

MR: AJ

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By email: simon.winckler@treasury.gov.au

Dear Mr Winckler

**TREASURY LAWS AMENDMENT (ENTERPRISE TAX PLAN BASE RATE ENTITIES) BILL 2017
SUBMISSION TO EXPOSURE DRAFT**

We refer to the Exposure Draft Legislation, and accompanying Explanatory Memorandum, of the *Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017* (“the Proposed Legislation”).

Having reviewed the Proposed Legislation and considered its possible application in a range of circumstances, we have prepared this submission for your consideration. Our detailed grounds of submission, which are set out in Appendix 1, are summarised as follows.

1. Removal of “carrying on a business” from definition of Base Rate Entity

We recommend the removal of the requirement that a “base rate entity” be “carrying on a business” at all.

The Government’s policy intention that the lower corporate tax rate not apply to “passive investment companies” is essentially achieved by the introduction of the passive income test in proposed paragraph 23AA(c).

Removing the definition of “carrying on a business” achieves this in relation to the flow through of active business income to holding companies and corporate beneficiaries of trusts (where a subsidiary or trust is carrying on the actual business).

Removing this requirement from the definition will eliminate uncertainties that companies may experience when self-assessing whether they are carrying on a business, and may stop some taxpayers from undertaking contrived actions so as to produce an outcome such that they meet the “carrying on a business” requirement.

2. Adjust definition of “base rate entity passive income” to clarify treatment of rent

“Rent” is not a defined term for the purposes of the income tax legislation. However, its ordinary meaning is broad enough to encompass many activities of an active, commercial character. For example, a Master Hire franchisee carrying on an equipment leasing business would be deriving base rate entity passive income under the proposed definition as drafted, and would be denied the lower tax rate, despite their turnover. This is clearly not the intended outcome of the Proposed Legislation.

As such, rather than including all rent in the definition of base rate entity passive income, we recommend that only “passive” rental income be included, possibly by reference to the definition of “eligible investment activities” applied to trading trusts, and/or the definition of “passive income” in the *Income Tax Assessment Act 1936* (“ITAA36”) with appropriate modifications.

3. Drafting errors

A number of drafting inconsistencies were noted in the exposure draft material, primarily in relation to the term “base rate entity passive income”.

Thank you for the opportunity to provide this submission. Please do not hesitate to contact the writer on 07 3233 3555 if you wish to discuss any of the points raised in greater detail.

Yours sincerely

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Appendix 1

Carrying on business - proposed paragraph 23AA(a)

An entity is regarded as a base rate entity if it meets the three conditions listed in paragraph 23AA of the Proposed Legislation.

While the legislation has introduced a passive income threshold (80% test) in proposed paragraph 23AA(c), it has failed to address the fundamental uncertainty in the application of the law, namely, when is a company “carrying on a business”.

The insertion of a passive income threshold does nothing to resolve the question of when is a company “carrying on a business” in the first place.

ATO commentary

Following the implementation of the provisions for base rate entities, the ATO’s commentary was reflected in both its draft tax ruling and in comments made on its website. In this respect, the following comments from the ATO are noted¹:

What is the ATO's view as to when a company will carry on a business?

*It is not possible to definitively state whether a particular company is carrying on a business. This is always question of fact. Based on the overall impression of the activities of a company and the relevant indicia of whether a business is carried on. However, where a company is established and maintained to make profit for its shareholders, and invests its assets in gainful activities that have a prospect of profit, then it is likely to be carrying on business. **This is so even if the company’s activities are relatively passive, and its activities consist of receiving rents or returns on its investments and distributing them to shareholders***

*While most companies will carry on a business in a general sense, this does not mean that every gain made by a company will be ordinary income and assessable under section 6-5 of the ITAA 1997. It is still necessary to determine the scope and nature of that business, in order to determine whether a gain will be an ordinary incident of that business and therefore assessable as ordinary income rather than a capital gain. (**emphasis added**).*

The comments on the ATO website follows its statement in its draft ruling TR 2017/D2 where it is stated that:

... generally, where a company is established or maintained to make 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.

¹ <https://www.ato.gov.au/General/New-legislation/In-detail/Direct-taxes/Income-tax-for-businesses/Reducing-the-corporate-tax-rate/>

Comments on ATO approach

The comments from the ATO and their interpretation of when a company is carrying on a business was at odds with the Minister for Revenue and Financial Services statement that:

As always it is up to the ATO to determine how the law applies and in this case whether a company is carrying on a business or not.

