THE TAX INSTITUTE

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

Dear Mr Winckler,

Eligibility for the lower company tax rate

The Tax Institute welcomes the opportunity to make a submission to Treasury in relation to the *Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017* Exposure Draft (**Exposure Draft**).

Summary

Our submission below addresses our main concerns in relation to the Exposure Draft and the broader issues arising from the circumstances which have necessitated the Exposure Draft, as follows:

- There is an overarching issue that there is a lack of clarity about what it means to 'carry on a business', which is a concept of wide application and importance in the tax system but which remains undefined;
- The Exposure Draft commendably mitigates this problem to a large extent in the context of giving effect to the Government's policy objective of excluding passive investment companies from being able to apply the lower company tax rate;
- However, the amendments retrospectively change the basis on which many companies would have already prepared and lodged their 2017 income tax returns; and
- There are numerous technical issues in the Exposure Draft that are likely to give rise to anomalies.

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Discussion

1. General

The introduction of a two-tiered corporate tax rate system in the 2015-16 income year and the subsequent amendments to progressively increase the turnover threshold for companies eligible to apply the lower corporate tax rate has brought with it additional complexity into the tax system. Consequently, one of the eligibility criteria for the lower corporate tax rate, namely whether a company carries on business, was brought to the fore and an increased amount of importance has been placed on how this term is interpreted. This placed the emphasis on the activities of the company and created much uncertainty regarding when a company is carrying on a business for the purpose of determining its eligibility for the lower corporate tax rate.

Members have advised us that they have been unsure how to determine whether a company that meets the relevant turnover threshold is, in fact, entitled to apply the lower corporate tax rate, thus creating uncertainty.

The introduction of the concept of 'base rate entity passive income' places an additional focus on the sources of income of the company. We understand this concept is being introduced to give effect to the Government's now stated policy position 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[1]".

While the amendments contained in the Exposure Draft are a partial solution to the current circumstances where there is a lack of clarity regarding the meaning of the concept of 'carries on a business' for the purpose of determining whether the lower company tax rate applies, it leaves the real and wider issue unresolved.

We note the key term 'carries on a business' has been left undefined and relies on interpretation by the administrator, the Australian Taxation Office (**ATO**). We have already made submissions to the ATO in relation to our views and will continue to do so as the ATO progresses with issuing guidance on this matter.

2. What it means to carry on a business

The Tax Institute does not agree with the way in which the ATO has currently indicated it will view a company that holds passive investments. The amendments in the Exposure Draft, and in particular the introduction of the concept of 'base rate entity passive income', attempt to overcome this and give effect to the Government's policy position that the lower company tax rate is not meant to apply to passive investment companies. However, the concept of 'carrying on a business' will still intrude even under the Exposure Draft requirements (see for example at Part 4 (ii) below). While the issue of

[1] Refer to the Minister for Revenue and Financial Services' media release date 4 July 2017: http://kmo.ministers.treasury.gov.au/media-release/056-2017/

the meaning of 'carrying on a business' is primarily for the ATO to address, we set out some comments below for context on the current position of that issue.

How to determine when a company is carrying on a business is, in The Tax Institute's view, a question of fact and requires an inquiry into the facts and circumstances of the particular company in question. The focus of the inquiry should be on the nature of the activities being carried on by the entity. The chosen structure of the entity, whether a company, individual or some other structure, should not unduly influence the determination of whether the entity is carrying on a business. The focus should be on the activities, including the passivity, or otherwise, of the activities, being undertaken.

The ATO's long held view on what it means to 'carry on a business' is contained in *Taxation Ruling TR 97/11 Income Tax: am I carrying on a business of primary production?* (**TR 97/11**) that has been followed by practitioners. While TR 97/11 is specifically focused on primary production, in our view, most of the principles can apply more broadly to companies.

Ferguson v FCT (1979) 37 FLR 310 (**Ferguson**), contains the indicia to consider when determining whether a company is carrying on a business. We have not restated these indicia here.

TR 97/11 sets out these indicia succinctly at paragraph 13, with further explanation offered later in the ruling. The table at paragraph 18 of TR 97/11 contains a very useful summary of the main indicators of when a company may be carrying on a business.

