Private and Confidential
Mr Simon Winckler
Manager
Corporate and Internatiional Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: simon.winckler@treasury.gov.au

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Dear Mr Winckler

Exposure Draft Law - Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017

PwC welcomes the opportunity to comment on the exposure draft law - Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017 - that seeks to clarify the eligibility for the company tax rate cuts.

PwC has been a strong supporter of a tax reform agenda to achieve corporate tax rate reductions for all companies. However, it is imperative that the pathway to such an outcome is simple and easy to apply and administer.

At the outset, it is our view that the existing uncertainty over the application of the tax rate applicable to any corporate tax entity should be resolved as soon as possible. This will be particularly relevant for private companies that will need to issue their distribution statements for the year ended 30 June 2017 by the end of October. Many companies will also be required to make a final payment of income tax for the year ended 30 June 2017 by 1 December 2017. It is also relevant for those companies which are preparing financial statements for interim or final reporting when accounting for income taxes.

In brief, our key comments on the current proposed modifications to the law relate to:

1. Retrospective nature of the proposal - adverse impact for those companies that have relied on the law as enacted in May 2017

2. Continued lack of certainty over the requirement for the corporate tax entity to be carrying on a business

PricewaterhouseCoopers, ABN 52 780 433 757
One International Towers Sydney, Watermans Quay, Barangaroo NSW 2000,
GPO BOX 2650 Sydney NSW 2001
T: +61 2 8266 0000, F: +61 2 8266 9999, www.pwc.com.au

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3. Definition of base rate entity passive income - compliance complexity and inequitable outcome in relation to capital gains and also in relation to the year that part of a company's capital gains tax 'active assets' are sold.

We also raise an additional observation on the consequential impacts of the rate reduction insofar as it relates to the treatment of excess franking offsets.

These issues are discussed in further detail in the attached Appendix.

We would welcome the opportunity to discuss our views further. Should you wish to do so, please contact me on (02) 8266 2266 or Lynda Brumm on (07) 3257 5471.

Yours faithfully
PricewaterhouseCoopers

Glen Frost
Partner
Private Clients

Appendix A

All section references are to the Income Tax Assessment Act 1997 (ITAA 1997) unless otherwise stated.

Retrospective nature of the proposed amendments

We are opposed to the changes proposed by the exposure draft law that are to apply retrospectively from the 2016-17 income year.

We submit that any changes to limit the ability for a corporate tax entity to qualify for the 27.5% tax rate should not apply to any income year that ended before the date that the current exposure draft law was publicly released on the basis that the changes are more than mere clarification and could not have been anticipated.

We are aware that there have been some corporate tax entities which had relied on the law as enacted in May 2017 such that they qualified as small business entities for their 2016-17 income year (which has since ended) and accordingly were eligible for the 27.5% tax rate for that income year but may now find that they are not eligible under the proposed measures. These companies applied the law as enacted in good faith and relied on the additional tax savings in budgeting cash flow, and in preparing financial statements and in planning for making company distributions to shareholders.

It is inequitable that an announcement is now made in the form of the current exposure draft which clearly changes the position for eligibility. To require corporate tax entities to revisit this position again brings with it an increased compliance cost.

We are aware of at least one company that will need to reissue their shareholder distribution statements (for the second time) if these proposed changes proceed as currently drafted. Distribution statements were initially issued reflecting the 30% tax rate and then again to cater for the law change in May 2017 to 27.5%. It now appears that they will have to reissue their distribution statements again as they predominantly derive passive income and will therefore need to reflect the 30% tax rate.

The two main aspects of retrospectivity which potentially prevent such companies from being eligible for the 27.5% tax rate for the 2016-17 income year relate to:

- the differences in the meaning of a 'small business entity' and 'base rate entity' (the latter originally enacted to apply only from the 2017-18 income year), and
- the new integrity measure for limiting the extent of the entity's passive income (i.e. the new concept of 'base rate entity passive income').

Although we acknowledge that it makes sense to have a consistent approach when determining eligibility for the corporate tax rate reduction between income years, it is disappointing to see this retrospective change made without prior warning to taxpayers. It is worth pointing out that the exposure draft law made no change to the previously enacted small business company tax rate of 28.5% which will still apply to the 2015-16 income year by reference to the 'small business entity' definition and without any limitations on the nature of its assessable income. Having said that, we are not suggesting that there be any change to the application of the law for that year. It is, however, unclear why the current proposal should now amend the law for the 2016-17 income year.

