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28 September 2017

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

Email: simon.winckler@treasury.gov.au

Dear Simon

EXPOSURE DRAFT LEGISLATION – TREASURY LAWS AMENDMENT (ENTERPRISE TAX PLAN BASE RATE ENTITIES) BILL 2017

Thank you for the opportunity to provide comments on the Exposure Draft Legislation ("**ED**") and Explanatory Memorandum ("**EM**") concerning the *Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017*, which contains proposed changes to corporate tax rates for companies that meet the definition of a '*base rate entity*'.

For the purpose of this submission, we have accepted the government's policy decisions contained in the ED, which will provide further clarity on the entitlement to the reduced rate. We have therefore not provided any comments in relation to policy decisions that have been made with respect to the proposed changes. However, there are a few important matters that we would like to raise for your further consideration, which we believe would otherwise result in anomalous outcomes under the current drafting. These are outlined in Appendix A to this letter. We would be happy to discuss these matters further with you in detail.

In addition, we would ask that the government work with the Australian Taxation Office to finalise its view on when a company would be regarded as carrying on a business in the form of a public ruling, so that certainty be given to the taxpayers on this issue.

Please contact me on (03) 8610 5170 at any time if you would like to discuss this further.

Yours sincerely

A M KOKKINOS
Executive Director

APPENDIX A – SPECIFIC COMMENTS RELATING TO THE ED AND EM

Issue #	Issue	Comments	Recommendation
1.	Application date	We note that the application date for the proposed changes in relation to both the corporate tax rate reduction and the reduced franking gross up rate is 1 July 2016. We are aware of a number of corporate tax entities that have already been affected by the retrospective application of the changes made by *Treasury Laws Amendment (Enterprise Tax Plan) Act 2016*[1]. While that Act reduced the corporate tax payable by the company, it also imposed an additional compliance burden on those companies that had over-franked distributions paid in the 2016/17 income year. We note that the ATO attempted to ameliorate the compliance burden with 'a practical compliance approach' set out in PCG 2017/D7. However, that draft 'practical compliance approach' only has application for the 2016/17 income year and only in relation to distributions that were over-franked. As such, it provides no assistance to those companies that, in good faith, have franked dividends paid since 1 July 2016 at the 27.5% rate which, in light of the proposals in the ED, could have been franked at the 30%. Further, the ED provides no mechanism allowing for a revision of the franking attributes of dividends already paid. This issue has been further complicated where a number of companies had to revise franking rates based on the ATO's draft interpretation of "carrying on a business" which was published on their website.	We believe the mandatory application of the amendments is not fair for those companies that have acted in good faith and have attempted to apply the laws as best as they could during the period of uncertainty. We would recommend that taxpayers should have the option to apply the measures from 1 July 2017 where the amendments are not consistent with how the corporate taxpayer has prepared its tax return or dividend statements. The government should also consider a transitional provision allowing corporate tax entities the opportunity to revise the franking credit attached to distributions paid since 1 July 2016 without the need to apply to the Commissioner[2] and without penalty. **Both of these proposed changes are (in our opinion) fair and reasonable given that the errors contained in the original legislation were not due to anything caused by taxpayers and therefore the amendments should not result in inadvertent penalties to taxpayers who have sought to apply the law in an appropriate manner.**

[1] Act No 41 of 2017.

[2] Pursuant to section 202-85 of the *Income Tax Assessment Act 1997* (Cth).

Issue #	Issue	Comments	Recommendation
2.	Schedule 1, Part 1 23AB(a) – exclusion of non-portfolio dividends	The exclusion of non-portfolio dividends from base rate entity passive income potentially creates the following issue where a non-base rate entity is wholly owned by a holding company: A non-base rate entity paying tax at 30% will be entitled to distribute dividends, franked to 30%, to its holding company. With non-portfolio dividends excluded from base rate entity passive income, the holding company could qualify as a base rate entity. It would qualify if it carries on a business and has an aggregated turnover of less than the relevant threshold. If the holding company does qualify as a base rate entity it would be taxed at the reduced rate of 27.5%. As a consequence, the holding company would have excess franking credits that would convert to a tax loss that could be carried forward. In addition, the holding company would be required to frank distributions to its shareholders at the 27.5% rate. As a consequence, the benefit of the fully franked non-portfolio dividend cannot be passed onto the shareholders of the holding company in its entirety. This outcome would make no sense, given that the group is entirely passive and should therefore be taxed at 30%.	We strongly recommend that the rules for dividends be changed. That is, all dividends should prima facie be included as passive income. Companies should then be given an option to choose to exclude non-portfolio dividends when calculating their base rate entity passive income. We do not believe that this would add to any compliance, would provide an appropriate outcome and would address the anomalous outcome raised.