Ideally, in principle, a single interpretation of 'carrying on a business' should be used to apply in all circumstances in which the phrase appears in the tax law. However, it would take significant work to ensure that the one interpretation applies equitably in all instances where the phrase is relied on. In the interests of expediency, we are seeking clarity from the ATO of the meaning of the phrase in this context.

3. Retrospective amendment

The amendments contained in Part 1 of Schedule 1 to the Exposure Draft contain amendments to the *Income Tax Rates Act 1986* (Cth) (**Rates Act**) similar to the amendments in the *Treasury Laws Amendment (Enterprise Tax Plan) Act 2017* (Cth) (**Enterprise Tax Plan Act**) enacted in May this year[2]. The amendments in the Enterprise Tax Plan Act retained reliance on the concept of a 'small business entity' for the purpose of determining whether the lower corporate tax rate applied for the 2017 income year with the concept of 'base rate entity' (as defined in the Enterprise Tax Plan Act) applying for the 2018 income year onwards.

[2] Apart from introducing the new concept of 'base rate passive income' which is reflected in the revised definition of 'base rate entity'.

The Exposure Draft seeks to apply the concept of 'base rate entity' (as defined in the Exposure Draft) from the 2017 income year onwards, amounting to a retrospective application of the definition of 'base rate entity'.

Issues arise because of the differences between how the concept of 'small business entity' and 'base rate entity' are defined. A 'small business entity' is defined in section 328-110 (1) the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**) as:

> **Section 328-110(1)**
>
> You are a *small business entity* for an income year (the *current year*) if:
> (a) you carry on a *business in the current year; and
> (b) one or both of the following applies:
>
> > (i) you carried on a business in the income year (the *previous year*) before the current year and your *aggregated turnover for the previous year was less than $10 million;
> >
> > (ii) your aggregated turnover for the current year is likely to be less than $10 million.

'Base rate entity' is defined in the Exposure Draft as:

> **Section 23AA Meaning of *base rate entity***
>
> An entity is a ***base rate entity*** for a year of income if:
> (a) it carries on a business (within the meaning of the *Income Tax Assessment Act 1997*) in the year of income; and
> (b) its aggregated turnover (within the meaning of that Act) for the year of income, worked out as at the end of that year, is less than $10 million; and
> (c) it does not have base rate entity passive income for that year of 80% or more of its assessable income for that year.

The change for the 2017 year from relying on the concept of 'small business entity' to the concept of 'base rate entity' (as defined in the Exposure Draft) causes a retrospective change to eligibility for the lower tax rate, even for some relevant companies that do not meet the 'base rate entity passive income' test (which is itself a retrospective amendment for the 2017 income year). This is because the definition of 'small business entity' is determined by reference to either current year aggregated turnover or prior year aggregated turnover. 'Base rate entity' is only determined by reference to current year aggregated turnover.

In this regard, a company may have determined their eligibility for the lower company tax rate for the 2017 income year based on their prior year's aggregated turnover. If this was less than $10 million in the prior year and its aggregated turnover was higher than $10 million for their 2017 income year, this results in two different outcomes for the taxpayer. Based on the 'small business entity' concept, it would be eligible for the lower company tax rate (assuming other factors are satisfied) and based on the new 'base rate entity' concept, it would not.

The difficulty with this difference arising is for the companies that have already lodged their 2017 income tax return and distributed franked dividends whose position will be

incorrect under the concepts in the Exposure Draft. These companies will have paid tax at the lower rate of 27.5% and issued distribution statements for dividends which would have been franked to 27.5%, rather than 30%. They will likely have to amend their returns to pay the top-up tax to the rate of 30% and apply to the Commissioner of Taxation to be permitted to amend their distribution statements[3] unless the Commissioner provides an administrative concession similar to that contained in draft Practical Compliance Guideline PCG 2017/D7.

In addition, taxpayers would not have had to consider what proportion of their assessable income was passive income for the 2017 income year. Where this is now to be taken into account retrospectively, this again may alter the outcome regarding which corporate tax rate applies that was previously determined by the taxpayer company and require the taxpayer to amend its 2017 income tax return and distribution statements as noted above.

