Company tax rate changes and 'bright lines'

23 October 2017

For small to medium corporations and their tax advisers, last week saw the release of some significant tax developments.

Last week's company tax rate developments

1. The Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017 (the Bill) was introduced into the House of Representatives.

   The Bill proposes to amend the *Income Tax Rates Act 1986*, from the 2017-18 income year to ensure that a company will not qualify for the lower company tax rate if more than 80 per cent of its assessable income is income of a passive nature income. The aim is to have a clearer 'bright line' test to judge when a company does not qualify for the lower company tax rate.

2. The ATO released draft Taxation Ruling TR 2017/D7 (Draft Ruling) outlining its preliminary views on when does a company carry on a business within the meaning of section 23AA of the *Income Tax Rates Act 1986.*

   The Draft Ruling noted that the requisite requirements under this section required a company to meet both the aggregated turnover requirement (e.g. less than $25 million in 2017-18) and to be carrying on a business. Furthermore, it distinguishes the underlying characteristics of companies from individuals and trusts. The Draft Ruling suggests that more often than not a company, will be carrying on a business in a general sense.

   Accompanying the release of the Draft Ruling, the ATO has also indicated on the ATO website that it will not select companies for audit based on their determination of whether they were carrying on a business in the 2016-17 year, unless their decision appears plainly unreasonable.

Proposed legislative change impacts

There are some subtle changes in this final Bill compared to the exposure draft legislation that was the subject of recent consultation.

Firstly, the final Bill has not sought to disturb the corporate tax rate tests in the 2016-17 income year. Thus, for this year a company still needs to be a 'small business entity' (which still contains a carrying on a business requirement) and still needs to have less than $10 million aggregated turnover to qualify for the 27.5% rate.

The company does not however need to satisfy any passive income test. It should also be remembered that the maximum franking credit that can be allocated to a distribution is based on a corporate's applicable tax rate. For the 2016–17 income year, a corporate entity works out their corporate tax rate for imputation purposes by:

- assuming that their aggregated turnover is the same as in the previous income year, and
- applying the corporate tax rate for the current income year.

Secondly, the Government has recognised the consequences of the ATO's preliminary views and has ultimately decided:

- The current two test requirement for 2017-18 and future income years (i.e. to be carrying on a business and have an aggregated turnover less than the threshold of $25 million in 2017-18 and $50 million in 2018-19) should be changed such that the 'carrying on a business' requirement will be dispensed with as it appears to be largely superfluous. (Depending on the final form of the Bill enacted, the ATO's Draft Ruling may need to be updated)
- Rather, the aggregated turnover threshold requirement should remain alongside a new passive income test that requires no more than 80% of the corporate's assessable income for the income year to be passive income as defined.
- The passive income definition is largely the same as that which appeared in the exposure draft. This income includes:
  - dividends other than non-portfolio dividends
  - franking credits on such dividends
  - non-share dividends
  - interest income, 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.

For the 2017-18 income year, a corporate entity works out their corporate tax rate for imputation purposes by:

- assuming that their aggregated turnover, their assessable income and their passive income is the same as in the previous income year, and
- applying the corporate tax rate for the current year.

Just how bright are the new bright lines?

On the one hand, the new passive income test has a relatively concessionary hurdle rate before it applies and the examples in the explanatory material accompanying the Bill are informative as to how the new passive income test is intended to operate in a number of instances.

Equally, however, it is apparent:

- the actual scope of certain passive income components (e.g. what is in or out of 'dividend, interest income, royalties and rent' amounts) is open to some debate
- the practical consequences of how you trace passive income through trusts and partnerships will sometimes be challenging
- the fact this is an annual test means that isolated transactions (e.g. large capital gains) could trigger a breach for otherwise very active companies, and
- understanding the actual mechanics of the basic calculations, namely calculating aggregated turnover, total assessable income and total passive income will be important for those close to the thresholds.

Accordingly, whilst the ink has still not dried on the ATO's view of what is meant by 'carrying on a business' by a company, it seems inevitable that the ATO will be called on to 'brighten up' the new passive income test.