EXPOSURE DRAFT

TREASURY LAWS AMENDMENT (ENTERPRISE TAX PLAN BASE RATE ENTITIES) BILL 2017

EXPLANATORY MEMORANDUM

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
Rates Act	*Income Tax Rates Act 1986*

Chapter 1
Enterprise tax plan base rate entities

Outline of chapter

1.1 This Bill amends the *Income Tax Rates Act 1986* (the Rates Act) to ensure that a corporate tax entity will not qualify for the lower corporate tax rate if 80 per cent or more of its assessable income is income of a passive nature.

Context of amendments

1.2 As part of the Government's Enterprise Tax Plan, the corporate tax rate for small corporate tax entities has been cut to 27.5 per cent. This lower corporate tax rate applies to a corporate tax entity that carries on a business and:

- for the 2016-17 income year — has an aggregated turnover of less than $10 million;
- for the 2017-18 income year — has an aggregated turnover of less than $25 million; and
- for the 2018-19 income year — has an aggregated turnover of less than $50 million.

1.3 Under the second phase of the Enterprise Tax Plan, the aggregated turnover that applies for corporate tax entity to qualify for the lower corporate tax rate is increased annually until it reaches $1 billion in the 2022-23 income year. In the 2023-24 income year, the corporate tax rate will be 27.5 per cent all corporate tax entities. The corporate tax rate will then be progressively lowered in stages until it reaches 25 per cent for the 2026-27 income year and for subsequent income years.

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

Summary of new law

1.5 This Bill amends the Rates Act to ensure that a corporate tax entity will qualify for the lower corporate tax rate for an income year only if:

- the corporate tax entity carries on a business in the income year;
- the aggregated turnover of the corporate tax entity for the income year is less than the aggregated turnover threshold for that income year; and
- the corporate tax entity does not have passive income for that income year of 80 per cent or more of its assessable income for that income year.

Comparison of key features of new law and current law

New law	*Current law*
A corporate tax entity will qualify for the lower corporate tax rate for an income year only if: • the corporate tax entity carries on a business in the income year; • the aggregated turnover of the corporate tax entity for the income year is less than the aggregated turnover threshold for that income year; and • the corporate tax entity does not have passive income for that income year of 80 per cent or more of its assessable income for that income year.	A corporate tax entity will qualify for the lower corporate tax rate for an income year only if: • the corporate tax entity carries on a business in the income year; and • the aggregated turnover of the corporate tax entity for the income year is less than the aggregated turnover threshold for that income year.

Detailed explanation of new law

1.6 A corporate tax entity will qualify for the 27.5 per cent corporate tax rate for an income year only if the corporate tax entity is a base rate entity for that income year. ***[Schedule 1, items 2 to 9 and 11 to 13, section 23AA of the Rates Act]***

1.7 A corporate tax entity is a ***base rate entity*** for an income year only if:

- the corporate tax entity carries on a business in the income year;
- the aggregated turnover of the corporate tax entity for the income year is less than:
  - for the 2016-17 income year **—** $10 million;
  - for the 2017-18 income year **—** $25 million;
  - for the 2018-19 income year **—** $50 million; and
- the corporate tax entity does not have base rate entity passive income for that income year of 80 per cent or more of its assessable income for that income year.

[Schedules 1, items 1, 10 and 14, definition of 'base rate entity' in subsection 3(1) and section 23AA of the Rates Act]

1.8 An amount of income is ***base rate entity passive income*** of a corporate tax entity if it is:

- a *distribution* (as defined in section 960-120 of the *Income Tax Assessment Act 1997* (ITAA 1997)) made by a corporate tax entity, other than a *non-portfolio dividend* (within the meaning of section 317 of the ITAA 1936);
- a *non-share dividend* (as defined in section 974-115 of the ITAA 1997) made by a company;
- *interest income* (as defined in subsection 6(1) of the ITAA 1936) **—** this will ensure that interest derived by, for example, an approved deposit-taking institution is not passive income;
- a royalty;
- rent;
- a gain on a *qualifying security* (as defined in Division 16E of Part III of the ITAA 1936);
- a *capital gain* (as defined in subsection 995-1(1) of the ITAA 1997);

- an amount that flows through a partnership (under Division 5 of Part III of the ITAA 1936) to the extent that it is attributable to an amount that is passive income; or

- an amount that flows through a trust (under Division 6 of Part III of the ITAA 1936) to the extent that it is attributable to an amount that is passive income.

[Schedule 1, items 1 and 10, definition of 'base rate passive income' in subsection 3(1) and section 23AB of the Rates Act]

1.9 In this regard, in relation to paragraph 23AB(a), a distribution made by a corporate tax entity includes dividends, and amounts that are taken to be dividends under the income tax law, made by a company (item 1 of the table in subsection 960-120(1) of the ITAA 1997).

1.10 In addition, a *non-portfolio dividend* (within the meaning of section 317 of the ITAA 1936) is not base rate entity passive income. A non-portfolio dividend is, broadly, a dividend paid to a company where that company has a voting interest amounting to at least 10 per cent of the voting power in the company paying that dividend. Consequently, dividends derived, for example, by a holding company which are made by a wholly-owned subsidiary company that carries on active trading business will not be base rate entity passive income of the holding company.

Consequential amendments

Consequential amendments to the ITAA 1997

Lower corporate tax rate applies base rate entities

1.11 For the 2016-17 income year, these amendments will result in the 27.5 per cent corporate tax rate being applied to an entity that is a base rate entity (rather a small business entity). The amendments effectively bring forward the concept of a base rate entity by one year. A range of consequential amendments are required to reflect this change.

