

Furthermore, as larger corporates have greater access to other avenues of funding, they are not as reliant on retaining profits for working capital purposes as small and medium sized corporates. Accordingly, even if a one year extension was provided to taxpayers in the small and middle markets to pay franked dividends at a 30% tax rate, it is difficult for small and medium sized taxpayers to simply pay out the entirety of their retained earnings as a dividend to shareholders in order to avoid the significant cost of the reduced imputation credits.

We submit that this is an unfair outcome for small and medium sized companies who, under the current drafting of the Bill, will effectively lose 11.5% of tax paid on retained earnings.

Recommendations

We strongly believe that transitional relief must be provided to small and medium sized companies in the Bill to reduce the inequities contained therein. We highlight two possible options that we consider to be both fair and equitable and would not (in our view) result in a significant compliance burden.

We acknowledge that these options would have a cost to revenue. However, in our view, these options are critically important for small and medium sized corporate taxpayers. Accordingly, in identifying those taxpayers most adversely affected by the Bill's current drafting, we believe that the proposed transitional relief outlined below should at least apply to taxpayers with a turnover of less than $10 million (for 30 June 2016 transitions) and with a turnover of less than $25 million (for 30 June 2017 transitions).

Option 1

The provisions should allow after-tax profits that existed at a company's transition time (for e.g. 30 June 2016) to be franked at the 30% rate (reflecting the rate of tax which the company paid on the profits) rather than the lower imputation rate. This rule could easily be implemented by quarantining a 30% franking on the lower of the franking credit balance or retained profits as at the transition date.

Option 2

The provisions should provide a transitional period where pre-existing profits can be franked at 30% for a limited amount of time after the transition date (for e.g. for up to five years).

*** ***

We implore the Senate Committee to recommend appropriate modifications to the Bill to ensure that small and medium businesses are not unfairly disadvantaged for simply retaining their profits to fund working capital requirements – which is the reality thousands of small businesses will face if the Bill is enacted in its current form. We are hopeful that an appropriate outcome can be provided to those taxpayers, where a credit should be provided equal to the amount of tax they have fairly paid in the past.

Should you have any questions in relation to the matters raised in this submission, please contact me anytime on .

Yours sincerely

A M KOKKINOS
Executive Director

APPENDIX A

Profit of $1 million is subject to corporate tax at a rate of 30%. The after tax profits of $700,000 are distributed over a period of seven years.

Shareholder – 2016 franking rates

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Total
Dividend	100,000	100,000	100,000	100,000	100,000	100,000	100,000	700,000
Gross-up (@ 30%)	42,857	42,857	42,857	42,857	42,857	42,857	42,857	300,000
Grossed up dividend	142,857	142,857	142,857	142,857	142,857	142,857	142,857	1,000,000
Tax payable (@ 41%)	-58,571	-58,571	-58,571	-58,571	-58,571	-58,571	-58,571	-410,000
Credit for franking offset	42,857	42,857	42,857	42,857	42,857	42,857	42,857	300,000
Tax paid by individual	-15,714	-15,714	-15,714	-15,714	-15,714	-15,714	-15,714	-110,000
Total tax paid	-315,714	-15,714	-15,714	-15,714	-15,714	-15,714	-15,714	-410,000
Effective tax rate								41.000%

Shareholder – 2017 franking rates

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Total
Dividend	100,000	100,000	100,000	100,000	100,000	100,000	100,000	700,000
Gross-up (@ 30%)	37,931	37,931	37,931	37,931	37,931	37,931	37,931	265,517
Grossed up dividend	137,931	137,931	137,931	137,931	137,931	137,931	137,931	965,517
Tax payable (@ 41%)	-56,552	-56,552	-56,552	-56,552	-56,552	-56,552	-56,552	-395,862
Credit for franking offset	37,931	37,931	37,931	37,931	37,931	37,931	37,931	265,517
Tax paid by individual	-18,621	-18,621	-18,621	-18,621	-18,621	-18,621	-18,621	-130,345
Total tax paid	-318,621	-18,621	-18,621	-18,621	-18,621	-18,621	-18,621	-430,345
Total additional tax								20,345
Effective tax rate								43.034%
Additional tax rate								2.03%

PITCHER PARTNERS

APPENDIX B

Profit of $1 million is subject to corporate tax at a rate of 30%. The after tax profits of $700,000 are distributed to the shareholder in subsequent years.

