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Simon Winckler
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The Treasury
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By email: simon.winckler@treasury.gov.au

Dear Simon

Eligibility for the lower company tax rate

Further to the release of the Exposure Draft (ED) legislation on 18 September 2017, we welcome the government's efforts to clarify which corporate tax entities can access the lower corporate tax rate with effect from 1 July 2016. However we would like to make a submission focusing on one specific issue, being the borderline between active and passive income.

We understand that as a matter of policy, companies carrying on an 'active trading business'[1] should benefit from the lower rate.. However we believe that the drafting of the ED does not reflect the intended policy. The ED in its current form would result in genuine active business income being incorrectly categorised as passive income for the purposes of the proposed 80 per cent threshold test.

The outcome of the policy intention is largely reflected for dividends and interest with these amounts being treated as active income:

- Non-portfolio dividends are excluded from passive income, and
- The definition of interest in section 6(1) contains exclusions whereby para (e) excludes interest derived from transactions directly related to the active conduct of a trade or business, and para (f) excludes interest where the income of the business is principally derived from the lending of money.

However the inclusion of all 'royalties, 'rent' and 'capital gains' within the proposed definition of 'base entity passive income' in section 23AB means that all of these amounts, **whether or not** associated with the carrying on of the active trading business, will be improperly categorised as passive income for these purposes. We believe that the proposed definitions serve as too blunt an instrument for these purposes.

For example, the ED fails to recognise a number of scenarios where the intended outcome will be frustrated, including the following situations:

[1] *Para 1.10 of the Explanatory Memorandum to the ED legislation*

- An active business that develops intellectual property and derives royalty income
- A business that derives rental income from a wide portfolio of commercial property assets that are managed as an active business.
- Capital gains that are realised on the disposal of active assets used to carry on the active trading business (for example, a factory).

We believe that such amounts do in fact represent the returns from genuine commercial activities, and should be classed as active income for these purposes. Rules should be incorporated to allow the active treatment of income in some cases, whilst retaining appropriate levels of integrity around the boundaries.

We believe that the appropriate treatment of these categories of income can be achieved by using existing provisions in the Tax Act that are currently used to distinguish between active and passive income. We note that any narrowing of the scope of passive income is still subject to the existing policy and integrity requirement that the company be carrying on a business.

For example, criteria could be borrowed from the controlled foreign company (CFC) rules in Part X of the *Income Tax Assessment Act 1936* (the 1936 Act) which provides boundaries for distinguishing between active and passive income:

- The section 23AB definition of royalty could link to aspects of 'tainted royalty income' in section 317 of the 1936 Act. For example, royalty income from a thing which originated with the company or which was substantially developed, altered, etc by the company could be treated as active (refer para (c)).
- Rental income could be treated as active if not derived from associates[2].
- The treatment of capital gains could also leverage off the definition of 'tainted assets' as defined in section 317, so that capital gains from an "asset used solely in carrying on a business" would be treated as active income.

It may also be possible to borrow concepts from Subdivision 768-G of the 1997 Act or section 23AH of the 1936 Act which treat certain gains as non-assessable non-exempt (NANE) income where the gain is relevantly, in relation to an active asset.

The better targeting of active income classifications mean that all active businesses benefit from the lower rate, irrespective of the nature of their industry sector. Basing the rules for active versus passive income on existing concepts would also provide a greater consistency in the tax legislation.

If you have any queries on any of the above, please do contact me on 02 9322 7251.

Yours sincerely

David Watkins
Partner

[2] Refer definition of tainted rental income in section 317, 1936 Act