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29 September 2017

Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017

Dear Simon,

BDO welcomes the opportunity to provide feedback in response to Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017 ('Exposure Draft'), released by the Treasury on 18 September 2017, which clarifies that corporate tax entities with predominantly passive income cannot access the base rate entity corporate tax rate.

This BDO submission identifies the following issues as outlined in the Appendix:

- clarification is required as to whether a company with subsidiaries in receipt of passive income can in effect convert it into an active non-portfolio dividend for the company
- a reference to net capital gains needs to be included in the definition of 23AB – 'meaning of base rate entity passive income', as they are required to determine the net amount in working out assessable income
- franking credits need to be included in the definition of 23AB – 'meaning of base rate entity passive income', with an example to illustrate this point
- a definition of 'attributable' needs to be included in the legislation, with clarification on the extent to which a taxpayer needs to trace through more than one trust or partnership.
- an exception needs to be provided for rents or royalties received derived in the active conduct of a trade or business
- Capital gains on the sale of active business assets should be excluded from passive income
- application of the legislation needs to be extended to the 2015/16 financial year
- the definition of 'aggregate turnover' needs to exclude 'base rate passive income'

The Exposure Draft is also lacking in examples.

Should you wish to discuss any of our comments, please feel free to contact me on +61 2 9240 9736, or via email: Lance.Cunningham@bdo.com.au.

Kind regards,

Lance Cunningham
BDO National Tax Director

Appendix

Passive income

Issue: A company in receipt of passive income could simply channel it through a subsidiary and convert it into an active portfolio dividend

The Exposure Draft at 23AB includes in the meaning of 'base rate entity passive income'

a) distributions (within the meaning of the Income Tax Assessment Act 1997) by corporate tax entities (within the meaning of that Act), other than non-portfolio dividends (within the meaning of section 317 of the Income Tax Assessment Act 1936)

According to this definition, the non-portfolio dividend will not be treated as passive income even if it is paid out of passive income by the dividend paying company.

Where the dividend paying company qualifies for the lower tax rate, the passive income of the dividend paying company would not be taken into account in the 80% test of the recipient company so there could be situations where a corporate group could qualify for the lower tax rate where more than 80% of the group's income is passive income (provided the group's aggregate turnover is below the relevant threshold). This provides an avenue for a company in receipt of passive income to channel it through subsidiary companies and, on payment of non-portfolio dividends by the subsidiaries, it ceases to be passive income in the hands of the holding company.

It is not clear whether this result is the Government's intention. If it is, it should be made clear in the Explanatory Memorandum to the Bill when it is introduced into Parliament.

BDO recommends that the Government clarify whether it intends that receipt of passive income channelled through subsidiary companies results in it being converted into an active portfolio dividend. BDO also recommends an example to illustrate this point be included in the Explanatory Memorandum.

Issue - Rent and Royalties are treated passive income even if received in carrying on an active business

The definition of passive income in 23AB of the Exposure Draft includes

c) interest income (within the meaning of the Assessment Act), royalties and rent

The exclusions in the definition of 'interest income' in subsection 6(1) of the ITAA 1936 ensures that interest derived by an entity that is from the 'active conduct of a business' or banking business or money lending business will not be "interest income and therefore will not be treated as passive income. However, it appears that the same does not apply to rent or royalties that come from the active conduct of a business.

According to the Exposure Draft rent and royalties will constitute passive income irrespective of the extent of activities that would otherwise point to an active business i.e. companies which are in the business of actively deriving rent and royalties will be considered passive investment companies. It has been widely accepted for a long time that taxpayers can be engaged in the business of deriving interest, rent and royalties. BDO questions the logicality of this on policy grounds.

BDO recommends an exception is provided for rents or royalties derived in the active conduct of a trade or business.

Issue: Passive income includes ‘capital gains’ but should refer to ‘net capital gains’

In the definition of passive income in 23AB of the Exposure Draft, it includes:

e) capital gains (within the meaning of the Income Tax Assessment Act 1997)

BDO are unclear as to why this definition does not refer to ‘net capital gains’ instead of ‘capital gains’. The definition of passive income is relevant for the definition of ‘base rate entity’ in 23AA of the Exposure Draft, with the formula in 23AA(c) having passive income as the numerator and assessable income as the denominator. Given that the assessable income of the entity would only include the ‘net capital gain’ the numerator should also only include the ‘net capital gain’

As the Exposure Draft currently reads, you would include all capital gains, without reducing for capital losses (current or previous year) or small business active asset reduction in the numerator and only ‘net capital gains in the denominator, resulting in an inappropriate outcome.

BDO recommends that the reference to ‘capital gains’ in 23AB(e) be changed to ‘net capital gains’.

Issue: It is not clear if franking credits are included in the definition of s23AB – the meaning of base rate entity passive income

Similar to the previous issue in relation to ‘net capital gains’, there is also an apparent mismatch in relation to franking credits because franking credits are included in assessable income but not in the definition of ‘base rate passive income’.

As the Exposure Draft reads now, it appears that franking credits are not included as passive income because section 23AB(a) refers to “distributions by a corporate tax entity as defined in the ITAA 1997”, which is defined in section 960-120 and refers to dividends and equivalent but does not refer to franking credits.

This means that the amount of real income (disregarding franking credits) can be more than 80% passive to the extent of the effect of the franking credits.

BDO has prepared the following example to illustrate our point.

Company A has assessable income of $40.5 million, consisting of $500,000 in business income, $24 million in franked portfolio dividends and $12 million in franking credits so the company will be entitled to the 27% tax rate because its $24 million “passive income” is less than 80% of its assessable income even though it is in fact 98% of its real income (i.e. not including franking credits).

If this is the Government’s intended outcome it should be made clear in the Explanatory Memorandum.

