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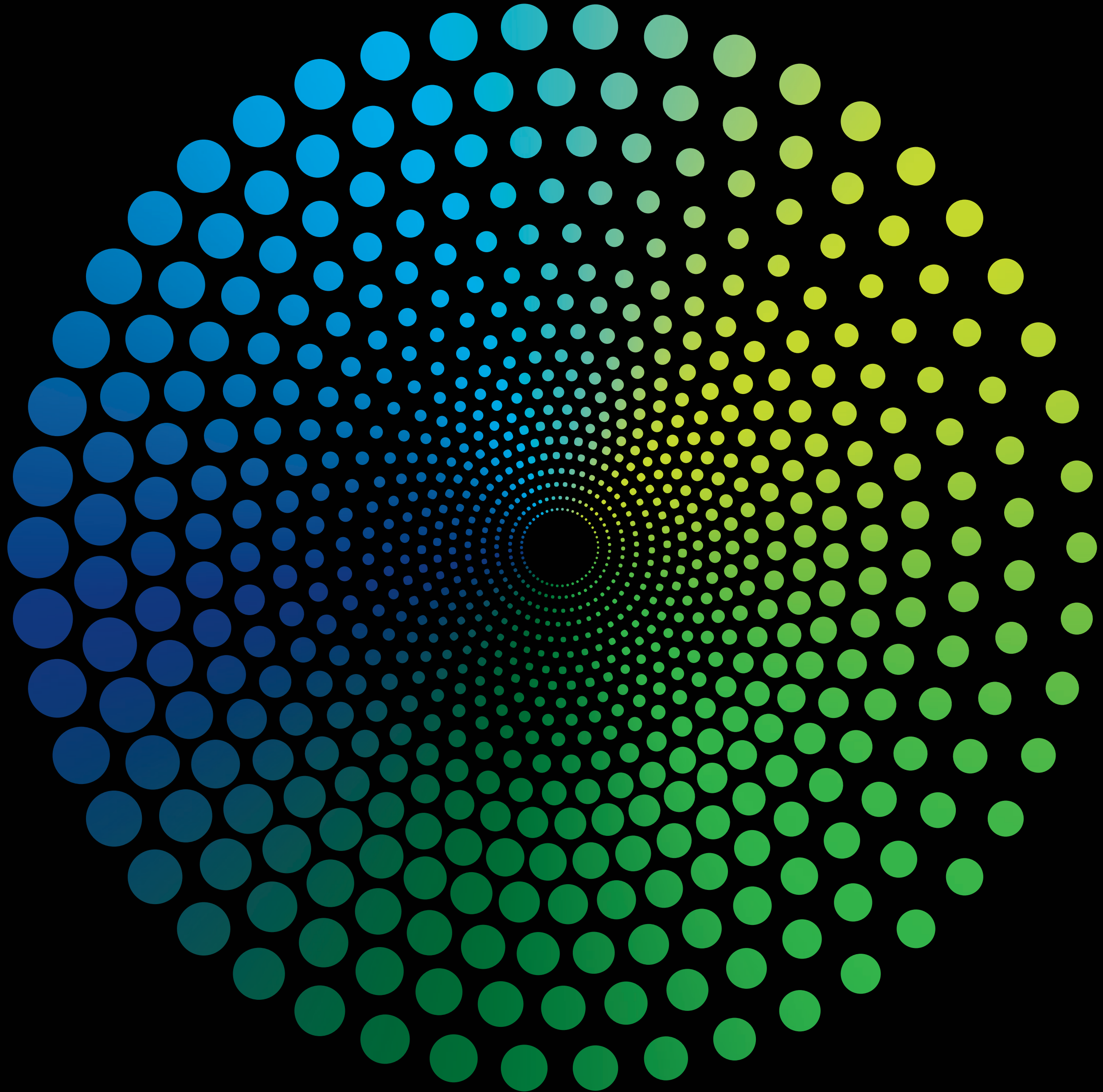
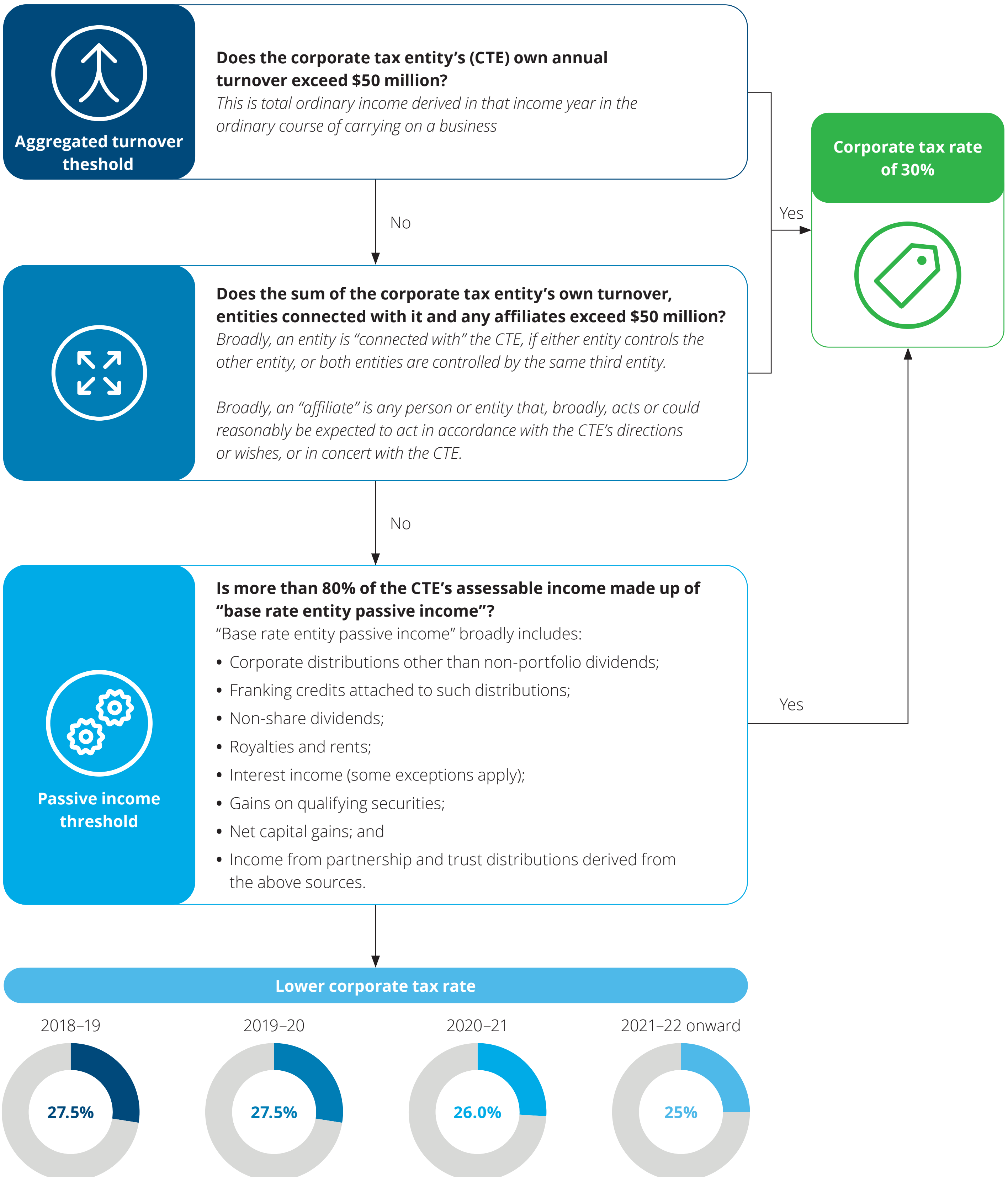


