

Government tries to fix the glitch in company tax cut. Does it make things worse?

Earlier in 2017, the Government introduced legislation to cut all company tax rates progressively from 30% to 25%, over the next decade. They did not get the full suite of tax cuts through the Senate but the Parliament did pass amended legislation providing tax cuts for smaller companies conducting a business. Unfortunately, there was a glitch in how eligible companies were determined. The Government has now introduced amending legislation to the Parliament to fix that glitch but there may be problems remaining.

Under the current law, companies that operate a business have their tax rate cut to 27.5% where:

- Aggregated turnover was less than \$10 million for the last financial year (2016/17)
- It is less than \$25 million for this year (2017/18), and
- It is less than \$50 million for next year (2018/19).

Broadly, aggregated turnover means the turnover of the company aggregated with its connected entities and affiliates and entities will be connected where there is a common 40% stake.

Also, for those companies in quite a few years' time, the company tax rate reduces further:

- To 27% in 2024/25
- 26% the year after that (2025/26), and
- 25% in 2026/27.

Big companies have missed out now but the government may have another go at getting the legislation for those larger enterprises through the Parliament at some stage in the future. A lot of the economic benefit from the overall, proposed tax cut regime happens at the larger company level because of increased foreign investment expected there.

There was a technical glitch in the tax legislation in that:

- The Government only wanted the tax cuts to go to companies actively running a trading enterprise
- The current legislation draws that distinction by using the word "business"
- Over many decades, the courts have ruled that a company is most likely by default to be operating a business even if it only receives passive income such as dividends, rents and interest, and
- The Government did not want those more passive companies access the early tax cuts.

On 18 October, the Government brought new legislation to the Parliament to fix this glitch for current and future income years. On the same day, the Tax Office issued a draft ruling defining when a company is in business under this reduced tax rate legislation, to cover off last year, 2016/17.

Under the Bill, a company can only access the lower corporate tax rate for current and future income years where no more than 80% of the company's assessable income is passive income. The Bill also drops the "business" test from this income year.

Here is a table that sets out the rates and thresholds for last year, this year and future years under

this new Bill.

Income year	Lower corporate tax rate	Aggregated turnover threshold	Other condition
2016/17	27.5%	< \$10 m	Company is a small business entity
2017/18	27.5%	< \$25 m	Base rate passive income is no more than 80% of assessable income
2018/19 - 2023/24 (six years)	27.5%	< \$50 m	Base rate passive income is no more than 80% of assessable income
2024/25	27%	< \$50 m	Base rate passive income is no more than 80% of assessable income
2025/26	26%	< \$50 m	Base rate passive income is no more than 80% of assessable income
2026/27	25%	< \$50 m	Base rate passive income is no more than 80% of assessable income

As you can see, it takes a long time for the tax cut to be fully realised and things stay on hold for six years!

What is base rate passive income under these new rules? Here is another table that provides the definition.

Includes	Excludes
Dividends	Non-portfolio dividends (shareholder has 10% or more of voting rights)
Franking credits	Franking credits attached to non-portfolio dividends
Non-share dividends	
Interest	
Royalties	
Rent	
Div. 16E gains	
Net capital gains	
Partnership distribution component that is referable to upstream base rate passive income	Distribution component not referable to upstream base rate passive income in the distribution chain (e.g. active partnership business income)
Trust distribution component that is referable to upstream base rate passive income	Distribution component not referable to upstream base rate passive income in the distribution chain (e.g. active trust business income)

Understanding that interest, royalties and rents are treated as base rate passive income under these new rules is fairly straight forward. Net capital gains is being treated in this way is also understandable. Broadly, Division 16 E gains are a form of deferred interest that also accords with the notion of passive income. Non-share dividends are taxable income arising from a contractual or

other arrangement that is deemed to be equity under the debt/equity rules. Dividends and associated franking credits will be base rate passive income unless the company receiving dividends holds 10% or more of the voting rights of the dividend payer (That is defined as a non-portfolio dividend). This is intended to allow holding companies of small business corporate groups to access the lower rate.

Under the new rules, partnership and trust distributions received by a company you will need to be dissected between these passive components and active partnership or trust business income. The active business income component will not be base rate passive income.

Unfortunately, when these types of distinctions introduced to the tax law, things get very complicated.

We foresee a problem when subsidiaries pay dividends inconsistently, partnerships make a loss or small business discretionary trusts vary the distributions of income and include a “bucket company” from time to time. In those circumstances, a company may move in and out of the lower corporate tax rate causing great complications when calculating the franking account.

One big disadvantage from this tax cut is that companies will only be able to frank dividends at the applicable, lower rate in the applicable year and shareholders will have to pay more top-tax. Perhaps the government would have been better leaving the “business” test in place.

22 October 2017

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