4. Base rate entity passive income (draft section 23AB)

The Tax Institute has a number of concerns with how this term is being defined. As an overarching comment, 'base rate entity passive income' should be defined to be that portion of assessable income attributable to the categories of passive income proposed to be included in the Rates Act. We propose the following simple amendment to draft section 23AB by insertion of the words '***Base rate entity passive income*** is that part of your assessable income comprised of:' instead of the words 'Each of the following is ***base rate entity passive income:'***. (This is discussed further below.)

i) Distributions other than non-portfolio dividends

- The definition of 'base rate entity passive income' excludes non-portfolio dividends (draft subsection 23AB(a)) with no reference to whether or not the underlying entity in which the shares are held meets the requirement of being a business entity. This potentially leads to income from investments in passive investment vehicles and entities that exceed the turnover tests being potentially eligible for the lower tax rate where the recipient company is eligible for the lower tax rate.

- Paragraph 1.10 of the Explanatory Memorandum (**EM**) states that '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'. In our view, as a non-portfolio dividend is excluded from being 'base rate entity passive income' anyway, the comment seems irrelevant.

  There also seems to be some confusion here. Based on our interpretation, it seems the EM is suggesting there is a requirement that the subsidiary entity needs to be carrying on active trading business for the distribution from that

[3] Section 202-85 of the 1997 Act

entity not to be regarded as 'base rate entity passive income' of the holding company, otherwise it will be. This requirement is not captured in the Exposure Draft.

If Treasury is trying to ensure that a typical holding company that derives non-portfolio dividends is actually able to access the lower company tax rate so that no top-up tax is payable by the holding company on distributions from a subsidiary by requiring the distribution to come from a subsidiary that carries on active trading business, then this needs to be made clear in the Exposure Draft and the EM.

ii) Interest

- Interest derived by a business whose income is principally derived from the lending of money is excluded from being 'interest income' under the definition of the term 'interest' in section 6 of the 1936 Act. We query the position of an internal finance company under these rules and whether it is intended the interest income it derives would also be excluded from being 'interest' and therefore 'base rate entity passive income' (once again, the undefined concept of 'carries on a business' creates uncertainty).

iii) Royalties

- There is a lack of clarity regarding how to treat the income derived by businesses primarily engaged in providing goods and services associated with information technology, for example as software developers, web developers, online content and website hosting, to name a few. In the past, their income may have been regarded as 'royalties'. In this regard, the Government's 'innovation agenda' should be carefully considered when defining passive income for the purpose of determining a company's eligibility for the lower company tax rate, particularly as what taxpayers have come to know as 'royalties' has changed so much.

- It is arguable that the 'royalty' derived by these businesses is in fact active trading business income rather than passive income. In this regard, we question whether it is appropriate for all royalties to be included in the definition of 'base rate entity passive income' or whether royalties derived which in effect amount to active trading business income should be excluded.

- We note the definition of 'royalty' as contained in section 6 of the 1936 Act is not relied on for this purpose. Is this intended? Not using the section 6 definition has advantages for, for example, a company carrying on an active business of leasing equipment.

iv) Rent

- What definition of 'rent' applies for this purpose? Does this cover all types of leasing and finance activities? Should it and does it cover income from a 'depreciating asset' as contained in section 328-175(6) of the 1997 Act?

- Where there is an entity in a group that leases the business premises to the operating entity, should the premises be treated as an 'active asset' within the meaning of section 152-40 so that the rent earned by the leasing entity would be excluded from being 'base rate entity passive income'? This is a significant issue and creates inequity where the business and the business premises are owned by the same entity (and therefore there is no rental charge) versus the circumstances where the business and the business premises are held in separate entities (this structure is ordinarily used for asset protection purposes)[4].

