

Mr Simon Winckler
Manager
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

29 September 2017

By Email

BY EMAIL: simon.winckler@treasury.gov.au

Dear Mr Simon

Eligibility for the Lower Company Tax Rate – Exposure Draft Legislation (September 2017)

Greenwoods & Herbert Smith Freehills thank Treasury for the opportunity to make this submission on the exposure draft legislation released on 18 September 2017, aimed at excluding entities with predominantly passive income from accessing the lower 27.5 per cent corporate tax rate ('ED').

Greenwoods & Herbert Smith Freehills is Australia's largest specialist tax advisory firm, with offices in Sydney, Melbourne and Perth. We advise ASX-listed and other large Australian businesses, SMEs as well as foreign investors and international financiers with interests in Australia.

1 Summary

We submit that:

- the currently proposed definition for 'base rate entity passive income' would result in genuine active business income being incorrectly classified as passive and therefore should be amended;
- clarification on when a corporate tax entity 'carries on a business' for the purposes of section 23AA(a) is required to provide certainty to taxpayers; and
- the 'part 1 amendments' should not take effect retrospectively for the 2016-17 year of income.

These points are explained below.

2 Definition of 'base rate entity passive income'

We submit that the currently proposed definition for 'base rate entity passive income' needs to be amended such that genuine active business income would not be incorrectly classified as passive.

The definition in the proposed paragraph 23AB(e) includes 'capital gains' as defined by section 995-1 of the *Income Tax Assessment Act 1997* (Cth) ('the 1997 Act'), which in turn defines capital gains by reference to the capital gains tax ('CGT') events.

Doc 510883832.8

However, this definition fails to reflect the following:

- the impact that anti-overlap rules and CGT exemptions and roll-over provisions may have on the computation of a capital gain;
- the concept of net capital gains and application of current year and prior year capital losses; and
- the potential active nature of the assets or underlying assets giving rise to the capital gain.

One way of dealing with these issues would be to define 'base rate entity passive income' by reference to existing and well established definitions for 'passive income' in the controlled foreign company rules (in section 446 of the *Income Tax Assessment Act 1936* (Cth)) or based on the concepts established in the definition of 'active business asset' in Subdivision 768-G (refer section 768-540 of the 1997 Act).

In addition, the draft definition of 'base rate entity passive income' in the proposed paragraph 23AB(a) excludes non-portfolio dividends whilst there is no corresponding exception for capital gains made in respect of non-portfolio investments.

These concepts are explained more fully below.

2.1 CGT exemption and roll-over provisions

Gains on the disposal of assets such as trading stock, depreciating assets and other assets held on revenue account *prima facie* give rise to income on revenue account (statutory income (in the case of trading stock and depreciating assets) and ordinary income (in the case of revenue assets)) and capital gains (as defined by section 995-1). However, for CGT purposes capital gains on trading stock and depreciating assets are disregarded under section 118-25 and 118-24 of the 1997 Act respectively and capital gains on other revenue assets are reduced under sections 118-20 of the 1997 Act, all being anti-overlap provisions to prevent double taxation of the gain.

In addition, CGT roll-over relief often operates to defer capital gains. For instance, under the replacement asset roll-over provisions in Division 124, the taxing point of any gains realised on the sale of an original asset may be deferred until such time as the replacement asset is sold (or otherwise dealt with by the taxpayer entity).

A lack of reference in the currently drafted definition to these outcomes would result in a capital gain that is otherwise disregarded, reduced or deferred under another provision of the tax law being taken into account for the purposes of assessing an entity's eligibility for the reduced corporate tax rate.

We expect that including the above mentioned disregarded, reduced or deferred capital gains as passive income is not consistent with the policy intention of the proposed amendment. Therefore, we submit that the definition be amended accordingly.

2.2 Net capital gain concept

Capital gains on the disposal of assets in an income year are reduced by capital losses made during that year, as well as carried forward capital losses under the method statement in section 102-5.

The currently proposed definition of capital gains fails to acknowledge that capital gains are taxed on a net basis under the tax law. Under the method statement in section 102-5 of the 1997 Act, the capital gain to be included in an entity's taxable income for an income year may be reduced by capital losses made on other assets during the income year and by carried forward capital losses from prior years.

