Corporate tax rate reduction – certainty at last

November 2017

In brief

Following a short consultation period on exposure draft law, the Government introduced legislation into Parliament on 18 October 2017 which, once enacted, will mean that a corporate tax entity will only qualify for the lower corporate tax rate if no more than 80 per cent of its assessable income is income of a specifically defined passive nature.

Although the new law also proposes to remove the requirement for the company to 'carry on a business' to be eligible for the reduced rate - a requirement which had caused much confusion and conjecture amongst taxpayers and tax practitioners alike - the Australian Taxation Office (ATO) has released its draft guidance on when a company carries on a business.

In a sensible turnaround, the Government is seeking to apply its amendments prospectively, with the proposed changes applying to the 2017-18 and later years of income.

However, taxpayers will still need to grapple with the question of whether or not they are carrying on business, and have an aggregated turnover of less than $10 million, in order to qualify for the 27.5 per cent tax rate in the 2016-17 income year.

In detail

The legislative amendments that are now before Parliament in *Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017* (the Bill) seek to introduce a 'bright line' test to ensure taxpayer certainty when determining whether the lower corporate tax rate is available.

Following consultation on the earlier Exposure Draft legislation, and on which PwC made a submission (see our TaxTalk Alert: Proposed changes to eligibility criteria for company tax rates from 20 September 2017), a number of welcome changes have been made.

In particular, there is no longer any requirement that a company be carrying on a business to qualify as a 'base rate entity' and furthermore, the measures no longer have retrospective application and only apply from the 2017-18 income year.

Income years commencing on or after the 2017-18 income year

In addition to introducing a limitation on the extent of the company's passive income, the Bill proposes to amend the definition of a 'base rate entity' to remove the requirement that the company be carrying on a business. This is a particularly welcome move as this requirement appeared redundant in light of the introduction of the passive income test and will provide much needed certainty for corporate taxpayers.

Consequently, if the Bill is enacted in its current form, a corporate tax entity will therefore only qualify for the lower corporate tax rate from the 2017-18 income year if:

- The actual aggregated turnover of the corporate tax entity for the income year is less than:
  - $25 million - for the 2017-18 income year
  - $50 million - for the 2018-19 and later income years, and
- The corporate tax entity does not have 'base rate entity passive income' of more than 80 per cent of its assessable income for the income year.

The new concept of 'base rate entity passive income' will include, among other things, dividends (excluding non-portfolio dividends which are broadly those dividends paid by a company in which the recipient has a voting interest of at least 10 per cent), franking credits, net capital gains, rent, interest, royalties, and certain amounts that flow through a partnership or a trust to the extent that it is attributable to an amount of passive income.

Although this definition has changed from that proposed by the exposure draft (for example, the inclusion of franking credits and net capital gains as opposed to gross capital gains), it is disappointing that the definition does not exclude net capital gains which arise from the sale of active assets.

For some companies, income that meets the definition of base rate entity passive income may not actually be passive income in the ordinary sense having regard to the nature of the activity for the particular company, but instead is income generated from the conduct of an active business (for example, rental income from a portfolio of commercial premises in a shopping centre(s)). Unfortunately, the law as proposed does not make any concession for those circumstances.

Income years commencing on or after 1 July 2015, and before the 2017-18 income year

No change is proposed to eligibility for the lower corporate tax rate of 28.5 per cent for the income year commencing on or after 1 July 2015, or 27.5 per cent for the 2016-17 income year. For those years, the law continues to require the company to be a 'small business entity' - that it carries on a business and meets the relevant aggregated turnover requirement - and with no need to test eligibility by reference to the extent of its passive income.

Consequently, for the 2016-17 income year, a company that carries on a business and has aggregated turnover of less than $10 million is eligible for the 27.5 per cent tax rate.

When reaching a position on the question of whether a company carries on a business for those years, a taxpayer will be able to glean some guidance from the ATO's recently released draft Taxation Ruling, TR 2017/D7 as to whether it is carrying on a business.

ATO's guidance on carrying on a business

Draft Taxation Ruling, TR 2017/D7, which was released on 18 October 2017, sets out the Commissioner's preliminary views as to what constitutes the carrying on of a business of the purposes of the definition of 'base rate entity'. Although the Draft Ruling will have strictly limited application if the Bill is enacted as currently drafted (since it will remove the requirement to carry on a business from the definition of base rate entity), it does provide a useful insight into the ATO's views on the matter (noting that the Draft Ruling clearly states that it is non-binding for the purposes of other provisions in the tax law).

The Draft Ruling concludes that whether a company is carrying on a business (within the meaning of the base rate entity definition) ultimately depends on an overall impression of the company's activities.

However, where a limited liability company is established and maintained to make a profit for its shareholders, and invests its assets in gainful activities that have both a purpose and prospect of profit, it is likely to be carrying on a business in a general sense. The Draft Ruling clearly states that this is so, even if the company's activities are relatively limited, and its activities primarily consist of passively receiving rent or returns on its investments and distributing them to its shareholders.

The Draft Ruling includes a number of relevant examples, including:

- Where a Family Trust, which carries on a profitable trading business, makes a corporate beneficiary presently entitled to the trust income, and the corporate beneficiary receives a cash distribution which is deposited in a non-interest bearing bank account, the Commissioner concludes that the corporate beneficiary is not carrying on a business. However, if the entitlement remains unpaid, and the corporate beneficiary reinvests the unpaid present entitlement via a written loan agreement on commercial terms with the Family Trust, the corporate beneficiary will be considered to be carrying on a business. This appears to be a favourable outcome for corporate beneficiaries of discretionary trusts.

Corporate taxpayers who are still required to satisfy the carrying on a business requirement should be able to take comfort from the ATO's statements that it will not select companies for audit based on their determination of whether they were carrying on a business in the 2016-17 income year, unless their decision is plainly unreasonable.

The takeaway

The amendments before Parliament confirm that it is imperative for any company seeking to apply the lower tax rate to carefully consider the circumstances in which it operates, and the nature of its assessable income.

Although the proposed changes remove the need to consider whether a company is 'carrying on a business' going forward, it still remains an issue for those seeking to apply the lower corporate tax rate to the 2016-17 and 2015-16 income years. Companies should revisit their prior year treatment in the light of the ATO's comments on what constitutes the carrying on of a business in the Draft Ruling, and consider whether they need to obtain a private binding ruling in relation to their individual circumstances.

Although the '80 per cent passive income test' is intended to provide certainty to taxpayers, this certainty may come at a cost for some. It will bring with it additional compliance requirements as some taxpayers will now be required to monitor their 'base rate entity passive income' each year in addition to their 'aggregated turnover'. This is also relevant for a company to correctly frank a dividend that it is paying but by reference to the actual outcomes for the immediately prior year.

The Government continues to remain committed to introduce a lower corporate tax rate for all companies by the 2023-24 income year, with a separate Bill to enact the remainder of the Government's Enterprise Tax Plan still before Parliament. If that is ultimately enacted, eventually there will be no limitation on the extent of any company's passive investment activity, as all companies will be subject to the lower rate from the 2023-24 income year.

Let's talk

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

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