1.12 First, a number of examples in the income tax law to illustrate the operation of certain provisions reflect the top corporate tax rate of 30 per cent. Consequential amendments are made to modify these examples so that they refer to an entity that is not a base rate entity.
[Schedule 2, items 1 to 3 and 6, examples in subsections 36-17(5), 36-55(1) 36-55(2) and 115-280(3) of the ITAA 1997]

1.13 Second, consequential amendments to the tax offset carry forward rules will ensure that those rules apply appropriately to an entity that is a base rate entity. ***[Schedule 2, items 4 and 5, paragraphs 65-30(2)(a) and 65-35(3A)(a) of the ITAA 1997]***

Operation of the imputation system

1.14 Under the company imputation system, when an Australian corporate tax entity distributes profits to its members, the entity has the option of passing to those members credit for income tax paid by the entity on the profits. This is done by franking the distribution.

1.15 The amount of franking credits that can be attached to a distribution cannot exceed the *maximum franking credit* for the distribution (section 202-60 of the ITAA 1997). The maximum franking credit is worked out by reference to the *corporate tax gross-up rate*, which is defined in subsection 995-1(1) by reference to the *corporate tax rate for imputation purposes*.

1.16 Corporate tax entities usually pay distributions to members for an income year during that income year. However, a corporate tax entity will not know its aggregated turnover, the amount of its passive income, or the amount of its assessable income for an income year until after the end of that income year. Therefore, generally, for the purposes of working out its corporate tax rate for imputation purposes for an income year, a corporate tax entity must assume that:

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

[Schedule 2, item 7, paragraph (a) of the definition of 'corporate tax rate for imputation purposes' in subsection 995-1(1) of the ITAA 1997]

1.17 However, if the corporate tax entity 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 per cent. ***[Schedule 2, item 7, paragraph (b) of the definition of 'corporate tax rate for imputation purposes' in subsection 995-1(1) of the ITAA 1997]***

Example 1.1

Company A is carrying on a business and, in the 2016-17 income year, has:

- aggregated turnover of $8 million;
- base rate passive income of $7.5 million; and
- assessable income of $8 million.

Therefore, for the 2016-17 income year, 92.59 per cent of Company A's assessable income is base rate entity passive income. Consequently, for that income year, Company A's corporate tax rate is 30 per cent (even though its aggregated turnover is only $8 million).

Company A proposes to pay a dividend to its shareholders in the 2017-18 income year. For the purpose of working out its corporate tax rate for imputation purposes for the 2017-18 income year, Company A must assume that its aggregated turnover, base rate passive income and assessable income are the same as for the 2016-17 income year.

As 92.59 per cent of its assessable income was base rate entity passive income for the 2016-17 income year, Company A's corporate tax rate for imputation purposes is 30 per cent. Therefore, Company A's corporate tax gross-up rate for that income year will be 2.33 (that is, (100% — 30%)/30%).

Company A makes a fully franked distribution of $100 per share in the 2017-18 income year. The maximum franking credit that can be attached to that distribution is $42.91 (that is, $100/2.33). Company A makes the dividend payment on 31 March 2018.

Amy holds 50 shares in Company A and receives a dividend of $5,000. Franking credits of $2,145 are attached to the dividend. For the 2017-18 income year, Amy includes $7,145 in her assessable income in relation to the dividend she has received from Company A — that is:

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

Amy is entitled to a refundable tax offset equal to the amount of the franking credits. Amy's total assessable income for the 2017-18 income year is $30,000 (so that her marginal tax rate is 19 per cent). Therefore, (ignoring medicare levy) the tax payable by Amy on the franked dividend is $1,357.55. The excess franking credits ($787.45) will be:

- applied to reduce Amy's other tax liabilities; or

- if she has no other tax liabilities, refunded to Amy.

Emma also holds 50 shares in Company A and receives a dividend of $5,000. Franking credits of $2,145 are attached to the dividend. For the 2017-18 income year, Emma includes $7,145 in her assessable income in relation to the dividend she has received from Company A — that is:

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

Emma is entitled to a refundable tax offset equal to the amount of the franking credits. Emma's total assessable income for the 2017-18 income year is $120,000 (so that her marginal tax rate is 37 per cent). Therefore, (ignoring medicare levy) the tax payable by Emma on the franked dividend is $2,643.65. Consequently, Emma will need to pay additional tax of $498.65 on the franked dividend that she has received from Company A.

Consequential amendments to the *Treasury Laws Amendment (Enterprise Tax Plan) Act 2017*

1.18 To bring forward the concept of a base rate entity by one year, these amendments replace some of the provisions in the *Treasury Laws Amendment (Enterprise Tax Plan) Act 2017*. Therefore, consequential amendments will repeal amendments made by that Act that are now redundant. ***[Schedule 2, items 9 to 12]***

Consequential amendments to the Rates Act

1.19 Under the second phase of the Enterprise Tax Plan, in the 2023-24 income year, the corporate tax rate will be 27.5 per cent all corporate tax entities, with the consequence that there will no longer be a need to identify an entity that is a base rate entity.

1.20 Consequently, if the *Treasury Laws Amendment (Enterprise Tax Plan No. 2) Act 2017* comes into force and commences, the definition of *base rate passive income* will be repealed with effect from the 2023-24 income year. ***[Item 7 of the table in subsection 2(1); Schedule 2, items 13 to 15]***

Application and transitional provisions

1.21 The amendments apply to the 2016-17 income year and later years of income and, broadly, commence on 1 July 2016. ***[Subsection 2(1); Schedule 1, item 15; Schedule 2, item 8]***

1.22 The application of the amendments to the 2016-17 income year is necessary to clarify the eligibility for the lower corporate tax rate. This change will make it easier for all small business entities to self-assess their eligibility for the lower corporate tax rate.