Again, we expect that failing to take account of current year and prior year capital losses applied against an entity's capital gains made in an income is not consistent with the policy intention of the proposed amendment. Therefore, we submit that the definition be amended accordingly.

2.3 Capital gains on the disposal of assets used in carrying on a business

Capital gains are often realised on the disposal of assets that are used to carry on a business (for example goodwill). We consider that such gains do not represent passive income. That is, we submit that assets used in carrying on a business are active assets. Therefore, gains realised on the sale of these assets should not be treated as 'passive income'.

This is consistent with other provisions in the tax law, including:

- the section 446 definition of 'passive income' which limits the definition to net gains realised on 'tainted assets'¹; and
- section 768-540 of the 1997 Act which expressly classifies assets used in the course of carrying on a business and the goodwill of a business as active business assets.

On the basis that inclusion in the definition of 'base rate entity passive income' gains realised on the disposal of active assets is not consistent with the policy intention of the proposed amendment, we submit that such gains be excluded.

2.4 Exclusion for capital gains on non-portfolio investments

The draft definition of 'base rate entity passive income' in the proposed paragraph 23AB(a) excludes non-portfolio dividends. It would follow that capital gains made in respect of non-portfolio investments should also be excluded.

3 When a company 'carries on a business'

We submit that clarification of when a company 'carries on a business' for the purposes of the proposed section 23AA(a) is required. This is particularly so given that the proposed definition of 'base rate entity passive income' contemplates that passive income can include the passive income from an underlying partnership or trust (in proposed paragraph 23AB(f)).

It is currently unclear as to whether it is intended that the reduced corporate tax rate should apply to holding companies that invest in active businesses through a partnership or trust (or receive distributions of active business income from a discretionary trust) where say that holding company has no other income or activities. We submit that in these circumstances the company should be deemed to carry on a business for the purpose of determining eligibility as a base rate entity.

Further, having regard to:

- footnote 3 in Draft Taxation Ruling TR 2017/D2 (which provides '....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'); and
- the Commissioner's comments contained in document QC48880 located on the Commissioner's website (last modified on 4 July 2017),

it would be useful if further statutory clarification be provided as to when a company 'carries on a business' for the purpose of the requirement in subsection 23AA(a) (i.e. the entity 'carries on a business' in an income year).

This is a legacy issue from *Treasury Laws Amendment (Enterprise Tax Plan) Act 2017*, the amending Act that codified phase one of the Government's Enterprise Tax Plan.

¹ 'Tainted assets' is defined in section 317 to specifically exclude assets that are trading stock or assets 'used solely in carrying on a business'.

4 Retrospectivity

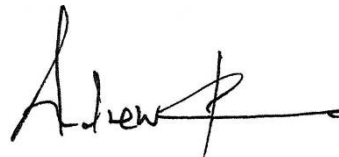
The additional requirement for taxpayers to be eligible to the reduced corporate tax rate (the passive income threshold requirement) is proposed to take effect for the 2016-17 and later years of income. Some taxpayers may have already lodged their income tax returns, determined and paid dividends and determined the percentage of franking applicable to those dividends for the 2016-17 year based on the law as enacted on 2 May 2016.² To announce retrospective changes two and a half months after the end of the relevant income year and to legislate the relevant changes further down the track is clearly not appropriate.

In addition, the complexity of these rules and the relevant dates of effect will make it very difficult for taxpayers to assess whether they have correctly determined their tax rate and/or their franking rate.

* * * * *

We are happy to discuss our submission further, should you wish to do so.

Yours sincerely



Narelle McBride
Director
Greenwoods & Herbert Smith Freehills
+61 3 9288 1715
+61 425 726 991
narelle.mcbride@greenwoods.com.au

Andrew White
Director
Greenwoods & Herbert Smith Freehills
+61 2 9225 5984
+61 439 255 470
andrew.white@greenwoods.com.au

² Treasury Law Amendment (Enterprise Tax Plan) Act 2017 (Cth).