However, the policy decision made by the Government to cut the tax rate for small companies was not meant to apply to passive investment companies.

The proposed insertion of paragraph 23AA(c) regarding the passive income threshold addresses the Minister's concerns by applying an 80% threshold to passive income earned by a company. However, it does not address whether or not a company is carrying on a business in the first instance.

Potential scenarios where company is not carrying on a business?

The proposed legislation presents a number of difficulties for companies determining whether or not they carry on business. This includes:

(A) Holding Company scenario

A primary example of the instance where a company may not be carrying on a business is in the situation of a holding company.

The draft explanatory memorandum in paragraph 1.10 provides:

... 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.

The ATO's views on the activities of holding companies are expressed in MT 2006/1, where it is explained that:

192. A holding company or similar entity that merely:

- holds membership interests in other entities and is able to control those entities by virtue of that interest; and/or*
- derives income from other entities because it holds membership interests or other securities in those entities*

is not considered to be carrying on an enterprise.

193. There are a number of Australian and overseas cases which touch on the issue of whether holding entities are carrying on a business or enterprise. They each turn on their own facts, but in the course of their judgments the courts have discussed the issue of whether the

company or other entity carries on a business or enterprise. Guidance may be found in those discussions.

194. In *Esquire Nominees Ltd (Trustee of Manolas Trust) v. Federal Commissioner of Taxation* 65 Menzies J, while not being required to decide upon the issue, made the following observation:

A dividend is payable out of the profits of the company paying it, and, in the case of a holding company, this profit-making business may merely be the receipt of a dividend from another company. It is, for instance, well known that Utah Mining Australia Ltd is presently a holding company and not an operating company. The fact, however, that it simply holds shares in Utah Development Co., an operating company from which it receives dividends which it distributes to its shareholders, does not signify that it does not itself carry on a profit-making business in Australia.

195. In *FC of T v. Total Holdings (Australia) Pty Ltd* 66 the holding company did more than passively own the shares in its subsidiary, it was also involved in borrowing and on-lending funds to its subsidiary. In this case the Commissioner conceded that the activities of the holding company constituted carrying on a business.

196. In *FC of T v. Email Limited* 67 in a joint judgment Hill, Drummond and Sackville JJ stated: *In arriving at his conclusion the learned primary Judge found that Email was at all material times carrying on a business which his Honour described as 'acting as the holding company of a group of companies'. It was not a merely passive holding company doing nothing but receiving and distributing dividends. Rather it was active in the administration of the affairs of its subsidiaries in various ways. In particular it provided services to its subsidiaries such as management of cash flows, currency fluctuations and interest rate exposure, legal, taxation, internal auditing and accounting services, training, information technology, recruitment and human resources. It provided guarantees for borrowing undertaken by subsidiaries and provided warranties and indemnities on sales of shares or businesses of subsidiaries.*

197. In the case of *Spassked Pty Ltd v. Commissioner of Taxation* 68 Hill J and Lander J (Gyles J in agreement) stated:

It can be accepted that a holding company can itself carry on a business, which may be referred to as the business of a holding company: Brookton Co-operative Society Ltd v. FCT (1981) 147 CLR 441 at 469-470; 11 ATR 880 at 898-89; 81 ATC 4346 at 4363. The taxpayer in Total Holdings on the facts of that case was held to carry on such a business. The cases sometimes distinguish between a holding company which is a passive investor, that is to say it does no more than acquire and hold shares in a subsidiary or subsidiary companies and a company the activities of which are properly characterised as a business.

That distinction is to be found not only in the context of income tax, but in the context of value added tax where liability turns effectively on whether the taxpayer is carrying on an economic activity such as a business, see for example, Wellcome Trust Limited [1996] 2

CMLR 909, Harnas & Helm CV v. Staatssecretaris van Financien [1997] 1 CMLR 649. Generally a company which may be referred to as carrying on business as a holding company will be seen to be actively involved in the management of the affairs of its subsidiaries. Active management is not, however, a necessary factual circumstance to permit there to be a finding of business. In Carapark Holdings Ltd v. FCT (1967) 115 CLR 653; 14 ATD 402 the taxpayer which was found to be carrying on a business lent money to its subsidiaries and performed 'specific management functions for the group as a whole' which seem to have been primarily, at least, secretarial, budgeting and financial matters (see at CLR 659). An example where an intermediate holding company was held to be carrying on a business is to be found in FCT v. E A Marr & Sons (Sales) Ltd (1984) 2 FCR 326; 15 ATR 879; 84 ATC 4580.69

As noted above, the fact that a company is a holding company does not of itself mean it is not carrying on a business according to the ATO or the Courts.

