Introduction

On 18 October 2017, the following related items were released regarding access to the lower 27.5% corporate tax rate:

- the Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017 ("Final Legislation");
- the ATO’s TR 2017/D7 “When does a company carry on a business within the meaning of s.23AA of the Income Tax Rates Act 1986" ("Draft Ruling"); and
- the Minister for Revenue and Financial Services’ Media Release “Passive Investment Companies Excluded from Lower Tax Rate” ("Media Release").

The above items represent the culmination of various, sometimes conflicting, ATO and Treasury announcements during the current calendar year regarding access to the lower 27.5% company tax rate, and finalises previous draft legislation that was released on 18 September 2017. This Tax Astute Snapshot explains the interaction between the above items and their likely practical effect when determining whether a company should apply the 27.5% or 30% corporate tax rate for tax payable and imputation/franking purposes.

How will a company’s tax rate payable be determined?

As illustrated in the diagram below, the method for determining whether a lower 27.5% corporate tax rate payable will apply to a given corporate tax entity/company will now vary between the 2016/17 year (where Small Business Entity ("SBE") status will be relevant) and the 2017/18 year (where Base Rate Entity ("BRE") status will be relevant) as follows:

- In order to pay tax at the lower 27.5% corporate tax rate in the **2016/17 income year**, the corporate tax entity/company must both:
  - have aggregated turnover (i.e. grouped business ordinary income/turnover for tax purposes per Subdiv 328-C ITAA 1997) of <$10 Million in 2016/17 or 2015/16; and
  - carry on business during at least part of the 2016/17 year.

- In order to pay tax at the lower 27.5% corporate tax rate in **2017/18 and later income years**, the corporate tax entity/company must both:
  - have aggregated turnover (i.e. grouped business ordinary income/turnover for tax purposes per Subdiv 328-C ITAA 1997) of <$25 Million (or <$50 Million from 2018/19 – see also Note B below); and
  - have <80% of its assessable income comprising BRE Passive Income (see below for further BRE Passive Income details).

**In all other cases, the corporate tax rate payable for the relevant year will be 30% as shown.**
Broadly:

- the **2016/17 method** retains the status quo under existing legislation (subject to additional information in the ATO’s Draft Ruling regarding when business is/is not carried on for corporate tax rate purposes – see further Draft Ruling details below); but

- the **2017/18 and later year method** importantly removes the requirement for the company to carry on business per se, replacing it with the statutory <80% BRE Passive Income requirement shown. The pre-existing aggregated turnover threshold requirement of <$25 Million in 2017/18 or <$50 Million from 2018/19 is retained from existing legislation – see also Note B below.

### Determining the Corporate Tax Rate in 2016/17 & 2017/18

<table>
<thead>
<tr>
<th>2016/17 Year</th>
<th>2017/18 Year onwards</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Small Business Entity (SBE) Status</strong></td>
<td><strong>Base Rate Entity (BRE) Status</strong></td>
</tr>
<tr>
<td>Aggregated Turnover &lt; $10 Million &amp; BUSINESS carried on during year</td>
<td>Aggregated Turnover &lt; $25 Million (OR &lt; $50 Million from 2018/19) &amp; ≤ 80% BRE PASSIVE INCOME</td>
</tr>
</tbody>
</table>

**NOTE**
- Use 30% tax payable rate if EITHER factor FAILED

Results in... 27.5% Tax Rate Payable

**Denotes TR 2017/D7 MAY have relevance**

- **Note A** – As indicated by * on the above diagram, the Draft Ruling TR 2017/D7 may have relevance when determining whether a company carries on business in 2016/17 and, possibly, when determining a company’s aggregated (business) turnover in 2016/17 and/or 2017/18. See below for further Draft Ruling details.

