Trusts and two-tiered company tax rates

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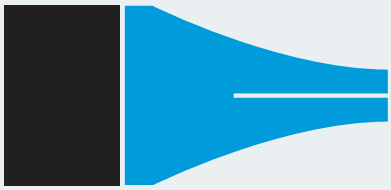

Two-tiered company tax rates create compliance and practical issues for trusts that distribute to bucket companies — not just for companies.

The lowering of the company tax rate to 27.5% for certain companies has implications not just for eligible companies, but also for trustees and beneficiaries of trusts. This article considers:

- eligibility for the lower company tax rate;
- how imputation works with two-tiered company tax rates (together with examples); and
- the practical implications for trusts as they approach 30 June 2018, including a question about whether the rules work in the context of trusts distributing to companies.

How did we get here?

The government lowered the company tax rate to 27.5% for eligible companies, with effect from the 2017 income year. Eligibility for the lower rate in the 2017 year requires that the company "carries on a business" and has "aggregated turnover" of less than $10m. The turnover threshold increases to $25m in the 2018 income year (and the government intends a $50m threshold for the 2019 income year).

In November 2016, the High Court handed down its decision in *Bywater*[1] (a case concerning corporate residency), and in March 2017, the Australian Taxation Office released TR 2017/D2 on the *Bywater* decision. Footnote 3 of TR 2017/D2 stated:

> "… generally, where a company is established or maintained to make a profit or gain for its shareholders it is likely to carry on business … This is so even if the company only holds passive investments, and its activities consist of receiving rents or returns on its investments and distributing them to shareholders."

Those comments in TR 2017/D2 on companies carrying on business, together with the increased turnover threshold of $10m ($2m for a 28.5% tax rate in 2016), led to speculation that "bucket companies", including those purely in receipt of trust distributions, may be eligible for the lower company tax rate.

On 4 July 2017, the Minister for Revenue and Financial Services, the Hon. Kelly O'Dwyer, issued a media release stating that "the policy decision made by the government to cut the tax rate for small companies was not meant to apply to passive investment companies",[2] and on 18 September 2017, the Treasury released exposure draft legislation that was to have applied (if passed) for the 2017 and 2018 income years to give effect to the policy intention stated on 4 July 2017 by Minister O'Dwyer.[3]

Under the exposure draft, eligibility for the lower company tax rate required:

- the company to be carrying on a business (undefined) in the income year;
- the aggregated turnover of the company to be less than the relevant turnover threshold for the income year; and
- the company's passive income to be less than 80% of its assessable income for that year.

Submissions on the exposure draft focused on technical errors, together with the exposure draft doing nothing to clarify when a company "carries on a business" for eligibility purposes.

Given this ongoing uncertainty, on 18 October 2017:

- the government introduced the Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017 (the Bill) into parliament which, if passed and assented to, will apply for the 2018 and later income years; and
- the ATO released TR 2017/D7 which outlines the ATO's preliminary view on when a company will be carrying on a business for purposes of eligibility for the lower company tax rate in the 2017 income year.

If enacted as drafted, the Bill will amend s 23AA of the *Income Tax Rates Act 1986* (Cth) with a "bright line" test for eligibility for the lower company tax rate, with effect from 1 July 2017. The test will ensure that a company that meets the turnover threshold ($25m in the 2018 income year) will not qualify for the lower company tax rate if more than 80% of its assessable income is passive income (such as interest, rent, dividends, royalties, or net capital gains). Unlike in the exposure draft and the requirements for the 2017 income year, for the 2018 income year, there will *not* be a "carrying on a business" requirement.

For the 2017 income year, to be eligible for the lower company tax rate, the company will need to be "carrying on a business" and have aggregated turnover of less than $10m. Rather than the proposed change set out in the exposure draft and the change in the Bill for the 2018 income year, for the 2017 income year, there is *not* a restriction on the amount of passive income derived by the company.

To (hopefully) help with deciding when a company is "carrying on a business" for the 2017 income year, the ATO released TR 2017/D7 which contains the ATO's preliminary views on that question, together with examples.

Bright line test for the 2018 income year onwards

A company will qualify for the lower company tax rate 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 threshold for that year.

Broadly, "base rate entity passive income" means assessable income that is any of the following:

- distributions by corporate tax entities,[4] other than non-portfolio dividends;
- non-share dividends (distributions on instruments classified as equity for tax purposes);
- franking credits;
- interest (other than certain interest derived by financial institutions), royalties and rent;
- gains on qualifying securities;
- net capital gains (thereby excluding disregarded capital gains and after capital losses); and
- partnership or trust distributions to the extent that partnership or trust income is referable (directly or indirectly) to "base rate entity passive income".

