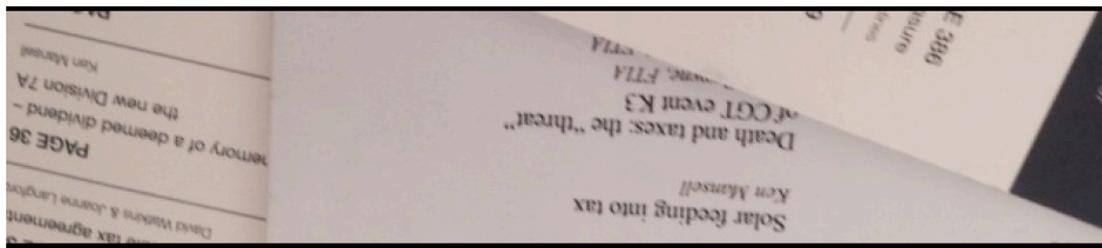


## What is the Company Tax Rate? And what is the Imputation Rate?

### Tax Rambling

*The rants of a tax nerd*



## What is the Company Tax Rate? And what is the Imputation Rate?

# Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017

These once were easy questions. Only a few years ago the answer was easy... 30%. But recently there have been numerous changes to both the company tax rate and how many imputation credits can be attached to a dividend.

This paper considers these changes, but focuses primarily on the position from 1 July 2017.

### 1. A brief history... 2015/16 and 2016/17

For the last few years we have had multiple company tax rates.

The image shows the header of an Australian Taxation Office (ATO) form for the 2017 financial year. It includes the Australian Government logo, the text "Australian Government Australian Taxation Office", and "Company tax return 2017". There is a date selection field with boxes for Day, Month, and Year, followed by "to" and another set of boxes for Day, Month, and Year. Below the date field, it says "Or specify period if part year or approved substitute period." There is also a barcode on the right side.

Back on 1 July 2015, a lower company tax rate was introduced. This rate of 28.5% was available to entities that were small business entities. In that year the turnover test for being a small business entity was only \$2 million. Also, even though these small business entities only paid a company tax rate of 28.5%, they could frank dividends at the 30% tax rate. They just had to watch out they did not end up having a negative franking balance or they would have to pay franking deficits tax.

Changes were made on 1 July 2016 that reduced the company tax rate for small business entities to 27.5%. However, these changes also meant that in most cases, these small business entities could only frank dividends at 27.5%. This meant that if a company wanted to pay out previous year retained earnings which had been taxed at either 28.5% or 30%, they could only pay out imputation credits at 27.5%.

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But for both these two years, to get the lower rate the company had to be a small business entity. And during these years the Commissioner started to reconsider some long-held ideas of what is a business. He even started to suggest that companies that just held passive investments might be carrying on a business.

The Government indicated in a media release that there was never an intension for these companies to get the lower tax rate and would act to make sure they do not...

## **ATO tax ruling**

Reports today that the Australian Taxation Office (ATO) has broadened the interpretation of company tax cuts are premature.

The Minister for Revenue and Financial Services, the Hon Kelly O'Dwyer MP, said the ATO has issued a draft ruling and will in due course provide other guidance.

"As always it is up to the ATO to determine how the law applies and in this case whether a company is carrying on a business or not," Minister O'Dwyer said.

"However, the policy decision made by the Government to cut the tax rate for small companies was not meant to apply to passive investment companies."

"If any further direction is required on the Government's policy intention by the ATO it will be provided by the Government."

"At the end of the day the Government wants to see lower taxes on small and medium businesses."

## **2. Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017**

Under the initial changes to the way Company tax and imputation would work from 1 July 2017, the lower corporate tax rate would only apply to any corporate tax entity that is a "base rate entity".

Under the current law, a base rate entity is a corporate tax entity that both carries on a business and meets a turnover threshold. The turnover threshold is:

- for the 2017-18 income year —an aggregated turnover of less than \$25 million; and
- for the 2018-19 income year —an aggregated turnover of less than \$50 million.

But as we have already discussed, there has been some confusion and disagreement between the Government and the Commissioner as to when a company will be carrying on a business.

Also, what if the business of the company is responsible for just a small part of the income of the company? Is it carrying on a business and all of its income is taxed at the lower tax rate?

