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Dear Simon

### Submission — Eligibility for the lower company tax rate

TaxBanter welcomes the opportunity to make a submission to The Treasury in relation to the exposure draft of the *Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017* ('the draft Bill') released on 18 September 2017.

TaxBanter provides professional tax training to businesses of all sizes throughout Australia. We regularly engage with The Treasury and the ATO in relation to the development and administration of tax policy.

### Submission

The provisions in the draft Bill are intended to clarify the current law affecting the eligibility of companies to access the lower corporate tax rate (27.5 per cent in the 2016–17 to 2023–24 income years with further reductions in the rate from 2024–25). However, in our view, there are several issues with the proposed amendments which are set out below.

In this submission:

- 'the First Condition' refers to the condition that a company is required to **carry on a business** to be eligible for the lower tax rate as set out in s. 328-110(1)(a) of the *Income Tax Assessment Act 1997 (ITAA 1997)* for small business entities (SBEs) and s. 23AA(a) of the *Income Tax Rates Act 1986 (ITR Act)* for base rate entities (BREs);
- 'the Second Condition' refers to the **aggregated turnover test** in:
  - for SBEs — s. 328-110(1)(b) of the *ITAA 1997*; and
  - for BREs — s. 23AA(b) of the *ITR Act*; and
- 'the Third Condition' refers to the proposed **base rate entity passive income (BREPI) test** in proposed s. 23AA(c) of the *ITR Act*.

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## 1. HOLDING COMPANIES

### *Is a holding company carrying on a business?*

While para. 1.10 of the draft Explanatory Memorandum (EM) makes it clear that a dividend paid from a wholly-owned subsidiary to its holding company would not be BREPI, para. 1.10 doesn't consider whether the holding company in this example would be considered to be carrying on a business, which (assuming its aggregated turnover is less than the aggregated turnover threshold) would entitle the holding company to access the lower tax rate, thereby preventing the holding company from being liable for top-up tax of 2.5 per cent where the subsidiary is a BRE.

During a telephone discussion with us on 19 September 2017, Paul Fischer (of The Treasury) confirmed that it is the Government's policy intent to treat a wholly-owned group consistently for tax purposes.

**WE SUBMIT** that if it is the Government's policy intent that the effect of the provisions is that a holding company — of a wholly-owned subsidiary which carries on a business, and satisfies the Second and Third Conditions, and which is therefore taxed as a BRE at 27.5 per cent — also be taxed at 27.5 per cent, the EM should make it clear that, in this circumstance, the holding company is taken to carry on a business and therefore satisfies the First Condition.

### *Subsidiary not wholly-owned*

It is not clear from the EM what the outcome would be in the case where the holding company has a non-portfolio interest in a subsidiary but does not wholly own that subsidiary. If the holding company holds an interest in the subsidiary of at least 10 per cent but less than 100 per cent, a dividend paid from the subsidiary would not constitute BREPI under proposed s. 23AB(a) in the hands of the holding company, but it is not clear whether the holding company would satisfy the First Condition.

**WE SUBMIT** that the EM should also consider the outcome where a holding company has a non-portfolio interest in a subsidiary of less than 100 per cent. This would explain the Government's policy intent and provide guidance to holding companies that hold a non-portfolio interest in, but do not wholly own, a subsidiary.

## 2. CORPORATE BENEFICIARIES

Based on proposed s. 23AB(f), to the extent a trust distribution to a corporate beneficiary is attributable to:

- business income derived by the trust, it will not be BREPI in the hands of the company;
- passive income derived by the trust, it will be BREPI in the hands of the company.

Assuming that the trust carries on a business and distributes its income to a company that satisfies the aggregated turnover test, then the Second and Third Conditions will be satisfied by the corporate beneficiary. However, the corporate beneficiary must still determine whether it satisfies the First Condition i.e. does it carry on a business?