The requirement that passive income is assessable income before the passive income can be base rate entity passive income means that passive income that is either exempt income or non-assessable non-exempt income would not be base rate entity passive income.

If the Bill is enacted as currently drafted:

- a "bucket company" in receipt of distributions of active income (or that has less than 80% of base rate entity passive income) will be eligible for the lower company tax rate if the company satisfies the turnover threshold;
- a company that actively manages (say) a portfolio of rental properties would not be eligible for the lower tax rate if rental income (and other base rate entity passive income) is more than 80% of assessable income; and
- companies that sell a business and make a net capital gain may not be eligible for the lower company tax rate due to the net capital gain being base rate entity passive income.

The tracing requirement for companies in receipt of trust and partnership distributions may result in increased compliance costs in terms of accounting fees and having to amend trust deeds and pro forma resolutions (see below).

2017 income year: "carries on a business" with new ATO guidance

For the 2017 income year, to be eligible for the lower company tax rate, a company will need to be "carrying on a business" and have aggregated turnover of less than $10m. As noted above, to assist with deciding when a company is "carrying on a business" for the 2017 income year, the ATO released TR 2017/D7. Consultation on TR 2017/D7 closed on 1 December 2017.

TR 2017/D7 only applies to companies (other than companies limited by guarantee) incorporated under the *Corporations Act 2001* (Cth) and excludes companies in their capacity as trustee of a trust, corporate limited partnerships, and public trading trusts.

TR 2017/D7 runs to 25 pages and includes many examples. However, TR 2017/D7 as drafted concludes that, where a company is established and maintained to make a profit for its shareholders, and 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 and therefore to be carrying on a business for the purposes of the lower company tax rate.[5]

Coinciding with the release of the Bill and TR 2017/D7, on 18 October 2017, the Hon. Kelly O'Dwyer stated in a media release that the ATO advised that it will adopt a facilitative approach to compliance in relation to the "carrying on a business" test for the 2017 year.[6] That is, the ATO will not select companies for audit based on the company's determination of whether they were carrying on a business in the 2017 income year unless the company's decision is "plainly unreasonable".

It will be interesting to see if what the ATO thinks is "plainly unreasonable" is the same as what advisers think.

Imputation in a system of two-tiered company tax rates

For dividend imputation purposes, the Bill, if passed, will amend the *Income Tax Assessment Act 1997* (Cth) so that the tax rate used in franking calculations will be based on the company tax rate for the income year, but assuming that aggregated turnover, base rate entity passive income, and assessable income are the same as in the prior year.

In light of the changes, it is worth assessing how the imputation system applies in the context of two-tiered company tax rates. This requires working our way through several definitions.

By way of a refresher, pursuant to Subdiv 202-D of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), the maximum franking credit on a distribution is equal to:

$$\text{Amount of the frankable distribution} \times \frac{1}{\text{Applicable gross-up rate}}$$

Section 203-50 ITAA97 defines the "applicable gross-up rate" as the "corporate tax gross-up rate" of the entity making the distribution for the income year in which the distribution is made.

Section 995-1 ITAA97 defines the "corporate tax gross-up rate" as the amount worked out using the following formula:

$$\frac{\text{100\% – Corporate tax rate for imputation purposes of the entity for the income year}}{\text{Corporate tax rate for imputation purposes of the entity for the income year}}$$

Section 995-1 defines the "corporate tax rate for imputation purposes" as the tax rate that applies for the income year:

- assuming that the entity's aggregate turnover for the income year is the same as for the previous income year; or
- if the entity did not exist in the previous income year, the "default" company tax rate of 30%.

The Bill amends the definition of "corporate tax rate for imputation purposes" but only as far as to assume that the entity's aggregate turnover, base rate entity passive income, and assessable income (as those terms are used when determining eligibility for the lower company tax rate) are the same as in the previous year.

The effect is that:

- if a company was on a tax rate of 30% in the 2017 income year, the maximum franking credit on dividends in the 2018 income year will be 30% unless the company's turnover in 2017 was less than the 2018 turnover threshold of $25m (and the company does not have more than 80% of base rate entity passive income), in which case, the maximum franking credit on dividends in the 2018 income year will be 27.5%; or
- if a company was on a tax rate of 27.5% in the 2017 income year, the maximum franking credit on dividends in the 2018 income year will be 27.5% unless more than 80% of the company's 2017 assessable income was base rate entity passive income, in which case, the maximum franking credit on dividends in the 2018 income year will be 30%.