- **Note B** – Subject to successful passage of the [Treasury Laws Amendment (Enterprise Tax Plan No. 2) Bill 2017](https://www.ato.gov.au/Tax-facts/Budget-and-tax-plan/Budget-2017/) (currently before the House of Representatives at the time of writing), the method shown for the 2017/18 year and beyond is likely to apply until at least 2022/23 (after which all companies are proposed to be eligible for a single low tax rate of 27.5% - with further rate reductions proposed from 2024/25). This Bill also proposes to introduce further aggregated turnover threshold increases from 2019/20 (e.g. <$100 Million in 2019/20, <$250 Million in 2020/21, <$500 Million in 2021/22 and <$1 Billion in 2022/23). If enacted as drafted, these measures will substantially increase the number of corporate tax entities and groups required to determine whether a 27.5% or 30% rate applies.

- **Note C** – The above tests are also relevant when determining a company’s imputation/franking rate for each of the above years, although subject to the important timing difference shown in the table below.
New Corporate Tax Rate Rules

- **Note D** – For a corporate tax entity with a Substituted Accounting Period (SAP) for Australian taxation purposes, the above diagram refers to their particular 2016/17 or 2017/18 income year (i.e. results will vary for early and late balancers).

**How will a company’s franking/imputation rate be determined?**

As explained at Note C above, the above principles also apply when determining whether a company’s corporate tax rate for imputation/franking is 27.5%. Imputation/franking rate testing is, however, subject to an important timing difference which involves testing the circumstances which arose in the prior year against the aggregated turnover threshold and other eligibility requirements of the current year being tested (as shown in the table below).

<table>
<thead>
<tr>
<th>2016/17 Franking Rate = 27.5% if...</th>
<th>2017/18 Franking Rate = 27.5% if...</th>
</tr>
</thead>
<tbody>
<tr>
<td>The company would have satisfied the required 2016/17 (current year) &lt;$10 Million SBE status based on its actual aggregated turnover in the 2015/16 (prior year).</td>
<td>2016/17 (prior year) BRE Passive Income is &lt;80% of 2016/17 assessable income &amp; Actual 2016/17 (prior year) aggregated turnover is &lt;$25 Million (the current year 2017/18 threshold)</td>
</tr>
<tr>
<td>NOTE – In most cases a company would need to carry on business in the 2015/16 prior year to satisfy the above aggregated turnover requirement.</td>
<td></td>
</tr>
</tbody>
</table>

**Note:**

- A corporate tax entity’s/company’s franking/imputation rate will, in many cases, match its corporate tax rate payable. If, however, a variation arises between the current and prior year results (e.g. a BRE Passive Income result of >80% in one year due to a large capital gain which may not occur in the other year – see below for further BRE Passive Income details) this may result in different rates for tax payable and franking purposes.

- For 2018/19 and later income years, the 2017/18 approach would apply such that the circumstances from the prior year would be applied to the tested year and its aggregated turnover threshold (i.e. 2017/18 actual turnover and BRE passive income outcomes would be applied to 2018/19 and its <$50 Million threshold to determine the 2018/19 franking/imputation rate and so on).

- While a lower corporate tax rate payable is generally viewed as a positive, a lower 27.5% franking rate reduces the rate at which franking credits can be provided to shareholders. This will generally shift more of the tax burden from a franked dividend to the recipient shareholder and can be problematic for pre-existing franking credit balances which were generated from paying tax at 30% in prior years.
How will the proposed BRE Passive Income threshold be applied?

As noted above, from 2017/18 and later income years a new statutory <80% BRE Passive Income threshold will replace the existing 2016/17 year requirement that a company must carry on business in order to access a 27.5% corporate tax rate.

Importantly, the BRE Passive Income threshold will no longer apply to the 2016/17 income year (contrary to the previous draft legislation released on 18 September 2017 which proposed it would retrospectively apply from 2016/17). The remaining BRE Passive Income rules are largely unchanged from the previous draft legislation, apart from:

- a <80% threshold replacing the previous draft legislation’s <80% threshold;
- franking credits being specifically included as BRE Passive income, confirming that dividends must be counted on a grossed-up basis (see A below); and
- “net capital gain” replacing the previous draft legislation’s (gross) “capital gain” definition (see C below).