- The derivation of rent from commercial leasing activity also has potential for controversy. Prima facie, this category of rent is considered to be passive income for the purposes of the 'base rate entity passive income' test, but as a matter of fact, the derivation of rent from commercial leasing activity can be quite an 'active' undertaking. Ignoring the $10 million threshold for the moment, it would be unlikely that the income derived by a company that owns and operates a large shopping centre would be considered to be passive. That undertaking requires management of the building, dealing with tenants, engaging of contractors to provide maintenance services, dealing with advisers including lawyers and accounts, extensive administration activities and the like. Certainly this company would be accepted as carrying on a business. We query, however, why a smaller version of that same activity, which does not exceed the $10 million threshold, ought not still qualify as an active business, doing exactly the same activities, but on a smaller scale. We suggest that this issue needs to be considered carefully, otherwise it is likely to lead to some very prejudicial outcomes.

v) Capital gains

- It appears that all capital gains are included in 'base rate entity passive income'. It is unclear whether this is a reference to 'gross capital gains' or 'net capital gains'.

- This does not seem to be an appropriate outcome and therefore we consider that 'base rate entity passive income' should be defined as a relevant portion of 'assessable income'. We note that this wording will attempt to ensure that the

[4] The same inequity issue arises for businesses where the intellectual property (**IP**) is held by a separate entity to the rest of the business and the business pays a royalty for use of the IP.

numerator and denominator in the 'base rate entity passive income' calculation are consistent (this is discussed further below).

- We consider that the reference should be to 'net capital gains' which is consistent with the amount for capital gains that would be included in 'assessable income'.

- While there is also the anti-overlap rule in section 118-20 of the 1997 Act which serves to reduce capital gains to the extent they are otherwise included in assessable income, in the interests of certainty, it would be preferable to not have to rely on the operation of rules like this and that the capital gains that are intended to be included in 'base rate entity passive income' are clearly defined in the Rates Act.

- We note that this is also likely to impact on decisions around the timing of the sale of capital assets that may impact whether the 80% threshold is exceeded or not for a particular income year. This will likely be problematic for taxpayers who otherwise carry on active business and in a particular income year make a very large capital gain on a genuinely active asset (e.g. sells a warehouse in the inner city to a developer) due to the 'lumpy' nature of capital gains (and refer also to the comments on the anti-overlap rule above). While we suggest that to alleviate the problem, net capital gains could be notionally spread over some years for the purposes of this calculation, this would add further complexity to these rules.

vi) Amounts attributable to distributions from partnerships and trusts

- The requirement to trace through partnerships and trusts seems a sensible compromise, but is likely to be complex in operation. For example, where a trust that derives both active and passive income incurs costs related to producing both types of income[5], a 'fair and reasonable' apportionment of these costs will need to be made and this may not always be simple to determine.

- If a trust purports to distribute only active income to a company and passive income elsewhere according to the exercise of a discretionary power in the trust deed, will the distribution of active income to the company be accepted as 'base rate entity passive income'?

- If a trust distributes to another trust before the distribution is made to the company in question, do you trace through to the first trust?

- Per draft subsection 23AB(f), amounts distributed from a trust (or partnership) retain their character and must also qualify as 'base rate entity passive income'. Where a group includes a discretionary trust that carries on a business, there may be opportunities for the 'controllers' of the group to manage distributions to

[5] For example, accounting and adviser fees, cost of lodging income tax returns etc.

enable a passive investment company that would not otherwise qualify for the lower corporate tax rate to obtain access to lower company tax rate.

- We note that the new rules appear to give rise to anomalous outcomes and are potentially open to manipulation. For example, common structures include entities that just own the assets or are captive financiers. In the absence of the ability to elect for 'grouping' of appropriately interconnected entities, then genuinely 'active' assets may be treated for this purpose as giving rise to passive income.

vii) Other types of income

- Should other types of income also be excluded? For example:
  - foreign exchange gains (to the extent they are separately calculated) related to passive income; a
  - Personal Services Income to the extent it is paid to the relevant individual as salary.

- How do these requirements interact with the CFC rules? Will attributed CFC income under section 456 of the *Income Tax Assessment Act 1936* (Cth) (**1936 Act**) relating to passive income be included in 'base rate entity passive income'? Technically, this should be included as otherwise there is an incentive for taxpayers to move passive income to an offshore entity.

In addition, we note the typographical error in the Exposure Draft at Item 1 of Schedule 1 where the phrase should be 'base rate entity passive income' rather than 'base rate passive income'.