BDO recommends that the Government clarifies whether it intends that franking credits are not included as ‘base rate passive income’.

Issue: The meaning of ‘attributable’ is not defined

The definition of passive income in 23AB of the Exposure Draft includes;

f) amounts included in assessable income under Division 5 or 6 of Part III of the Assessment Act, to the extent that they are attributable to base rate entity passive income under a preceding paragraph of this definition.

BDO seek clarification on the meaning of ‘attributable’ and clarification and extent to which a taxpayer needs to trace through more than one trust or partnership.

BDO has prepared the following example to illustrate our point.

Example 1: If a trust derives active income and distributes it to another trust, which then distributes it to a company, does this get treated as passive or active income in the company?

Example 2: If a trust derives a non-portfolio dividend and distributes it to another trust, which then distributes it to a company, does this qualify?

We believe that the word 'attributable' means that you trace through trusts and partnerships, but it is not clear whether you can trace through more than one partnership and/or trust. The draft law should confirm this.

BDO recommends a definition of 'attributable' be included in the legislation.
BDO recommends clarification on the extent to which a taxpayer needs to trace.
BDO also recommends an example to illustrate this point.

Issue – Capital gains on the sale of active business assets

In the definition of passive income in 23AB of the Exposure Draft it includes:

e) capital gains (within the meaning of the Income Tax Assessment Act 1997);

BDO can understand why capital gains could ordinarily be viewed as being passive income. This is especially the case where companies that hold equity investments and rental properties as passive investments sell those assets, the capital gains should be viewed as being passive, on the basis that the dividend and rental income derived from those assets is treated as passive income under these provisions.

However, capital gains realised on the disposal of active business assets should not be treated as passive income. The income tax legislation contains numerous examples of capital gains realised on the disposal of business assets being treated differently to other forms of capital gains. Consider the treatment of capital gains realised on the disposal of active assets in the small business CGT concessions, and in Division 768.

Consider the example of a company carrying on a small business using exclusively active assets. While the company trades, it will derive immaterial amounts of passive income, such that it will qualify for the lower company tax rate. The family who own the company and operate the business decide to retire, and the company sells the business.

As the sale of the business gives rise to a capital gain, which, under the Exposure Draft, is treated as passive income, the company may find it difficult to derive sufficient active income in this final trading year. It would be inequitable for the company to not qualify for the lower tax rate, however, the company would be at risk of so doing as the capital gain on its active assets would be treated as passive.

BDO recommends that the capital gains derived from the sale of active business assets be treated as active, not passive, income.

Retrospective amendment

Issue – The retrospective amendment does not apply to the 2015/16 financial year

Paragraph 1.22 of the Explanatory Memorandum states that the application of the amendments to the 2016/17 income year is necessary to clarify the eligibility for the lower corporate tax rate of 27.5% to make it easier for all small business entities to self-assess eligibility for the lower corporate tax rate.

BDO queries why the application of the amendments does not extend to the 2015/16 financial year when the tax rate was 28.5% for companies with a turnover threshold of $2 million. If the Government is of the belief that extending application of the measures to 2015/16 is too retrospective, then BDO argue that most of these companies would have paid tax at the 30% rate because until recently it was the common belief that passive investment companies were not carrying on business. Therefore, it could be seen as, in effect, a retrospective change by leaving 2015 out of the changes.

With respect to the imputation issues, the ATO website update does provide some clarity. The ATO advises that it has commenced processing eligible 2016–17 company tax returns at the 27.5% tax rate. Where a company has lodged their 2016–17 tax return using the 28.5% tax rate the ATO will identify them and amend them. Where a company has lodged their 2016–17 tax return using the 30% tax rate, but now believe they are entitled to the 27.5% tax rate, an amendment should be sought. Despite the ATO having clarified its view on applicability of the small business company tax rate eligibility for investment companies the associated imputation issues remain. These could be mitigated if the application of the legislation is extended to the 2015/16 financial year.

BDO recommends that the application of the legislation is extended to the 2015/16 financial year.

Aggregate turnover of passive investment companies and trusts

Issue - The inclusion of 'base rate passive income' in the definition of 'annual turnover'

The Exposure Draft provides some clarity in relation to passive investment companies being not entitled to the base tax rate but it does not clarify a related problem with respect to the definition of 'aggregate turnover' in section 328-115 ITAA 1997, which is also an important factor in determining which companies are entitled to the lower tax rate. The definition of 'aggregate turnover' is dependent on the definition of 'annual turnover' in section 328-120 ITAA 1997, which refers to the ordinary income an entity derives in the ordinary course of business.

Prior to the ATO's recent clarification that virtually all companies are treated as carrying on business, including passive investment companies, it was generally assumed that the 'passive income of companies and their connected entities would not be included in the 'annual turnover' because it was not thought to be 'business income'. However, since the ATO's clarification, this is not that clear. The Exposure Draft does not clarify the extent to which 'passive income' is to be taken into account for the 'aggregate turnover' of the company and its connected entities.

This issue also needs to be considered for trusts that are connected entities for a company that is looking to qualify for the lower tax rate. The ATO has clarified that passive investment companies are considered to be carrying on business, however, there is still some doubt whether the same rationale should apply to trusts.

If passive investment trusts are also considered to be carrying on business this could bring in the 'turnover' of many more trusts into the aggregate turnover for companies that the trusts are connected to. BDO submits that if the 'base rate passive income' is to be relevant in determining whether a company is entitled to the lower tax rate, the passive income of connected entities should be excluded from the 'aggregate turnover' for the company.

BDO recommends that the amending legislation include an amendment to section 328-120 ITAA 1997 to exclude 'base rate passive income' from the definition of 'annual turnover'.