Examples help to illustrate these scenarios. These examples assume that the Bill

is passed in its current form and in all examples the company had taxable income of $1m.

Example 1: 30% tax rate in 2017, 30% franking rate in 2018

A company carried on a business and had a turnover of $12m in the 2017 income year (comprised solely of passive income) and so the company was on a company tax rate of 30% for 2017 (as the company's turnover was more than $10m).

The "corporate tax rate for imputation purposes" assumes that the company's turnover (and composition) for the 2018 income year is the same as in 2017 (that is, $12m of passive income). Therefore, the "corporate tax rate for imputation purposes" in the 2018 income year is 30%.

If the company pays a cash dividend of $700,000 during the 2018 income year ($1,000,000 of taxable income less 30% tax), the "corporate tax gross-up rate" will be 2.3333 (that is, (100% – 30%)/30%). The maximum franking credit that can be attached to that dividend is $300,000 (that is, $700,000/2.3333).

For a shareholder on a marginal tax rate of 45% (ignoring the Medicare levy), the grossed-up dividend will be $1,000,000 ($700,000 + $300,000), tax on the grossed-up dividend will be $450,000, and the shareholder will have a franking credit offset of $300,000 and top-up tax to pay of $150,000 (top-up tax of 15% on the grossed-up dividend).

Example 2: 30% tax rate in 2017, 27.5% franking rate in 2018

A company had a turnover of $15m of active income in the 2017 income year and so was on a company tax rate of 30% for 2017. For the 2018 income year, the turnover threshold for the lower 27.5% company tax rate increases to $25m.

The "corporate tax rate for imputation purposes" assumes that the company's turnover (and composition) for the 2018 income year is the same as in 2017 (that is, $15m of active income). Therefore, the "corporate tax rate for imputation purposes" in the 2018 income year is 27.5% as the $15m turnover is less than the $25m threshold. The 27.5% rate for imputation purposes is despite the company paying tax for the 2017 income year at 30%.

If the company pays a cash dividend of $700,000 during the 2018 income year ($1,000,000 of taxable income less the 30% tax for 2017), the "corporate tax gross-up rate" will be 2.6364 (that is, (100% – 27.5%)/27.5%). The maximum franking credit that can be attached to that dividend is $265,517 (that is, $700,000/2.6364).

For a shareholder on a marginal tax rate of 45% (ignoring the Medicare levy), the grossed-up dividend will be $965,517 ($700,000 + $265,517), tax on the grossed-up dividend will be $434,483, and the shareholder will have a franking credit offset of $265,517 and top-up tax to pay of $168,966. The company will also have a balance in its franking account of $34,483. (Perhaps the company could have borrowed to pay a larger dividend?)

Example 3: 27.5% tax rate in 2017, 27.5% franking rate in 2018

A company had a turnover of $8m of active income in the 2017 income year and so was on a company tax rate of 27.5% for the 2017 income year.

The "corporate tax rate for imputation purposes" assumes that the company's turnover (and composition) for the 2018 income year is the same as in 2017 (that is, $8m of active income). Therefore, the "corporate tax rate for imputation purposes" in the 2018 income year is 27.5%. (This would be the case even if the company's actual turnover in the 2018 income year increased to (say) $100m.)

If the company pays a cash dividend of $725,000 during the 2018 income year ($1,000,000 of taxable income less 27.5% tax), the "corporate tax gross-up rate" will be 2.6364 (that is, (100% – 27.5%)/27.5%). The maximum franking credit that can be attached to that dividend is $275,000 (that is, $725,000/2.6364).

For a shareholder on a marginal tax rate of 45% (ignoring the Medicare levy), the grossed-up dividend will be $1,000,000 ($725,000 + $275,000), tax on the grossed-up dividend will be $450,000, and the shareholder will have a franking credit offset of $275,000 and top-up tax to pay of $175,000 (top-up tax of 17.5% on the grossed-up dividend compared with 15% if the dividend was franked to 30%).

Example 4: 27.5% tax rate in 2017, 30% franking rate in 2018

A company was carrying on a business and had turnover of $8m comprised solely of passive income in the 2017 income year and so was on a company tax rate of 27.5% for 2017.

The "corporate tax rate for imputation purposes" assumes the company's turnover (and composition) for the 2018 income year is the same as in 2017 (that is, $8m of passive income). Therefore, the "corporate tax rate for imputation purposes" in the 2018 income year is 30%. (This is because while the turnover in the 2017 income year was less than the $25m threshold for 2018, the company has more than 80% base rate entity passive income.)

