LOWE LIPPMANN
Chartered Accountants & Business Advisors

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TAX ALERT: NEW PASSIVE INCOME TEST TO ACCESS THE REDUCED CORPORATE TAX RATE

Introduction

On 18 October 2017, the Government introduced the *Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017*. This Bill proposes that corporate entities with no more than 80% passive income will be eligible for the lower corporate tax rate.

Provided the Bill passes both houses of Parliament, it will apply prospectively from the 2017-18 income year, commencing on 1 July 2017.

Current eligibility

A company is eligible for the concessional tax rate if it is:

- for the 2016–17 income year — a small business entity (**SBE**); and
- from the 2017–18 income year — a base rate entity (**BRE**).

A company is an SBE for an income year if:

- it carries on a business in the current year; and
- either its previous year or current year (2016–17) turnover is less than $10 million.

Currently, a company qualifies for the reduced corporate tax rate of 27.5% if they are a corporate tax entity that is a BRE. A company is a BRE for an income year if:

- it carries on a business in the income year; and
- its aggregated turnover for the 2017-18 income year is less than $25 million ($50 million from 2018–19).

The BRE definition tests only the current year's aggregated turnover; the previous year's turnover is not relevant. This contrasts with the SBE definition which allows an examination of either the current year's or previous year's turnover in determining whether the turnover test is satisfied.

Proposed additional condition

The Bill imposes an additional condition to the turnover and business tests.

Under the proposed changes, a corporate tax entity will qualify for the lower corporate tax rate for an income year if:

- it carries on a business in the income year (above);
- it meets the aggregated turnover threshold test (above); and
- no more than 80% of its assessable income for that income year is "passive".

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Passive income is defined to include (amongst other things); portfolio dividends, interest, royalties, rent, capital gains and trust and partnership distributions sourced from such income.

Potential issues to consider

We note the following potential issues in relation to the proposed changes:

- It will apply retrospectively to the start of 2016-17 income year, and therefore may require amendment to 2017 company tax returns already lodged;
- It may also lead to an increase in compliance costs for small businesses, if they start:
  - monitoring their turnover across all related entities to determine if they have breached the turnover threshold;
  - monitoring the mix of different income streams each year to determine if they have breached the 80 percent "passive income threshold";
  - tracing trust distributions through one or more trusts back to their original source to determine the character of income;
- The Bill does not address the issue that companies that qualify for the reduced tax rate can only frank dividends at 27.5 percent, notwithstanding that they may have paid tax on their retained profits at 30 percent. Some companies may therefore prefer to stay outside the reduced tax rate regime in order to be able to pass on greater franking credits; and
- Some significant active businesses that would otherwise be entitled to the lower tax rate may miss out, even though their business activities would not typically be regarded as passive (e.g. companies with significant property portfolios that principally derive rent may not qualify).

Conclusion

These proposed changes will impact corporate taxpayers in different ways, and there may be some winners and some losers.

Affected taxpayers will need to consider their position carefully to ensure both the tax rate and franking credit implications are understood.

Please do not hesitate to contact your Lowe Lippmann Relationship Partner if you wish to discuss any of these matters further.

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