5. The 80% threshold (draft section 23AA(c))

The 80% threshold is determined by measuring the 'base rate entity passive income' of the subject company as a percentage of its 'assessable income'. By virtue of the 1936 Act being incorporated in the Rates Act, the definition of 'assessable income' from the 1997 Act (referred to in the 1936 Act) applies.

It appears that anomalies arise in determining this percentage where capital gains and franking credits are considered.

i) Capital gains

A 'net capital gain' is included in assessable income per section 102-5 of the 1997 Act which will feed into the denominator of the percentage calculation. However, 'capital gains' within the meaning of the 1997 Act are included in the denominator. This appears to include gross capital gains and does not appear to factor in capital losses.

In this regard, a gross figure is included in the numerator and a net figure is included in the denominator. This may distort the outcome of the percentage calculation. We demonstrate with an example.

<u>Example</u>

A company carries on a business, and derived the following during an income year:

- Aggregated turnover of $5,000,000;
- A capital gain of $4,050,000.

The company also had a net capital loss carried forward of $4,050,000. This means the company has a net capital gain for the year of nil.

The company's 'base rate entity passive' income under draft section 23AB is $4,050,000, being the capital gain.

The company's 'assessable income' for the year is $5,000,000, being the aggregated turnover of $5,000,000, plus the net capital gain of nil.

This produces a percentage of 81% ($4,050,000 / $5,000,000) under draft subsection 23AA(c).

The outcome is that draft subsection 23AA(c) is not satisfied, and the company is not a 'base rate entity'.

However, this is an anomalous outcome because of the asymmetry between the numerator and denominator – the numerator includes the $4,050,000 gross capital gain, but the denominator does not (it includes the net capital gain of $0). This skews the percentage upwards. Other forms of passive income, like interest, would symmetrically be included in both the numerator and denominator, and therefore there is an inconsistency here.

Another way this anomaly could arise is where the capital gain is reduced by the 50% reduction, retirement exemption and/or roll-over concessions in the small business relief rules (but not where the 15-year exemption applies, as that amounts to disregarding of the capital gain).

ii) Franked dividends

The opposite effect occurs in relation to franked dividends. In this scenario, 'base rate entity passive income' includes distributions by corporate tax entities within the meaning of the 1997 Act. A 'distribution' is defined in section 960-120 of the 1997 Act to be a dividend (or something taken to be a dividend) from a company. It does not appear to include franking credits. However, 'assessable income' does include franking credits by operation of section 207-20(1) of the 1997 Act. Therefore, franking credits

form part of the denominator but do not form part of the numerator in working out the percentage of 'base rate entity passive income'. Asymmetry arises again.

Example:

A company carries on a business, and receives a $70 fully-franked dividend (and this is not a non-portfolio dividend). The $70 is included in 'base rate entity passive income' per draft subsection 23AB(a). The $70 is also included in 'assessable income', as is the $30 franking credit. Therefore, $70 is included in the numerator, but $100 is include in the denominator. This skews the percentage downwards.

Ensuring that 'base rate entity passive income' is defined as the relevant portion of 'assessable income' would remove these anomalies. In this regard, franking credits attached to distributions from corporate tax entities should also be included in 'base rate entity passive income'.

6. Example in the Explanatory Memorandum

The numbers used in Example 1.1 in the EM seem somewhat artificial and unrealistic. We query the nature of the business being carried on by Company A that would give rise to this outcome. We infer that this may arise in the instance of a company in the business of leasing intellectual property where the $7.5 million may be passive income from royalties and ordinary income for the purpose of the aggregated turnover, though this would likely be an anomalous situation.

We suggest that Treasury may like to include a more realistic situation eg a company that holds a mixed use commercial property with multiple tenancies.

7. Post-implementation review

The Tax Institute considers that it would be useful if these provisions were subject to a post-implementation review to ensure they are achieving the desired policy outcome that passive investment companies are not intended to be eligible for the lower company tax rate. The review would give the opportunity to confirm that these types of businesses have only been able to access the higher 30% corporate tax rate and not the lower rate of 27.5%.

If you would like to discuss any of the above, please contact either myself or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours faithfully,

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President