If the company pays a cash dividend of $725,000 during the 2018 income year ($1,000,000 of taxable income less 27.5% tax), the "corporate tax gross-up rate" will be 2.3333 (that is, (100% – 30%)/30%). The maximum franking credit that can be attached to that dividend is $310,714 (that is, $725,000/2.3333). However, the company only paid $275,000 of income tax for the 2017 income year and so the company is only able to attach a franking credit of $275,000 to the dividend. (If the company had franking credits from before the 2017 income year it may be possible for the company to frank the dividend to the maximum extent.)

For a shareholder on a marginal tax rate of 45% (ignoring the Medicare levy), the grossed-up dividend will be $1,000,000 (that is, $725,000 + $275,000), tax on the grossed-up dividend will be $450,000, the shareholder will have a franking credit offset of $275,000 and top-up tax to pay of $175,000.

Table 1 summarises the numbers.

These examples illustrate that, in an imputation system of corporate and shareholder taxation, lowering company tax rates has no effect on the tax burden for Australian resident shareholders — the higher top-up tax offsets the lower company tax. However, lower company tax rates can have a positive economic effect for foreign resident shareholders, depending on the tax treatment in their country of residence, due to fully franked dividends paid to foreign residents being exempt from further Australian tax.

What do the changes mean for trusts?

A common tax planning technique is for a trust to distribute income to a corporate beneficiary. The corporate beneficiary pays tax at the company rate and retains the income (or perhaps loans it back to, or has an unpaid present entitlement with, the trust).

Table 1. Imputation in a system of two-tiered company tax rates

	Example 1	Example 2	Example 3	Example 4
Australian resident company				
Turnover in 2017 income year	$12,000,000	$15,000,000	$8,000,000	$8,000,000
Type of income	Passive	Active	Active	Passive
Taxable income in 2017	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Company tax rate for 2017	30%	30%	27.5%	27.5%
"Corporate tax rate for imputation purposes" for 2018	30%	27.5%	27.5%	30%
"Corporate tax gross-up rate" for 2018	2.3333	2.6364	2.6364	2.3333
Maximum franking credits	$300,000	$265,517	$275,000	$310,714
Australian resident shareholder				
Cash dividend	$700,000	$700,000	$725,000	$725,000
Grossed-up dividend	$1,000,000	$965,517	$1,000,000	$1,000,000
Tax at 45% on grossed-up dividend	$450,000	$434,483	$450,000	$450,000
Franking credit offset	$300,000	$265,517	$275,000	$275,000
Top-up tax payable by the shareholder	$150,000	$168,966	$175,000	$175,000
Cash after tax	$550,000	$531,034	$550,000	$550,000
Franking credit balance	Nil	$34,483	Nil	Nil

In a two-tiered system of company tax rates, for a bucket company in receipt of trust distributions, the company will need to know the character of the trust distribution to determine whether the company pays tax at 27.5% or 30% (assuming that the company meets the turnover threshold). The tests apply annually. As such, a company that is close to the 80% threshold may have different rates of tax between income years, which could cause consequent franking issues.

The Bill says that partnership or trust distributions, to the extent that the distribution is referable (directly or indirectly) to "base rate entity passive income", will themselves be base rate entity passive income. The accompanying explanatory memorandum says that an amount that "flows" directly or indirectly to a company "will retain its character" for deciding whether the amount is base rate entity passive income.[7]

Assuming that the Bill receives assent in its current form, trustees (particularly of trusts with diversified income) that distribute to bucket companies should, before 30 June 2018, review and determine that:

- accounting systems and procedures allow the trust to identify the various types of income (together with associated deductions);
- the trust deed allows the trust to stream income (beyond franked dividends and capital gains) to beneficiaries;
- pro forma resolutions include enough information to enable a corporate beneficiary to determine the components of the distribution for company tax rate eligibility; and
- no new bucket companies are required (see below).

The Bill raises practical issues in its application beyond moving between tax rates in different years and increased compliance costs. The Bill also raises a theoretical issue regarding whether the new rules actually work without legislative clarification (unlikely) or guidance from the ATO.

First, the practical issues — bucket companies and deductions.