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**To solve this a new Bill has been introduced by the Government changing how are we to determine if a company is a base rate entity and therefore what companies use the lower company tax rate of 27.5%**

This new Bill will modify the requirements that must be satisfied for a company to qualify as a base rate entity by replacing the requirement to be carrying on a business with a passive income test.

Under the passive income test, companies that are generating predominantly passive income will not be eligible for the lower corporate tax rate.

Therefore, from 1 July 2017, a company will qualify for the lower corporate tax rate for an income year only if:

- no more than 80% of the company's assessable income for that income year is base rate entity passive income; and
- the aggregated turnover is less than the aggregated turnover threshold for that income year.

### ***23AA Meaning of base rate entity***

An entity is a ***base rate entity*** for a year of income if:

- (a) no more than 80% of its assessable income for the year of income is base rate entity passive income; and
- (b) its aggregated turnover (within the meaning of the *Income Tax Assessment Act 1997*) for the year of income, worked out as at the end of that year, is less than \$25 million.

### **3. 80% passive income test**

Under the Bill, an amount is base rate entity passive income if it is:

- A distribution or dividend by a corporate tax entity, other than a non-portfolio dividend;
- Franking credits attached to such a distribution or dividend;
- A non-share dividend made by a company;
- Interest income;
- A royalty;
- Rent;
- A gain on a qualifying security; or
- A net capital gain.

### **23AB Meaning of *base rate entity passive income***

***Base rate entity passive income*** is assessable income that is any of the following:

- (a) a distribution (within the meaning of the *Income Tax Assessment Act 1997*) by a corporate tax entity (within the meaning of that Act), other than a non-portfolio dividend (within the meaning of section 317 of the Assessment Act);
- (b) an amount of a franking credit (within the meaning of the *Income Tax Assessment Act 1997*) on such a distribution;
- (c) a non-share dividend (within the meaning of the *Income Tax Assessment Act 1997*) by a company;

Also, an amount that flows through a trust to a corporate tax entity will retain its character for the purposes of determining whether or not the amount is base rate entity passive income of the corporate tax entity.

For example, a dividend which passes directly from the trust to a beneficiary that is a corporate tax entity will be base rate entity passive income of the corporate tax entity because the trust distribution is directly referable to the dividend of the trust.

#### **Example 1**

*Jane and Dave Smith are the sole shareholders and directors of Smith Pty Ltd. Smith Pty Ltd holds a diversified portfolio of shares from which it earns dividend income as well as several term deposits from which it earns interest. It is also the beneficiary of a trust which owns a commercial investment property. All rental income earned by the trust is distributed to Smith Pty Ltd.*

*Smith Pty Ltd also earns a small amount of fee for service income. This is derived from the consulting services Jane Smith, a retired business woman, provides to a number of independent businesses year.*

*In the 2017-18 income year, Smith Pty Ltd had an aggregated turnover that is under the \$25 million aggregated turnover threshold. The amount of its assessable income was \$900,000, comprising:*

- *dividends, rent and interest income of \$620,000;*
- *net capital gains of \$180,000; and*
- *consulting income of \$100,000.*

*Smith Pty Ltd is a passive investment company as 89 per cent of its assessable income is base rate entity passive income. Consequently, for the 2017-18 income year, Smith Pty Ltd's corporate tax rate is 30 per cent.*

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### **4. Imputation changes**

Companies can pay franked dividends to their shareholders at any time during a year. Under these new rules, a company will not know its aggregated turnover, the amount of its base rate entity passive income, or the amount of its assessable income for an income year until after the end of that income year and therefore it will not know its franking rate until after the end of the year.

To solve this problem, to work out what rate a company can frank its dividend in a year, the company must assume that:

- Its aggregated turnover for the income year is equal to its aggregated turnover for the previous income year;
- Its base rate entity passive income for the income year is equal to its base rate entity passive income for the previous income year; and
- Its assessable income for the income year is equal to its assessable income for the previous income year.

However, if the company did not exist in the previous income year, its corporate tax rate for imputation purposes for an income year will be the lower corporate tax rate of 27.5%.