Shareholder perspective (on top marginal tax rate)

	2016-17	2017-18
Dividend (Franked Component)	700,000	700,000
Dividend (Franking Credit)	300,000	265,517
Grossed Up Dividend	1,000,000	965,517
Individual Tax (49%)	490,000	473,103
Total tax after credits	490,000	507,586
Effective Tax Rate	49.00%	50.76%
Additional Tax	0.00%	1.76%
Top-up tax at shareholder level	190,000	207,586
Additional tax paid	-	27,586

APPENDIX C[5] - FRANKING ACCOUNT BALANCE FOR SMALL TAXPAYERS

Taxable status	Residency status	Company type	Company size, by total income	Number of companies no.	Franked dividends paid $	Unfranked dividends paid $	Franking account balance $	Balance for taxpayers regarded as small $
Taxable	Resident	a. private	a. Loss/Nil	316	6,002,709	231,870	45,734,595	45,734,595
Taxable	Resident	a. private	b.Micro	275,654	9,991,497,957	180,758,139	49,774,368,469	49,774,368,469
Taxable	Resident	a. private	c. Small	38,850	7,795,995,336	69,523,579	27,785,028,100	27,785,028,100
Taxable	Resident	a. private	d. Medium	9,972	9,692,746,561	221,988,201	28,206,862,545	
Taxable	Resident	a. private	e. Large	578	2,314,968,599	57,724,027	7,456,293,789	
Taxable	Resident	a. private	f. Very large	222	2,861,485,830	243,115,008	12,707,861,688	
Taxable	Resident	b. public	a. Loss/Nil & b.Micro	978	40,575,074	63,589,250	263,432,335	263,432,335
Taxable	Resident	b. public	c. Small	479	229,150,738	147,707,036	2,880,316,660	2,880,316,660
Taxable	Resident	b. public	d. Medium	856	2,010,874,997	468,794,759	4,982,616,111	
Taxable	Resident	b. public	e. Large	264	2,678,479,731	196,416,209	6,184,134,401	
Taxable	Resident	b. public	f. Very large	446	78,447,442,468	5,337,064,482	87,778,388,159	
Taxable	Resident	c. Other	g. All ranges	33,112	101,788,674	46,942,860	1,273,700,787	
Taxable	Non-resident	d. All types	g. All ranges	1,548	227,657,912	57,563,791	423,240,426	
Non-taxable	Resident	a. private	a. Loss/Nil	104,377	1,027,552,644	71,123,850	6,293,203,476	6,293,203,476
Non-taxable	Resident	a. private	b.Micro	349,847	2,402,595,709	126,937,544	14,795,245,174	14,795,245,174
Non-taxable	Resident	a. private	c. Small	17,281	1,247,319,189	483,646,580	5,224,232,502	5,224,232,502
Non-taxable	Resident	a. private	d. Medium	3,595	917,738,741	116,600,979	7,292,774,229	
Non-taxable	Resident	a. private	e. Large	210	212,500,093	39,090,660	1,869,019,289	
Non-taxable	Resident	a. private	f. Very large	121	220,565,975	277,009,170	3,196,076,083	
Non-taxable	Resident	b. public	a. Loss/Nil	725	4,349,364	9,740,445	19,647,884	19,647,884
Non-taxable	Resident	b. public	b.Micro	2,925	75,476,184	70,280,151	456,663,696	456,663,696

[5] We note that, for the purposes of the analysis contained in this submission, we have included the franking account balance attributable to small and medium taxpayers (below $10 million turnover) based on the Australian Taxation Office's criterion of "a. Loss/Nil", "b. Micro" and "c. Small". We further note that these franking account balances may be attributable to corporate tax entities deriving passive income rather than business income and thus may be outside of the provisions (as the provisions only apply to corporate business taxpayers). Consequently, an unquantified portion of the $107 billion of franking credit balances for these taxpayers would be affected by the tax rate change.

Taxable status	Residency status	Company type	Company size, by total income	Number of companies no.	Franked dividends paid $	Unfranked dividends paid $	Franking account balance $	Balance for taxpayers regarded as small $
Non-taxable	Resident	b. public	c. Small	656	64,110,615	75,211,715	326,686,842	326,686,842
Non-taxable	Resident	b. public	d. Medium	698	566,570,927	200,525,899	2,443,431,960	
Non-taxable	Resident	b. public	e. Large	183	230,192,704	354,037,412	3,035,003,517	
Non-taxable	Resident	b. public	f. Very large	247	998,878,157	2,796,395,943	20,908,294,195	
Non-taxable	Resident	c. Other	g. All ranges	41,723	15,836,260	34,471,001	270,437,852	
Non-taxable	Non-resident	d. All types	g. All ranges	1,486	27,008,821	261,152,947	458,454,429	
Totals				**887,349**	**124,409,361,969**	**12,007,643,507**	**296,351,149,193**	**107,864,559,733**