Accordingly, the comments in paragraph 1.10 in the explanatory memorandum to the exposure draft are potentially misleading; even if the dividend is from a non-portfolio holding company (and therefore not passive) it is still a requirement that the holding company carry on business to access the same tax rate.

(B) Passive income amounts to carrying on a business

The draft legislation provides that a company that has less than 80% passive income but otherwise carries on a business and is under the aggregated turnover threshold will be a base rate entity.

This means a company could carry on a business, in situations such as:

- Company carries on business from deriving passive income, while receiving 20% or more other income, such as trust distributions (where the trust itself is running a business); or
- Company carries on a consulting business (which may or may not be subject to the Personal Services Income provisions) and receives 20% or more income from this, with the balance from passive sources.

ATO view on carrying on a business

As noted above, the ATO holds a broad view on what is meant by “carrying on a business”. In response to the concerns raised over companies accessing the lower rate the ATO stated that:

*where a company is established and maintained to make profit for its shareholders, and invests its assets in gainful activities that have a prospect of profit, then it is likely to be carrying on business. **This is so even if the company's activities are relatively passive, and its activities consist of receiving rents or returns on its investments and distributing them to shareholders***

This statement has not helped to clarify the issue; with the phrase “relatively passive” having no definition or meaning.

Already this uncertainty has resulted in an ATO private ruling² that a company engaged in renting properties is not carrying on business for the purposes of accessing the small business company tax rate.

There are other examples of ATO private rulings being issued where the activities of a company do not amount to carrying on of a business due to various factors, including but not limited to, their scale (i.e. relatively small number of rental properties), involvement of the company's agents, as well as commerciality³.

These rulings demonstrate that the determination of whether or not a company is carrying on a business is not straightforward where the company's activities are primarily passive in nature. As noted in nearly any ATO private ruling, whether an activity amounts to carrying on of a business depends on the circumstances of each case.

Examples

Introducing the passive income tax for "base rate entity" does not address the uncertainty, and does not appear to produce an outcome which is consistent with the legislative intent.

As noted above, requirement to carry on business creates issues in situations such as:

Example 1

A Coy Pty Ltd ("A Coy") carries on an active trading business, and pays a dividend to its 100% shareholder, B Coy Pty Ltd ("B Coy"). A Coy is carrying on a business, and does not derive any base rate entity passive income.

Applying case law, (i.e. Spassked and Email cases), B Coy may be considered to be carrying on a holding company business by holding an income producing asset (shares in A Coy) and managing the flow of dividends to shareholders. B Coy does not carry on any other activities.

Applying the proposed law, the dividend from A Coy to B Coy is a non-portfolio dividend, and is therefore excluded from the definition of "base rate entity passive income" under proposed paragraph 23AB(a).

Assuming the aggregated turnover for A Coy and B Coy is less than the relevant threshold, both A Coy and B Coy are base rate entities, and the 27.5% corporate tax rate applies.

Contrast this outcome where the business operated by A Coy is instead operated by a trust:

² PBR 1051181111925

³ PBR 1012459233320, 1012420780834, 1012497403697.

Example 2

Trustee of C Trust (“C Trust”) carries on an active trading business, and generates net income for a year. This income is distributed entirely to A Coy, a corporate beneficiary. Other than managing the income received from C Trust, A Coy has no other activities.

The net income distributed to A Coy retains the character of active trading income, specifically it is not “base rate entity passive income” under proposed paragraph 23AB(f).

However, as A Coy exists merely to act as a corporate beneficiary and prima facie is not carrying on a business, it is not a “base rate entity”, and thus the active business income distributed to A Coy is taxed at 30% in the hands of the corporate beneficiary.

Applying the proposed law to the second example, the corporate beneficiary (A Coy) would need to be carrying on a business on its own account, specifically one which does not result in the corporate beneficiary having 80% or more of its assessable income from “base rate entity passive income.”