Under the Final Legislation, from its 2017/18 income year, in addition to satisfying the relevant year’s aggregated turnover threshold (see diagram and Note B above for further details) a company will also need to satisfy the new BRE passive income requirement under s.23AB ITRA 1986 by determining its BRE Passive Income for the year divided by its total assessable income. As illustrated below if BRE Passive Income (i.e. A + B + C + D items shown below) divided by the company’s total assessable income is:

- >80% then the company will be required to apply a 30% corporate tax rate; or
- <80% then the company will be required to apply a 27.5% corporate tax rate (assuming that its aggregated turnover is below the required threshold – see Diagram and Note B above).

For example, if the company shown below had $8 Million BRE Passive Income and $12 Million total assessable income (i.e. approximately a 67% result) it would be subject to a 27.5% tax rate in 2017/18 (assuming that grouped aggregated turnover was <$25 Million in that year). By contrast, if BRE Passive Income was $10 Million and total assessable income $12 Million (i.e. approximately 83%) then the company would be subject to a 30% tax rate due to exceeding the BRE Passive Income threshold.

As illustrated below, the Final Legislation proposes to include the following amounts as BRE Passive Income for purposes of applying the new 80% threshold:

- Distributions (e.g. actual and deemed dividends) received by the tested company from other corporate tax entities (e.g. other companies, public unit trusts and/or corporate limited partnerships) will generally increase BRE Passive Income at A below. However, to the extent dividends represent non-portfolio dividends under s.317 ITAA 1936 (where the tested company broadly holds a >10% interest in the paying entity) they are not counted as BRE Passive income. Note also that non-share dividends (e.g. some returns on at call loans or other...
items which may fail the Div 974 ITAA 1997 debt test but satisfy the equity test) will always count as BRE Passive income, regardless of whether a non-portfolio interest is held. Franking credits have been specifically included as part of BRE Passive Income under the Final Legislation, confirming that grossed-up dividends must be included.

- Interest, royalty and/or rent income at B below (with “interest income” as defined in s.6 ITAA 1936 and royalty and/or rent presumably taking their ordinary legal meanings). The definition of “interest income” contains some important exceptions (including an effective “carve out” for some business-related interest income). See Note B below regarding how a company’s business income may concurrently be BRE Passive Income.

- Net capital gains and gains on qualifying securities under Division 16E ITAA 1936 at C below. It is noted that the Final Legislation has removed the previously proposed gross capital gain definition such that capital losses and various Div 152 ITAA 1997 Small Business CGT concession reductions may now reduce the capital gains amount included as BRE Passive Income.

- Assessable Trust or Partnership distributions on a “look through” basis (including through a chain of partnerships or trusts) at D below to the extent those distributions are assessable under Div 5 or Div 6 ITAA 1936 and reflect any of the items at A, B or C. For example, if a trust or partnership distributed service fee or trading stock revenue to the tested company, this would not count as BRE Passive Income. By contrast, a distribution of rent, royalties or capital gains would count towards the 80% threshold test.
• Note A – Unlike the aggregated turnover threshold (per Subdiv 328-C ITAA 1997 – see the first diagram in this Snapshot document and its Note B), the BRE Passive Income threshold is not tested on a grouped basis and is applied separately to each corporate tax entity based on its own assessable and BRE Passive Income.

• Note B - The BRE Passive Income definition in the Final Legislation generally does not carve out business income amounts which may fall within the above items A to D (subject to exceptions for some business-related interest income and some reductions to business-related capital gains, to the extent they are eligible for relevant Div 152 ITAA 1997 Small Business CGT Concessions - see B and C above). Importantly, companies deriving primarily royalties and rent as business income and/or realising a capital gain regarding an active business asset (subject to Small Business CGT reductions noted above) may fail the 80% BRE Passive income percentage and therefore remain on a 30% corporate tax rate solely because their business income concurrently falls within the definition of BRE Passive Income.

• Note C - Where a subsidiary company pays assessable dividends to its holding company, it would generally be expected that such dividends would be non-portfolio dividends and therefore would not count as BRE Passive Income of the holding company. If, however, other amounts shown above (e.g. rent, royalties and similar) are paid to a head company, this may change the head company’s BRE Passive Income threshold outcome. See below for further comments regarding the ATO’s Draft Ruling and its potential implications for whether a head company carries on business.