Tax Essentials
Understanding which corporate tax rate to use

January 2020 | Australia

Corporate tax rate decision tree for 2018–19 onwards



Snapshot

The Government's "Enterprise Tax Plan" as initially proposed sought to cut the company tax rate for all companies to 25% over the course of ten years. However, heated political debate led to the plan being restricted to broadly **small and medium-sized companies with a turnover of less than $50 million ("base rate entities").**

The final legislation accelerated the cuts to apply a **25% rate** to all "**base rate entities**" from the 2021–22 income year and for all subsequent income years.

This Tax Essentials steps through the various **qualifying factors** for companies to access the lower tax rate in each income year, including:

- The **aggregated turnover threshold**; and
- The **passive income threshold**.

Further, we note the implications for franking because of the changing tax rates.

Who qualifies for a lower tax rate?

Base rate entities

Only a "*base rate entity*"[1] can qualify for the lower corporate tax rate. This definition has two requirements:

1. The company's **aggregated turnover** is below the threshold; and
2. The company satisfies the **passive income threshold**.

Aggregated turnover threshold

To be a "base rate entity" and qualify for a lower tax rate, companies must have an "***aggregated turnover***" (a **defined term**) below the threshold. This threshold changes according to the income year, however, from the 2018–19 income year onward, the turnover threshold is $50 million.

1. The definition of a "base rate entity" applies to income years from **2017–18 onward**. For the income years **2015–16 and 2016–17**, a business had to be a "***small business entity***" to benefit from the lower tax rate.

A company's aggregated turnover is the sum of:[2]

- The company's **own annual turnover**; and
- The annual turnover of entities "*connected with*" the company; and
- The annual turnover of any "*affiliate*" of the company.

Broadly, annual turnover is the **total ordinary income derived that income year** in the ordinary course of carrying on the business.

Broadly, an entity is "***connected with***" the company, if either entity controls the other entity, or both entities are controlled by the same third entity. For instance; by **owning at least 40% of the interests**, or having the right to receive at least **40% of its distributions**.

Broadly, an "***affiliate***" is any person or entity that, broadly, **acts or could reasonably be expected to act in accordance** with the company's directions or wishes, or in concert with the company.

