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Dear Sir

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

Chartered Accountants Australia and New Zealand (**CA ANZ**) is pleased to provide the following comments on the abovementioned Exposure Draft (**ED**) and Explanatory Material (**EM**) designed to ensure that corporate tax entities with predominantly passive income will not qualify for the lower corporate tax rates which apply from 2016-17.

Executive summary

The Government's decision to amend the law is a welcome circuit-breaker for the issue of whether a company is carrying on a business when it derives passive income. That issue has caused considerable confusion since the original 2016-17 Federal Budget announcement in May 2016 which was exacerbated following the introduction of *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2017* (**the Bill**) in September 2016 which did not address the issue despite the absence of ATO guidance.

On the basis that the proposed amendments will apply to the 2017 income year, legislative clarity is required as soon as possible. For this reason, when suggesting changes to the proposed legislation, we have taken a minimalist approach. A consequence of this, however, is that the final legislation is unlikely to be ideal and may well create new issues and have higher compliance costs than are necessary.

We therefore recommend that there be a post- implementation review of the final legislation by Treasury or the Board of Taxation. This is particularly relevant given our understanding that whether a company is predominantly a passive investment company will be relevant under the second phase of the Enterprise Tax Plan until the 2024 income year when all companies will be subject to the same 27.5% rate.

In relation to the proposed legislation we recommend that:

- The Government reconsiders the retrospective elements of the proposed amendments and, in particular, the replacement – without prior warning - of the 'small business entity' (**SBE**) concept with the 'base rate entity' concept for the 2017 income year.
- The definition of passive income be refined to better reflect what is intended.
- Given the number and level of sophistication of taxpayers impacted by the changes, the current confusion and the complexity of the amendments, the ATO be asked to provide guidance contemporaneously with the introduction of the Bill.

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Retrospectively of proposed amendments

In its 2016-17 Budget in May 2016 the Government released a proposed 10 year company tax rate reduction schedule commencing with the 2017 income year. Soon after, the question of whether passive investment companies were carrying on a business was raised with the ATO by CAANZ and others, including in our 27 September 2016 submission to the Senate Economics Legislation Committee.

Despite this widespread concern, the Bill was ultimately passed on 9 May 2017, with amendments, but without this issue being addressed legislatively or through public guidance from the ATO. Informal indications from the ATO suggested that, other than in limited situations, all companies were likely to be regarded as carrying on a business. Unrelated to the small business tax cuts, this was also the view expressed in TR 2017/D2 dealing with the central management and control of a company.

It was not until 4 July 2017 – more than 12 months after this issue was identified - that the Government indicated that the tax rate cut for small business companies were not meant to apply to passive investment companies.

The ED seeks to amend the law to achieve that outcome. However, in relation to the 2017 income year, it goes further than denying access to the lower corporate tax rate to small business companies whose assessable income consists predominantly of passive income.

The proposed amendments also deny – without any warning - access to the lower corporate tax rate to companies:

- Which are SBEs for the 2017 year[1];
- Whose passive income is less than 80% of 2017 assessable income; *but*
- Which are not 'base rate entities' for that year because actual aggregated turnover is $10m or more.

Given the length of time this issue has been on foot there is an argument that the proposed amendments should simply not apply for the 2017 income year. When the law was enacted in May 2017 small business companies, including some public companies, assessed their eligibility for the 27.5% tax rate. This was reflected this in their financial statements and, in some cases, dividend statements which will now need to be amended (sometimes for a second time).

At a minimum, in our view, the Government should reconsider denying access to the lower rates to SBEs simply because they do not qualify as 'base rate entities' for that year. This change was not announced or mooted at any time prior to the release of the ED.

Definition of passive income

General

Before commenting on the specific amounts which are treated as passive income we make two observations:

- Based on the ED, to determine eligibility for the 27.5% company tax rate companies are required to calculate their aggregated turnover (based on ordinary income concepts), passive income (which is a mix of ordinary income and assessable income concepts) and total assessable income.

  At first blush, if the focus is on an income test, there would appear to be some merit in passive income comprising amounts of ordinary income and the 80% test based on aggregated turnover (modified as necessary). This would have two potential benefits. Firstly, for many companies aggregated turnover – and hence their tax rate for a year - will be known earlier than assessable income for that year which is generally only known with certainty around the time an income tax return is required to be lodged. This is an important consideration for companies on the borderline of the 80% passive income test. Secondly, it reduces the number of calculations required to determine the applicable tax rate.