Effectively, this means the amount a company can frank a dividend will depend on the factors used to assess last year's company tax rate.

***corporate tax rate for imputation purposes***, of an entity for an income year, means:

- (a) unless paragraph (b) applies—the entity's \*corporate tax rate for the income year, worked out on the assumptions that:
  - (i) the entity's \*aggregated turnover for the income year is equal to its aggregated turnover for the previous income year; and
  - (ii) the entity's base rate entity passive income (within the meaning of the *Income Tax Rates Act 1986*) for the income year is equal to its base rate entity passive income for the previous income year; and
  - (iii) the entity's assessable income for the income year is equal to its assessable income for the previous income year; or
- (b) if the entity did not exist in the previous income year—the rate of tax in respect of the taxable income of a company covered by paragraph 23(2)(a) of the *Income Tax Rates Act 1986*.

### **Example 2**

*In the 2017-18 income year, Bear Co has:*

- *aggregated turnover of \$8 million;*

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- base rate entity passive income of \$7.5 million; and
- assessable income of \$8 million.

*Therefore, for the 2017-18 income year, 92.59 per cent of Bear Co's assessable income is base rate entity passive income. Consequently, for that income year, Bear Co's corporate tax rate is 30 per cent (even though its aggregated turnover is only \$8 million).*

*Bear Co proposes to pay a dividend to its shareholders in the 2018-19 income year. For the purpose of working out its corporate tax rate for imputation purposes for the 2018-19 income year, Bear Co must assume that its aggregated turnover, base rate entity passive income and assessable income are the same as for the 2017-18 income year.*

*As 92.59 per cent of its assessable income was base rate entity passive income for the 2017-18 income year, Bear Co's corporate tax rate for imputation purposes is 30 per cent. Therefore, Bear Co's corporate tax gross-up rate for that income year will be 2.33 (that is,  $(100\% - 30\%)/30\%$ ).*

*Bear Co makes a fully franked distribution of \$100 per share in the 2018-19 income year. The maximum franking credit that can be attached to that distribution is \$42.91 (that is,  $\$100/2.33$ ). Bear Co makes the dividend payment on 31 March 2019.*

*Amy holds 50 shares in Bear Co and receives a dividend of \$5,000. Franking credits of \$2,145 are attached to the dividend. For the 2018-19 income year, Amy includes \$7,145 in her assessable income in relation to the dividend she has received from Bear Co — that is:*

- the amount of the dividend (\$5,000); plus
- the amount of franking credits (\$2,145).

### **5. Draft Taxation Ruling TR 2017/D7 Income tax: when does a company carry on a business within the meaning of section 23AA of the Income Tax Rates Act 1986?**

## Draft Taxation Ruling

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### TR 2017/D7

Income tax: when does a company carry on a business within the meaning of section 23AA of the *Income Tax Rates Act 1986*?

Interestingly, on the same day the Government introduced this legislation to remove the requirement for a company to be carrying on a business to get the lower company tax rate, the Commissioner released a draft Tax Ruling on what it means to be carrying on a business in relation to this lower company tax rate.

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Even though the draft Ruling will become useless if the Bill we have just discussed becomes law, it is worth looking at as it is a fundamental change in relation to what the Commissioner considers can be a business.

But it must be noted that the draft Ruling clearly states that it is only expressing the Commissioner's opinion on what is a business for the purpose of establishing if a company is a base rate entity that can apply the 27.5% company tax rate.

The Commissioner states that it is not possible to be certain whether a company is carrying on a business, primarily as it will be based on the facts of each different situation.

However, companies are likely to be carrying on a business if they are both established and maintained to make a profit for their shareholders and invest their assets in gainful activities that have both a purpose and prospect of profit.

This can mean a company can be carrying on a business even if its activities are just receiving passive income and distributing it to shareholders.

The examples in the draft Ruling of what can be a business for the purpose of establishing if a company is a base rate entity are very different to what most practitioners would have thought. For example, these are companies carrying on a business according to the draft Ruling:

- A share investment company; and
- A family company with income consisting only of an unpaid trust entitlement, which it reinvests, even if it is just under a loan agreement back to the trust.

It is unlikely that any practitioner has considered these companies to be carrying on a business previously.