From a practical perspective, however, the activities of A Coy in either example may not be significantly different.

This difference in outcome is anomalous and, we believe, contrary to the intended legislative outcome.

Recommendation

The proposed legislation does nothing to resolve the uncertainty with its application. Accordingly, we recommend the removal of the requirement in proposed paragraph 23AA(a) of the definition of “base rate entity” – that is, removing the need for a company to be “carrying on a business” at all.

The Government’s policy intention that the lower corporate tax rate not apply to “passive investment companies” is essentially achieved by the introduction of the passive income test in proposed paragraph 23AA(c) of the definition.

By removing the definition of “carrying on a business”, the flow through of active business income to holding companies and corporate beneficiaries of trusts (where a subsidiary or trust is carrying on the actual business) is achieved, without the holding or corporate beneficiary being obliged to do more.

In making this change companies will only be eligible to access the lower tax rate, without otherwise accessing other concessions in the tax law itself. For example, companies that are not carrying on business would still not be able to access the small business entity provisions in Division 328 of the *Income Tax Assessment Act 1997* (“ITAA97”), nor would they be likely to be engaged in an enterprise for the purposes of registering for GST.

Furthermore, by removing the requirement to carry on business, companies that are involved in passive activities such as (i) providing loan finance, (ii) renting of plant and equipment or (iii) owning real property, will benefit from:

- Not attempting to enter into artificial or contrived arrangements so as to be seen as actively carrying on a business in order to meet the test; and
- Not incurring unnecessary costs in applying for ATO rulings on whether they are in a business due to concerns over the tax rates that apply. This removes the concern that a company will incur interest and penalties if it self-assesses its tax rate incorrectly.

Meaning of *base rate entity passive income* – proposed section 23AB

“Base rate entity passive income” includes rent (proposed paragraph 23AB(c)).

The term “rent” is not defined in the ITAA97 or the ITAA36. The *Macquarie Dictionary* defines rent as:

1. a return or payment made periodically by a tenant to an owner for the use of land or building.

2. a similar return or payment for the use of property of any kind.

3. Economics the excess of the produce or return yielded by a given piece of cultivated land over the cost (labour, capital, etc.) of production; the yield from a piece of land or property.

4. profit or return derived from any differential advantage in production.

5. Obsolete revenue or income.

–verb (t) 6. to grant the possession and enjoyment of (property) in return for payments to be made at agreed times.

7. to take and hold (property) in return for payments to be made at agreed times.

–verb (i) 8. to be leased or let for rent.

https://www.macquariedictionary.com.au/features/word/search/?word=rent&search_word_type=Dictionary

The definition of rent is broad enough to encompass business income from many active trading businesses, including commercial equipment rental hire business, car hire operators, plant and equipment leasing business, and many others. Companies carrying on such businesses are not “passive investment companies”.

It is common for privately-owned groups to incorporate an equipment leasing company which makes available commercial plant and equipment to other entities or businesses within the family group. This has increased as a result of the ATO’s ruling on the taxation of unpaid present entitlements for trust purposes. Accordingly, it is now common for corporate beneficiaries to invest the trust distributions in acquiring plant to lease back it to trust operating the business.

Where income from leasing of plant and equipment or real property is derived from a related party which is carrying on a business that would itself would qualify for the lower tax rate (or if a trust would do so if a company), this should not be treated as passive income.

We submit that proposed paragraph 23AB(c) be redrafted to either exclude rent or leasing activities, to related entities, which themselves qualify.

We further submit that consideration be given to:

- Including a reference in paragraph 23AB(c) to section 102M of the ITAA36, specifically the “eligible investment business” definition; and
- Incorporating the definition of “passive income” contained in section 6(1) of the ITAA36 to indicate types of income that are passive, with appropriate modifications specific to base rate entity passive income.

There are no definitions in the Tax Rates Act for any of the items specified as “passive income”, whereas the above provisions and the related legislation and case law have been in place for a significant time, and therefore will be easier for taxpayers to interpret.

General observations - drafting

There are a number of inconsistencies in both the draft Bill and Explanatory Memorandum regarding the reference to “base rate entity passive income”. We noted several instances referring to “base rate passive income” instead – see for example proposed section 1, Schedule 1 of the draft Bill, and paragraphs 1.8, 1.16 and 1.20, along with Example 1.1, of the draft Explanatory Memorandum.