Carrying on a business

Although these proposed changes are intended to clarify the Government's position with respect to passive entities, the question of whether a company is 'carrying on a business' still remains a matter of considerable conjecture.

Although the Australian Taxation Office (ATO) has indicated it is currently consulting on this issue, we are yet to see any additional guidance. Unfortunately, the position is not made clearer by these proposed amendments.

Until some further ATO guidance or legislative change is announced, there will still be an unresolved question as to whether all companies are able to satisfy the 'carrying on a business' requirement.

Given this uncertainty and in light of the proposed passive income limitation we submit that the 'carrying on a business' requirement should be removed. This would considerably simplify matters and provide much needed certainty for corporate taxpayers.

Definition of base rate entity passive income

The proposed definition of 'base rate entity passive income' of a corporate tax entity includes 'capital gains (within the meaning of the Income Tax Assessment Act 1997)'.

Having regard to the requirement to measure base rate entity passive income as a percentage of the entity's assessable income when determining whether an entity qualifies as a base rate entity, we believe that the use of the term 'capital gains' is inappropriate. This is because this term as defined pays no regard to the fact that only 'net capital gains' (which is determined after applying capital losses and appropriate small business discounts) are included in assessable income. We submit that the definition should make reference to 'net capital gains (within the meaning of the Income Tax Assessment Act 1997)' which is what is included in the entity's assessable income.

In addition, we submit that this definition be further adjusted to exclude capital gains which arise from the sale of active assets as defined in section 152-40 of the ITAA 1997.

Although the small business CGT concessions contained in Subdivision 152-A of the ITAA 1997 may operate to disregard all or part of a capital gain on the sale of active assets, these concessions will not apply to all taxpayers who are potentially able to access the lower corporate tax rate due to the differing aggregated turnover thresholds and conditions that apply.

Without amendment to the proposed definition of 'base rate entity passive income' we may therefore see companies, who have previously been carrying on an active business and able to access the lower corporate tax rate, denied access to the lower rate in the year of sale of their business or a substantial part of their business assets, as the capital gain on the sale of active assets results in the failure of the 80% base rate entity passive income test. Similar outcomes may also result where capital gains from the sale of active assets are distributed through trusts to corporate beneficiaries.

To disallow access to the lower corporate tax rate in these instances seems inequitable as taxpayers who are exiting from their active business operations will be disadvantaged.

The introduction of the 80% base rate entity passive income test will also result in additional compliance obligations for many corporate taxpayers as they will now be required to identify and trace the receipt of base rate entity passive income through group structures or other intermediary partnerships and trusts.

For some corporate taxpayers this may be a simple process given the types of assessable income derived and structure adopted. But for others this may be a time consuming task, particularly where they are in receipt of different types of passive income and there is a requirement to trace through multiple trusts and partnerships. This is an added compliance cost which may partially negate the benefits provided by the lower corporate tax rates.

It would be useful if the proposed Explanatory Material also includes an example that applied the notion of base rate entity passive income in determining whether or not a corporate tax entity qualified as a base rate entity having regard to the 80% base rate entity passive income test.

Consequential amendments

Although this issue is not a result of the proposed changes set out in this current exposure draft law, it is unclear why the law requires that the amount of the tax loss for an income year which results from an excess franking offset for that year be worked out by reference to the 'corporate tax rate for imputation purposes' for that year. We submit that it is more appropriate for the tax loss to be worked out by reference to the actual corporate tax rate.

The definition of corporate tax rate for imputation purposes effectively requires corporate tax entities to take into account their prior year aggregated turnover (and now proposed to also include prior year base rate entity passive income and assessable income) when working out the corporate tax rate that applies for imputation purposes in the current year.

It is our view that it is unnecessary to apply this 'look back' approach when calculating the amount of a tax loss that arises from an excess franking offset in subsection 35-55(2) simply because:

- the amount of actual tax that the company pays for the income year in which the excess franking offset arises (the current year) is determined by reference to its actual corporate tax rate (there is no need to make any assumptions as to the company's actual aggregated turnover etc for the current year as the actual income year has ended); and
- the excess franking offset cannot be calculated until after the current year has ended.

To ensure that the resulting tax loss is properly reflective of the corporate tax entity's actual income tax rate that applies for the current year, we submit that references to the 'corporate tax rate for imputation purposes' in the subsection 35-55(2) Method Statement be replaced with the 'corporate tax rate'.