Although this draft Ruling may never be finalised due to the Bill introduced on the same day, the draft Ruling shows that the Commissioner is considering a major change in his understanding of what can be carrying on a "business" and this could open the door for many more corporate entities claiming the small business concessions that exist.

### **6. "Reducing the corporate tax rate", Commissioner of Taxation, [www.ato.gov.au](http://www.ato.gov.au), 2 November 2017**

#### **Reducing the corporate tax rate**

Enterprise Tax Plan  
2016

#### **Reducing the corporate tax rate**

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On 1 September 2016, the Government introduced Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016 that proposed to progressively reduce the corporate tax rate from 30%

The Commissioner has announced he will use this Draft Ruling and the basis of a new ruling on when an entity will be carrying on a business for the small business entity rules.

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If the new ruling on when an entity is carrying on a business under the small business entity rules is similar to the Draft Ruling, many more entities will be able to claim the small business concessions. Also, many companies that were assessed in the 2016/17 year at 30% will not be small business entities and should have been assessed at 27.5% for that year.

But we will have to wait to see what is in this new ruling.

### **Carrying on a business**

The ATO has issued a [draft Taxation Ruling](#) on when a company carries on a business.

Early consultation on the Ruling has highlighted a question about the provision around which the advice should be framed. The draft Taxation Ruling addresses whether a company is carrying on a business for the purpose of identifying whether it is a base rate entity in section 23AA of the Income Tax Rates Act 1986 (ITRA 1986). This is relevant for determining whether it is subject to the 27.5% or 30% corporate tax rate in the 2017/18 and later income years. The reasoning expressed in the Ruling is, however, equally applicable to determining whether a company is a small business entity within the meaning of section 23 of the ITRA 1986 and section 328-110 of the Income Tax Assessment Act 1997 (ITAA 1997) for the 2015/16 and 2016/17 income years and therefore which rate is applicable to it in those income years.

In light of this and the proposed changes to the law, the Commissioner is proposing to finalise the draft Ruling in relation to section 23 of the ITRA 1986 and 328-110 of the ITAA 1997, rather than section 23AA of the ITRA 1986 as it is presently drafted.

## **7. Take away message**

For the 2015/16 small business entities should have franked at 30% even if they paid tax at 28.5%.

For the 2015/16 and the 2016/17 year, to get the lower company tax rate the entity had to be a small business entity, which means it must have been carrying on a "business". But what does the word "business" mean now? Will it cover many more companies than we ever imagined and will we have to amend many returns? We will have to wait until the Commissioner finalises his position.

While the draft Ruling states it only applies to the word "business" in section 23AA of the Income Tax Rates Act 1986, it might be reasonable in the 2015/16 and 2016/17 year to say that many more companies, like bucket companies, were carrying on a business in these years and could get the lower company tax rate...

Remember that when the Commissioner released the draft Ruling, he indicated on the ATO website that he 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. If you comply with the draft ruling that can't really be unreasonable.

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However, we understand that there has been some uncertainty about the 'carrying on a business' test and so we will adopt a facilitative approach to compliance in relation to the 'carrying on a business' test for the 2016-17 year. That is, we will not select companies, or their shareholders, for audit based on the company's determination of whether they were carrying on a business in the 2016-17 income year, unless that decision was plainly not reasonable.

From <https://www.ato.gov.au/General/New-legislation/In-detail/Direct-taxes/Income-tax-for-businesses/Reducing-the-corporate-tax-rate/>

But going forward, from 1 July 2017 we know what or company tax rate will be. But is it possible to have all the income of a company taxed at 27.5% but all dividends at 30%

### **Example 3**

*Ken and Vicky Investments is carrying on a business that earns \$100,000 a year on a turnover of \$200,000. The only passive income is \$1 of interest each year.*

*The tax payable each year will be at 27.5% as it is a base rate entity. The company retains all the profits.*

*But in a year in the future the owners close the business down and in that year the only income is \$1 interest. As this is the only income the company is no longer a base rate entity and so the interest is taxed at 30% (or 30 cents).*

*If the retained profits are paid out as dividends in the subsequent year, even though they were all taxed at 27.5%, the imputation rate will be 30%.*