Confusion over eligibility for company tax rate reduction

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In brief

Although the law has been enacted to give small business companies a tax rate reduction with effect from the 2016-17 income year, there has been a lot of discussion in the media generating confusion around which entities might actually qualify. This uncertainty has arisen around when a company is taken to be carrying on a business.

In detail

As noted in our TaxTalk Alert dated 28 April 2017, in addition to meeting the relevant aggregated turnover threshold, it is a requirement that a company carry on a business in order to qualify for the reduced company tax rate. Furthermore, in working out a company's aggregated turnover, it is necessary to determine total ordinary income that the company (and its connected or affiliated entities) derives in the income year in the "ordinary course of carrying on a business".

Once it is established that a company is carrying on a business (no matter how small or large) and meets the relevant aggregated turnover threshold, all of the company's taxable income (not just that derived in the ordinary course of carrying on a business) is subject to the lower tax rate.

Whether or not a taxpayer is carrying on a business is a question of fact and degree. Having regard to relevant case law and previous experience with the small business tax concessions, it is not possible to say that every company is carrying on a business.

For some companies it will be extremely clear that their activities amount to conduct in carrying on a business. However, for others it might not be so easy. Ignoring the legal nature of the taxpayer, it has generally been accepted that purely passive investment activity may not amount to the carrying on of a business.

In the case of a company, this does not mean that passive investment activity will never constitute the carrying on of a business. It will be a question of fact and degree considered in the particular circumstances.

For example, it would be highly irregular to say that a corporate beneficiary of a discretionary trust, which does nothing more than be the passive recipient of distributions from the trust, is carrying on a business.

In such a case, a corporate beneficiary would not be eligible for the lower company tax rate under the current law.

At this stage, the Australian Taxation Office (ATO) has not provided specific and definitive guidance to assist potentially affected companies. In fact, its latest comments on its website is that "it is not possible to definitively state whether a particular company is carrying on a business. This is always question of fact. Based on the overall impression of the activities of a company and the relevant indicia of whether a business is carried on."

The ATO is currently undertaking further consultation and consideration of this issue with a view to provide much needed certainty and guidance. At the same time, the Minister for Revenue has waded into the debate and affirmed that "the policy decision made by the Government to cut the tax rate for small companies was not meant to apply to passive investment companies."

The takeaway

Who would have thought that knowing what is the appropriate tax rate for a company would have become such a complicated issue? There is no choice in the tax law for a company to simply choose to pay income tax at a rate of 30 per cent or lower.

It is imperative that a company knows what its tax rate is according to the law – not just for when the time comes to lodge its income tax return and pay its income tax for the year, but for purposes of working out the appropriate rate at which any distributions it makes to its shareholders during the year are to be franked.

In the absence of further binding guidance by the ATO, a company that is seeking to apply the lower tax rate of 27.5 per cent should carefully consider the circumstances in which it operates and specifically, the question of whether or not it is carrying on a business.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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