Passive income threshold

If a company satisfies the aggregate turnover threshold, it must **also** satisfy the passive income threshold to qualify as a "base rate entity". This test is satisfied if **no more than 80%** of the company's **assessable income** is made up of "***base rate entity passive income***" (a defined term).

"*Base rate entity passive income*" broadly includes:[3]

- Corporate distributions (and franking credits);
- Royalties and rents;
- Interest income (some exceptions apply – see below);
- Gains on qualifying securities;
- Net capital gains; and
- Income from partnership and trust distributions derived from the above sources.

Non-portfolio dividends are excluded;[4] these are, broadly, dividends from companies in respect of a 10% or greater voting interest.

The **tests must be applied annually**. Corporate tax entities that are close to the thresholds may have **differing rates of tax between income years**. This could cause consequent franking issues (see below).

Law Companion Ruling 2019/5 – Base rate entities and base rate entity passive income

The ATO released a Law Companion Ruling (LCR) on 13 December 2019, describing how the Commissioner would apply the law to "base rate entities" from the 2017–18 income year onward.

The ruling considers the meaning of certain types of base rate entity passive income. Several examples are included to illustrate the rules.

- **Interest**: Interest income is generally considered "*passive*", unless it is derived by a financial institution, a registered body providing finance, or businesses that are Australian credit licensees or financial services licensees. Interest to the extent it is a return on equity will not be base rate entity passive income.
- **Royalties**: The LCR notes that the definition of "royalties" is extended to include specified payments. This definition includes the right to use industrial, commercial or scientific equipment.
- **Rent**: Rent takes its ordinary meaning and is the consideration payable by a tenant to a landlord for the exclusive possession and use of land or premises. The LCR refers to the Commissioner's view as set out in TD 2006/78.
- **Net capital gain**: The LCR states that the value of net capital gains are calculated for the purpose of the passive income threshold normally under section 102-5 of the ITAA 1997. This is adjusted for any capital losses and small business concessions where applicable.
- **Trusts and partnerships**: Where a company receives income from a trust or as a partner, this income is passive to the extent that the income was passive in the hands of the trustee or partnership. Where a franked dividend paid to a trustee of a trust is streamed to a company beneficiary, it cannot be a non-portfolio dividend as the dividend is not directly paid to a company that has a voting interest of at least 10% of the voting power in the company paying the dividend.
- **Non-share dividends**: Non-share dividends are defined in s 974-120 of the ITAA 1997. These are broadly returns on non-share equity interests.

2. *Income Tax Assessment Act 1997*, s 328-115
3. *Income Tax Rates Act 1986*, s 23AB(1).
4. *ITRA 1986*, s 23AB(1)(a), Income Tax Assessment Act 1936, S317

Tax rate table

The legislated tax rates are as follows:

Income year	Aggregated turnover threshold	Lower tax rate	Non qualifying corporate tax entity rate	Qualifying entity
2015–16	$2m	28.5%	30.0%	"Small Business Entity"
2016–17	$10m	27.5%	30.0%	"Small Business Entity"
2017–18	$25m	27.5%	30.0%	"Base Rate Entity"
2018–19 and 2019–20	$50m	27.5%	30.0%	"Base Rate Entity"
2020–21	$50m	26.0%	30.0%	"Base Rate Entity"
2021–22 onward	$50m	25.0%	30.0%	"Base Rate Entity"

Franking effects

For dividend imputation, from the **2016–17 income year onward**, the maximum franking credit that can be attached to a distribution is relative in the "***corporate tax rate for imputation purposes***".[5]

Essentially, this rate is the **expected current year corporate tax rate**, assuming that the aggregated turnover, assessable income, and base rate entity passive income will be the same as the previous income year.[6]

For some taxpayers, changes in the aggregated turnover thresholds, annual turnover or passive income, can result in a mismatch of the corporate tax rate and franking rate in particular years, sometimes trapping franking credits in the company.

Companies subject to the tax rate changes should review their franking and retained profits position to consider their dividend strategy.

ATO Guidance "Carrying on a business"?

The "***carrying on a business*" test no longer applies for tax rate purposes**. This test was used to determine what was a "small business entity" instead of the passive income test, **in income years 2015–16 and 2016–17**. To address any uncertainty surrounding when a company was "carrying on a business" for these purposes, the ATO released a tax ruling, TR 2019/1.

The tax ruling notes that there is no precise test for whether a person is carrying on a business. The answer will turn on the **facts of each case**, regarding several **indicia**, including:

- Profit-making purpose;
- Repetition and regularity;
- Organisation in a systemic manner;
- Size and scale of operations; and
- Changes in activity and purpose.

The ruling concludes that certain businesses are presumed to be carrying on a business. For example, if a **company** is established and maintained to make a profit, and/or 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. This presumption may be rebutted, if it can be shown that, on the facts, the company had no aim or prospect of making a profit.

5. *ITAA 1997*, s 995-1(1)(a).
6. *Note*: For the **2015–16 income year only**, the maximum franking credit that could be attached to a distribution is worked out by reference to the 30% corporate tax rate. This included "*small business entities*", although their company tax rate was 28.5%.

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