- Our second observation is that there are now a number of provisions in the income tax law that seek to draw a distinction between active and passive income or assets, e.g. the small business CGT concessions in Division 152 of the Income Tax Assessment Act 1997 (**the 1997 Act**), the controlled foreign company rules in Part X of the Income Tax Assessment Act 1936 (**the 1936 Act**) and the active foreign business asset rules in Subdivision 768-G of the 1997 Act.

  The ED uses income, as opposed to assets, to determine whether a business is active or passive. Given the time constraints we have not considered whether there

[1] Generally because their aggregated turnover for the 2016 income year was less than $10m or they genuinely estimated their aggregated turnover for the 2017 income to be less than $10m (as was the case in previous two income years).

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is a more compliance friendly and holistic approach based on assets. However, this is likely to be relevant should the Government accept our recommendation that the final legislation be subject to a post-implementation review.

In the event that there is too little time to properly consider changing to a new test we make the following comments on proposed concept of passive income.

Distributions by corporate tax entities (other than non-portfolio dividends)

As the ED is drafted dividends, other than non-portfolio dividends, are passive income. Broadly speaking, a non-portfolio dividend is any dividend paid to a shareholder company which has a voting interest of at least 10 per cent in the payer.

So, dividends paid by a wholly owned subsidiary to its holding company will not be passive income, regardless of whether the subsidiary carries on an active trading business or a predominantly passive investment business. We understand that the ED has intentionally been drafted this way.

In these circumstances we recommend that this be made clear in the EM which, as currently drafted, could be read as suggesting that non-portfolio dividends will not be passive income only if the company paying the dividend carries on an active business (see paragraph 1.10).

The effect of this approach is that while dividends paid by a predominantly passive investment company directly to its shareholders will attract a franking credit based on the company's 30% tax rate, they will only attract a 27.5% franking credit if routed through a holding company (assuming the dividend is the holding company's only income).

We note, as drafted, passive income includes only portfolio dividends paid to a company and not the franking credits attached to the dividends which are also included in assessable income. So, a small business company which derives only dividends fully franked at either 30 or 27.5 per cent (or a mixture of both) will be a base rate entity as less than 80% of its assessable income will be passive income. For example, a small business company which in a year receives $70,000 dividend income, fully franked at 30%, from portfolio interests in listed companies will have 70% passive income, i.e. $70,000 passive income/$100,000 assessable income. If this is unintended the definition of passive income will require modification.

Interest income (as defined), royalties and rent

The proposed definition of base rate passive income in proposed s23AB(c), includes 'interest income' within the meaning of the 1936 Act. In relation to the definition we observe that:

- The definition is very old[2] and potentially problematic. It will require small business companies to revisit the circumstances in which amounts which are not interest might properly be regarded as being in the nature of interest.

[2] The definition of 'interest income' replicates the definition contained in former s 160AE(3) employed for the purposes of the foreign tax credit system which was replaced by the foreign income tax offset rules in Division 770 of the 1997 Act with effect from 1 July 2008. The definition, together with the definition of 'passive income' which includes interest income, were moved to s6 as they were relevant to the calculation of the (now abolished) mature age worker tax offset.

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- The definition excludes interest derived from a transaction directly related to the active conduct of a trade or business. As we understand it, the ATO proposes issuing guidance on when a company is carrying on a business. That or separate guidance will need to consider the circumstances in which a company carrying on a business derives interest income which is not directly related to the active conduct of that business.
- The exclusion from passive income of interest income directly related to the active conduct of a trade or business begs the question of why a similar exclusion does not apply to other items of passive income, e.g. rent in the case of a leasing company or a property rental company.

We assume that in the context of proposed s23AB the term 'royalties' is intended to bear its ordinary meaning and not its extended meaning based on the definition in s6(1) of the 1936 Act. We agree with this approach and recommend that the legislation, by way of note, or the EM make this clear.

Unlike the term 'royalty', the term 'rent' is not defined in either the 1936 or 1997 Act and should therefore bear its ordinary meaning.