### *Does a corporate beneficiary carry on a business?*

During the telephone discussion on 19 September 2017, Paul Fischer stated that:

- where a trading trust distributes its business income to a company, it is the Government's policy intent to treat the trust and the company as a 'single business unit' for income tax purposes; and
- it is likely that, in this case, the company would be carrying on a business and would therefore be taxed at the lower rate of 27.5 per cent.

I asked Paul whether the same outcome would arise where the business is carried on in a unit trust that is owned by a discretionary trust, and the unit trust distributes its business income to the discretionary trust which then distributes the income to the corporate beneficiary. Paul replied that, in that case, the corporate beneficiary is further down the chain and more removed from the unit trust that carries on the business, so it is unlikely that the company would be carrying on a business and would therefore be taxed at the higher rate of 30 per cent.

In most cases, it is generally understood that a corporate beneficiary does not carry on a business in its own right; rather the trustee of the trust confers on the company a present entitlement to a share of its trust income, and that proportionate share of the trust's net income is assessable to the [resident] company under s. 97 of the *ITAA 1936*. Most taxpayers regard a corporate beneficiary as a passive entity that would be taxed at 30 per cent. However, the view expressed by The Treasury above suggests that, not only could the lower tax rate of 27.5 per cent apply to a corporate beneficiary, but a different tax rate could apply to different corporate beneficiaries depending on how removed they are from the trust that is carrying on the business.

The same issue arises in relation to distributions to non-resident corporate beneficiaries — these distributions are assessed to the trustee under s. 98(3)(b) of the *ITAA 1936*, based on the rates set out in s. 28(a) of the *ITR Act*, which refers the taxpayer back to the rates in s. 23(2) of the *ITR Act*.

#### *Examples of structures involving corporate beneficiaries*

Following a request to us to submit examples of structures involving corporate beneficiaries, below we list some of the common structures where a trust directly or indirectly distributes its income to a corporate beneficiary.

We ask that you consider the following typical scenarios and determine whether the policy intent is that these companies should always be taxed at the lower rate of 27.5 per cent or whether some should not qualify for the lower rate (assume that, in all cases listed below, the Company satisfies the Second and Third Conditions):

- a business is carried on by a discretionary trust that distributes some or all of its trust income to a Company;
- a business is carried on by a unit trust in which some or all of the units are held by a Company and the unit trust distributes some or all of its trust income to the Company;
- a business is carried on by a unit trust in which some or all of the units are held by one or more discretionary trusts, which distribute some or all of their trust income to one or more Companies;
- a business is carried on by a partnership of two or more discretionary trusts which each receive a partnership distribution, then each discretionary trust distributes some or all of their trust income to one or more Companies;
- a business is carried on by a company in which some or all of the shares are held by one or more discretionary trusts, which distribute some or all of their trust income to one or more other Companies; and
- there may be structures involving a trading entity and two or more entities interposed between the trading entity and the Corporate beneficiary.

The issue is whether the policy intent is to treat corporate beneficiaries as carrying on the business that is carried on by an entity that directly or indirectly distributes its income to that corporate beneficiary. It is accepted that if the corporate beneficiary does not satisfy the aggregated turnover test or the proposed BREPI test, the Second and Third Conditions are failed; so regardless of whether the company carries on a business as a question of fact, it will be taxed at the rate of 30 per cent and its maximum franking rate will also be 30 per cent.

**WE SUBMIT** that where the distribution received from the trust is not attributable to BREPI and therefore the Third Condition is satisfied (assume that the Second Condition is also satisfied), there should be no difference in the tax rate applicable to corporate beneficiaries. The policy intent should not result in some corporate beneficiaries being taxed at 27.5 per cent because they receive the income directly from a trading trust while others are taxed at 30 per cent merely because they happen to receive the income indirectly from a trading trust or trading company via one or more interposed trusts.

Alternatively, if the policy intent is to apply the lower tax rate to corporate beneficiaries that receive non-BREPI directly from a trust that carries on a business (i.e. there are no entities interposed between the trading trust and the corporate beneficiary) and satisfies the Second Condition, then **WE SUBMIT** that:

- both the currently legislated and proposed provisions be reviewed to ensure they clearly reflect this policy intent; and
- the EM should clearly state this policy intent and provide a number of practical examples.