Issue #	Issue	Comments	Recommendation
3.	Schedule 1, Part 1 23AB(b) –non-share dividends	We note that the Income Tax Assessment Act generally treats non-share dividends in the same way as dividends. We also note that Subdivision 768-A replaced section 23AJ to treat as non-assessable non-exempt income, dividends and non-share distributions received by an Australian corporate tax entity on a participation interest of at least 10% in the foreign company. Further, Subdivision 768-A extended that treatment to amounts that flow to the Australian corporate tax entity through interposed trusts and partnerships. In contrast, this reform of section 23AJ is not reflected in the proposed section 23AB. Accordingly, we are unclear why the provisions utilise old legislative provisions to deal with non-portfolio distributions from companies.	The government should align the treatment of dividends and non-share dividends (including amounts that flow to a corporate tax entity through interposed trusts and partnerships) to the current non-portfolio test contained in section 768-15 (rather than by reference to older non-applicable provisions).
4.	Schedule 1, Part 1 23AB(c) – blanket inclusion of interest, royalties and rent	We note that, through its National Innovation and Science Agenda, the government is seeking to support innovative start-up companies. Many of those start-up companies are involved in creating intellectual property, the commercialisation of which will generate royalties. Under the proposed definition of base rate entity passive income, those companies will be denied access to the reduced tax rate. We believe there is a key difference between businesses that "create" intellectual property to be used in its business as compared to ones that "acquire" intellectual property for royalty streams. We believe it is counter intuitive to deny start-up Fintech entities the ability to access a 27.5% tax rate simply because they have created intellectual property assets (for example in relation to new software).	The government should consider excluding (from passive income) royalties received where the company substantially developed or improved the property or right for which the royalty is paid[3]. This will mean that Fintech companies that derived royalties from substantially developing intellectual property will be able to access the lower tax rate.

[3] We note that such amounts are excluded from the definition of 'tainted royalty income' in section 317 of the *Income Tax Assessment Act 1936* (Cth).

Issue #	Issue	Comments	Recommendation
5.	Schedule 1, Part 1 23AB(e) – capital gains derived on sale of business	It is foreseeable that a base rate entity might sell its business and derive a capital gain equal to 80% or more of its assessable income for the year. It is inappropriate that such amounts are to be considered passive where the asset disposed of is a business asset (an active asset for Division 152 purposes). This outcome (in our view) would not make sense. It also seems inappropriate that such a situation should result in the corporate tax entity being denied access to the reduced tax rate particularly if the entity had qualified for the reduced rate in respect of all other income generated from the business.	The government should consider excluding capital gains in respect of an active asset from base rate entity passive income.

Issue #	Issue	Comments	Recommendation
6.	Schedule 1, Part 1 23AB(e) – capital gains	Passive income is to include capital gains within the meaning of the Income Tax Assessment Act 1997. That is, passive income is to include the gross capital gain made on the happening of a CGT Event. The provision does not refer to the amount of the capital gain included in your assessable income. Instead it just compares the gross capital gain to the total assessable income. We note that the amount of a capital gain may be different to the amount actually included in assessable income: the gain may be disregarded entirely (for example, a capital gain on a pre-CGT asset, trading stock or a depreciating asset) or be reduced by operation of a concession or the availability of a capital loss. By way of example, an entity may sell a depreciating asset for a gain of $30,000, which results in a (prima facie) capital gain under CGT event A1 (section 102-22 and 102-23). Under section 118-24, the capital gain is then disregarded. As there is still a capital gain from a CGT event, this amount of $30,000 would be regarded as passive income and compared to total assessable income (along with any other passive income). This could result in an unintended result for the income year.	The government should clarify that the amount of a capital gain that is included in base rate entity passive income is the amount of the net capital gain that is included in assessable income (i.e. under section 102-5 of the ITAA 1997).

Issue #	Issue	Comments	Recommendation
7.	Schedule 1, Part 1 23AB(f) – amounts included in assessable income under Division 5 or 6	We foresee that a number of questions could arise in determining whether an amount is "attributable to" base rate entity passive income, including: • Does passive income included in calculating the net income of a first tier partnership or trust retain its character as such on flowing from one or more intermediate partnerships or trusts before flowing to a corporate tax entity? • How are expenses and losses of a partnership or trust to be allocated to different components of gross income? We therefore believe that further clarity is required with respect to the treatment of "indirect" distributions and the allocation of expenses.	The government should consider amending paragraph (f) to clarify that an amount included in the assessable income of a partner in a partnership or beneficiary of a trust is passive income to the extent that it is "attributable (directly or indirectly) to base rate entity passive income…". Further, the government should consider including a comment in the EM to the effect that any reasonable allocation of losses and expenses between passive and other income would be acceptable.