• Note D - It is assumed that tax consolidated groups should assess their BRE percentage for the head company’s corporate tax rate purposes based upon assessable amounts received from outside the group in accordance with the single entity rule in s.701-1 ITAA 1997.

Importantly, under pre-existing legislation once a company carried on business and had grouped aggregated turnover below the increasing turnover thresholds noted above, it was most unlikely that their corporate tax rate would revert to 30% unless that company ceased to carry on business in a future year. Under the new Final Legislation, a company’s tax rate may, in some cases, fluctuate year to year due to changes in their BRE passive income, including via discretionary trust distributions and/or once-off capital gains.

How is the ATO’s Draft Ruling (TR 2017/D7) likely to interact with the Final Legislation?

The ATO’s Draft Ruling broadly explains their view regarding whether or not a company carries on business for corporate tax rate purposes under pre-existing s.23AA ITRA 1986. The following diagram illustrates the ATO’s broad approach in the Draft Ruling that there will usually be a rebuttable presumption that a company will carry on business in most cases, but subject to some exceptions where there is insufficient profit motive (see further details noted below). This approach is largely based upon companies having a different “underlying commercial nature” in comparison to individuals and trusts (which are viewed as less likely to carry on business due to
their potential for private domestic/hobby activity and specific issues surrounding the trustee/beneficiary relationship respectively).

Note that a wide variety of business vs non-business indicators are addressed in the Draft Ruling including, but not limited to, the following:

- that business or non-business status of company activities may be assessed on a grouped basis in appropriate cases (see paragraph 22);
- “A company that holds assets which generate ongoing returns [e.g. rent, interest, dividends etc.] will still be engaged in activity sufficient to amount to the carrying on of a business, even though there is little work for it to do…” (see paragraph 28);
- a company’s business activities “…may be limited to its ongoing management, receipt and distribution of income and other matters of an administrative nature” (see paragraph 28). This may increase the chance that a holding company (or another investment entity) which provides use of assets to other group members, and/or is entitled to dividend returns from subsidiaries, will carry on a business under the Draft Ruling for corporate tax rate purposes. Paragraph 30 notes that such inter-entity activities may still be a business even if no return is received.

A company is, however, less likely to carry on business for corporate tax rate purposes in circumstances including, but not limited to, the following:

- “The company exists solely to provide services or facilities to its members” without a profit making intention (e.g. bodies corporate, incorporated not-for-profits or charities and public statutory bodies) (see paragraph 18);
- the company’s returns on its assets (e.g. interest income) are unlikely to exceed its costs (e.g. ASIC and other compliance fees) on an ongoing basis. An example might be a true “bucket
company” which has minimal interest and other income derived in comparison to its compliance costs (see paragraph 38); or

- scenarios where the company has permanently ceased its former business activities (e.g. a company with a single UPE or debt which is being wound up) or its activities are too preliminary to be carrying on business (e.g. activities to assess feasibility of future investment) (see paragraphs 40 to 42 inclusive).

As indicated with an * in the first diagram in this Snapshot document, the Draft Ruling approach explained above is likely to be of most relevance to determining a company’s 2016/17 corporate tax rate because carrying on business is a pre-requisite for applying a 27.5% corporate tax rate in that year.

Importantly, the Treasury Media Release referenced at the start of this Snapshot document notes that:

“the ATO has advised that it will adopt a facilitative approach to compliance in relation to the ‘carrying on a business’ test for the 2016/17 year. That is, it will not select companies for audit based on their determination of whether they were carrying on business in the 2016/17 income year, unless their decision is plainly unreasonable”

In its own document, the ATO also notes that (emphasis added):

- “This draft Ruling sets out the Commissioner’s preliminary, but considered, views on when a company carries on business within the meaning of s.23AA ITRA 1986”; and

- “the case law highlights that it is not possible to definitively state whether a person is carrying on a business. Whether the activities of a person constitute the carrying on of a business is a question of fact, and must be answered based on a wide survey and the overall impression of the activities of the person and having regard to the indicia of carrying on a business as a whole”.