We recommend that:

- As small business companies affected by the proposed amendments are unlikely to be familiar with what constitutes interest income, as defined, ordinary concepts royalties or rent, appropriate guidance should be provided on these concepts in the EM and/or by the ATO simultaneously with the introduction of the legislation.

- As a matter of policy, any income derived directly from the active conduct of a business should not be treated as passive income. This should extend not only to royalties and rent but all other categories of passive income, including net capital gains on disposal of active assets used in a business, including goodwill.

Gains on Division 16E qualifying securities

Proposed s 23AB(d) treats as passive income 'gains on qualifying securities (within the meaning of Division 16E of Part III of the Assessment Act)'. We note that Division 16E does not contain a concept of 'gains'. As a result, the returns in respect of Division 16E qualifying securities which are intended to be treated as passive requires further refinement.

At the same time consideration should be given to the treatment of returns on qualifying securities under Division 230 and on traditional securities.

As indicated above, in our view, passive income should exclude amounts derived in relation to the active conduct of a trade or business.

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Capital gains

The proposed definition also takes into account 'capital gains' within the meaning of the 1997 Act. This means that passive income will include things like:

- gains on the disposal of assets such as trading stock or motor vehicles which give rise to capital gains, as defined, but which are then subsequently disregarded for CGT purposes;
- capital gains on the disposal of assets in an income year but which are reduced by capital losses made during that year, as well as carried forward capital losses; and
- importantly, capital gains on the disposal of active assets that are used to carry on a business (for example goodwill).

A consequence of this is that, in calculating whether a company's passive income is 80% or more of its assessable income, the numerator (passive income) will include amounts which are not reflected in the denominator (assessable income).

The treatment of capital gains needs revisiting and amending to achieve an appropriate outcome. We have already made the point that in our view passive income should exclude net capital gains arising from the disposal of active assets.

Passive income derived though a trust/partnership

As currently drafted, to the extent that partnership and trust amounts included in assessable income are attributable to passive income they retain that character in the hands of the small business company partner or beneficiary. This is regardless of whether the distribution is from a family discretionary trust or an interest in a fixed or unit trust, including managed funds.

In our view, requiring small business companies to trace through distributions from managed funds which they do not control is simply unworkable.

Tracing through other trusts and partnerships will also be problematic in circumstances where the small business company does not have sufficient control over the partnership or trust to allow it to access information to determine the extent to which distributions are attributable to passive income. To require them to do so in these circumstances invites non-compliance with the law.

In our view the treatment of distributions from trusts and partnerships requires further refinement which should take into account the level of control a small business company has over the partnership or trust.

Interaction with imputation

The proposed amendments do not address the ongoing concerns regarding the disparity between the company tax rate and the rate at which dividends may be franked.

These concerns have previously been raised by CAANZ in submissions and discussions with both the Treasury and Government and are not repeated here.

Need for contemporaneous ATO guidance

As noted at the outset, there has been unprecedented confusion and uncertainty amongst small business companies and their advisers as to whether they would qualify for the small

business company tax cuts announced in the 2016-17 Budget in May 2016 which required that they carry on a business. That uncertainty should have been clarified at the latest by the time the Bill giving effect to the announcement was passed in May 2017. But it was not.

The ED seeks to address legislatively the circumstances in which a company, which does carry on a business, will qualify for the lower company tax rate and seeks to do so retrospectively for the 2017 income year. As we understand it, the ATO is intending to provide guidance on the threshold question of when a company is actually carrying on a business.

Given this background and the complexity of the proposed amendments, in our view it is essential that, contemporaneously with the introduction of amending legislation, the ATO issue guidance on:

- the threshold issue of when a company will be regarded as carrying on a business;
- the amending legislation itself, including the passive income concepts we have identified as requiring guidance (to the extent they are not dealt with in the explanatory memorandum to the amending legislation); and
- any administrative issues which arise as a result of the amendments applying retrospectively to the 2017 income year.

There is also an important education and awareness campaign needed.

We are cognizant the ATO's view on when a company is carrying on a business may have implications for other parts on the income tax law and possibly also the GST law. However, this should not delay the release of guidance relevant to these proposed amendments.

If you wish to discuss our comments please contact Michael Croker on 02 9290 5609 or by email at michael.croker@charteredaccountantsanz.com or Susan Cantamessa on 02 9436 1176 or by email at susan.cantamessa@charteredaccountantsanz.com.

Yours sincerely

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