For trusts that have large unpaid present entitlements with corporate beneficiaries that are held on sub-trust under PS LA 2010/4, when determining the amount to distribute to the corporate beneficiary, consideration will need to be given to the income from the sub-trust arrangement in addition to the distribution from the main trust when determining the appropriate company tax rate. For trusts that have corporate beneficiaries with large unpaid present entitlements, the income from the sub-trust arrangements may necessitate incorporating a new bucket company to access the lower company tax rate. This issue will be compounded if the mooted changes to Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), from 1 July 2018, to possibly include pre-4 December 1997 loans and pre-16 December 2009 unpaid present entitlements become law.[8]

Eligibility for the lower company tax rate requires a company to compare "base rate entity passive income" (a gross amount) with assessable income. With respect to distributions from a trust (not being franked dividends or capital gains), under s 97 ITAA36, the assessable income of the company will include the company's share of the net income of the trust. Therefore, the trustee will need to identify the deductions that relate to base rate entity passive income (forming part of net income) and, if a deduction cannot be traced to a specific income stream, a reasonable basis for apportionment, for the company to determine whether it satisfies the test for the lower company tax rate.

For example, a family group includes a trust and a company. The company earns $250,000 of active income and the trust earns $850,000 of rent with $100,000 of deductions. If the trust distributes 100% of the income of the trust to the company, the company will have assessable income of

$1m (that is, $250,000 + $750,000), but the company will not be eligible for the lower company tax rate as passive income (rent) will be 85% of assessable income. Does the group incorporate a new company so that the trust can distribute only so much income that the first company is eligible for the lower rate and the second company pays 30% on the excess?

And now the theoretical issue — is income character determined by *Greenhatch*[9] or the Bill?

On the one hand, the Bill refers to an amount of a trust distribution that is "referable" to base rate entity passive income, while the explanatory memorandum to the Bill says that amounts "retain [their] character for the purposes of determining whether or not the amount is base rate base income". On the other hand, the Full Federal Court in the decision of *Greenhatch* held that, once the share of the income of the trust is determined, the share should not be used to determine the components of s 97 assessable income. The ATO in the decision impact statement for *Greenhatch* states:

> "… the Commissioner views the approach of the Full Federal Court as consistent with the proposition that absent any specific rules elsewhere in the Tax Acts, the proportionate share of the net income of a trust that is included in the assessable income of a beneficiary under section 97 of the ITAA 1936 has no character beyond that inherent in the share of the net income as being a proportionate share of *all* of the net income. In particular, absent specific statutory rules that lead to a different result (such as can now be found in Subdivision 115-C of the ITAA 1997), the character for trust law purposes of the income to which the beneficiary was made presently entitled does not inform the character of the share of the net income assessed to the beneficiary under section 97 of the ITAA 1936 for tax law purposes. *Put differently, streaming of amounts for trust law purposes by reference to the character of those amounts will only be effective for tax law purposes where that result is facilitated by specific statutory rules.*" (emphasis added)

What does *Greenhatch* (and the ATO view in the decision impact statement) mean for the application of the rules for determining eligibility for the lower company tax rate? If a trust with passive and active income distributes the passive income to (say) individual beneficiaries, and the active income to a bucket company, is the company eligible for the 27.5% company tax rate (assuming that the company has no other income)? Is the 80% test satisfied because the distribution was only of active income or does *Greenhatch* mean that the components of the distribution (the s 97 assessable income) representing active income and passive income are indeterminate (or a proportionate share of all of the income of the trust)? If the amounts are indeterminate, what does that mean for satisfying the onus of proof that the 27.5% rate applies? Section 6B ITAA36 (which deems certain trust distributions to be passive income) may be helpful in this regard.

Irrespective of what the answers are to those questions, trustees are faced with uncertainty when it comes to the application of the rules in the Bill. Given the chequered history leading up to the Bill, the author considers that legislative clarity on this point is unlikely and so taxpayers will need to turn their attention to how the ATO administers the law.

Perhaps, picking up on the 18 October 2017 media release by the Hon. Kelly O'Dwyer (see above) concerning the ATO approach to the 2017 income year, the ATO will administer the new rules on the basis that tracing is allowed so long as it is not "plainly unreasonable".

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References

1 *Bywater Investments Ltd v FCT* [2016] HCA 45.
2 The Hon. Kelly O'Dwyer, "ATO tax ruling", media release, 4 July 2017.
3 Exposure draft of the Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017.
4 For ease of exposition, "company" rather than "corporate tax entities" is used in this article.
5 On 2 November 2017, the ATO announced that TR 2017/D7 is "equally applicable" to determining whether a company is a small business entity within the meaning of s 328-110 ITAA97.
6 The Hon. Kelly O'Dwyer, "Passive investment companies excluded from lower tax rate", media release, 18 October 2017.
7 Explanatory memorandum to the Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017, paras 1.10 to 1.13.
8 See Board of Taxation, "Post-implementation review of Division 7A of Part III of the Income Tax Assessment Act 1936" and Commonwealth Budget 3 May 2016.
9 *FCT v Greenhatch* [2012] FCAFC 84.