While not free from doubt, it is assumed at the time of writing that 2016/17 year corporate tax rate decisions already reasonably made (based upon existing understanding of when a company does or does not carry on business) may, in practice, be unaffected by the new Draft Ruling. Subject to the particular circumstances involved, the majority of existing corporate tax rate decisions are arguably unlikely to be “plainly unreasonable” based upon the above excerpts.

Further * items in the first diagram in this Snapshot document note a possible application of the Draft Ruling to the aggregated turnover threshold requirement which is relevant for corporate tax rate purposes in both 2016/17 and 2017/18 and beyond. This potential application of the ATO’s Draft Ruling has not been specifically addressed in either the Draft Ruling or the Treasury Media Release. It is possible, however, that “business” status per the Draft Ruling may have relevance for aggregated turnover purposes on the basis that:
• The ATO has not limited application of its Draft Ruling to the 2016/17 income year, stating instead that the Draft Ruling is proposed to apply “both before and after its date of issue” once finalised;

• The Draft Ruling states that (at paragraph 9) it is “…concerned with…does a company carry on business in a general sense and therefore whether it carries on a business within the meaning of s.23AA ITRA 1986”;†

† Note that the Draft Ruling contrasts this issue with carrying on a “particular business” (not addressed in the Draft Ruling) which is stated to be relevant to more specific taxation issues such as whether a gain made is on capital or revenue account; and

• Existing s.328-120 ITAA 1997 defines “annual turnover” (which is ultimately grouped under rules in s.328-120 ITAA 1997 to arrive at “aggregated turnover” for corporate tax rate threshold purposes) as (emphasis added):

“…the total ordinary income that the entity derives in the income year in the ordinary course of carrying on a business”

In combination, these statements may suggest a possible ongoing relevance for the Draft Ruling in the identification of aggregated turnover of the company testing its corporate tax rate and/or that company’s various corporate connected entities under Subdiv 328-C ITAA 1997.

Importantly, the possible interaction between the Draft Ruling and aggregated turnover issues noted above should currently be viewed in a cautious and preliminary manner due to:

• ATO comments at paragraph 2 of the Draft Ruling that:

“caution should be exercised in applying the reasoning expressed in this ruling in relation to other provisions of the law, and it should be borne in mind that this ruling does not bind the Commissioner in respect of those other provisions”;

• The fact that the Draft Ruling specifically states an ATO view regarding current s.23AA ITRA 1986 which will be amended under the Final Legislation to remove a requirement to specifically carry on business from 2017/18 (see the first Diagram in this Snapshot document); and

• The fact that the Draft Ruling is yet to be finalised and the ATO’s position regarding aggregated turnover and the broader application of their views regarding companies carrying on business may well be clarified in coming months once the Final Legislation receives Royal Assent and the Draft Ruling is finalised.

It is also important to note that the ATO’s Draft Ruling applies only to entities which satisfy the definition of “company” in the ITAA 1997 (i.e. some corporate tax entities (as defined) are excluded from the Draft Ruling’s application).
**NEW CORPORATE TAX RATE RULES**

**WANT MORE DETAILS?**
In addition to details available at [www.taxastute.com.au](http://www.taxastute.com.au), Tax Astute clients receive more information and specific details, questions and answers underlying the brief snapshot summary above as a part of their:

- Tax Astute training session;
- Tax Astute reference notes; and
- detailed multimedia recording.

---

**COPYRIGHT & DISCLAIMER STATEMENT**

©Tax Astute Pty Ltd (as Trustee for the Tax Astute Trust) 2017

This training material snapshot summary is subject to copyright and may not be reproduced, reused or adapted in any manner, except in accordance with the *Copyright Act* 1968 (Cth) for bona fide study purposes, other than with the express written consent of Tax Astute Pty Ltd (as Trustee for the Tax Astute Trust).

This material has been prepared with the objective of maximising accuracy and currency, but is provided for personal educational purposes only and must not be relied on as legal, financial or any other type of advice. Tax Astute Pty Ltd (as Trustee for the Tax Astute Trust) hereby excludes any and all liability arising, whether directly or indirectly, from the use of this training material snapshot summary and any information contained herein.