*Franking rate of distributions made by corporate beneficiaries*

A corporate beneficiary will need to determine its maximum franking rate when it makes a franked distribution to its shareholders from retained earnings that comprise trust distributions received in one or more prior income years.

It is not clear from the legislated or proposed provisions whether the maximum franking rate that applies to a distribution made by a corporate beneficiary in an income year is 27.5 per cent or 30 per cent to work out the **corporate tax gross-up rate**.

Consider whether the outcome is affected by whether the corporate beneficiary:

- is taken to carry on a business in the income year in which the company makes a distribution to its shareholders ('the current income year') or in the previous income year;
- receives a trust distribution in the current income year as well as the previous income year;
- receives a trust distribution only in the current income year but not in the previous income year;
- received a trust distribution only in the previous income year but not in the current income year; and
- received a trust distribution in one or more prior income years but not in the previous income year or the current income year.

**WE SUBMIT** that the provisions and/or the EM provide guidance on the Government's policy intent in relation to the maximum franking rate of a corporate beneficiary that makes a distribution to its shareholders from its retained earnings where:

- (a) no income is derived by the company in the current year but income was derived in the previous income year; and alternatively
- (b) no income is derived by the company both in the current income year and in the previous income year.

### 3. INCOME TESTS

#### (a) Treatment of capital gains in proposed BREPI test

Paragraph (e) of proposed s. 23AB provides that 'BREPI includes capital gains (within the meaning of the *ITAA 1997*)'. Section 995-1(1) of the *ITAA 1997* defines a **capital gain** as:

for each \*CGT event a capital gain is worked out in the way described in that event

Accordingly, in working out the amount of a capital gain that is included in a company's BREPI, the company includes the gross capital gain, after reducing the asset's capital proceeds by the asset's cost base, but **before** applying reductions or concessions such as:

- capital losses;
- small business CGT concessions (Div 152); and
- a CGT roll-over or exemption.

However, for the purpose of working out whether the company satisfies the proposed BREPI test in s. 23AA(c), the company includes in its 'assessable income' the **net capital gain** which is worked out using the method statement in s. 102-5 of the *ITAA 1997*. Under this method statement, any applicable reductions and concessions are applied against the gross capital gain. In some cases, the net capital gain may be reduced to nil.

It is possible that, not only could the capital gain for BREPI purposes be at least 80 per cent of the company's assessable income; it could be equal to it or even exceed it. This would cause the company to fail the Third Condition and be taxed at 30 per cent.

This could easily occur if a company makes a significant capital gain that is disregarded or reduced under the tax law but the gross capital gain (before the concession or reduction applies) is taken into account in working out the company's BREPI.

For example, a company carries on a business and has an annual turnover of \$1.5 million. It sells its business premises and makes a capital gain of \$1.8 million from the sale of the property. The company either is a **CGT small business entity** or satisfies the maximum net asset value test (s. 152-10(1)(c)) and so is eligible for the small business CGT concessions. Assume the company qualifies for the 15-year exemption (Subdiv 152-B) and disregards the capital gain of \$1.8 million; none of the capital gain is included in the company's assessable income.

However, paragraph (e) of proposed s. 23AB and proposed s. 23AA(c) require the company to include the gross capital gain of \$1.8 million in its BREPI, causing the company to exceed the 80 per cent threshold (its BREPI would be 120 per cent of its assessable income). Accordingly, the company would be taxed on its business income at the rate of 30 per cent rather than 27.5 per cent, even though the company satisfies the First and Second Conditions and none of the capital gain is included in the company's assessable income.

This is inconsistent with the Government's small business policy which provides certain concessions to small business; in the example above, the company would be eligible for the 15-year exemption but not eligible for the lower tax rate of 27.5 per cent.

**WE SUBMIT** that proposed s. 23AB(e) should include the company's **net capital gain** not the gross capital gain.

#### (b) No grouping rules apply to BREPI and assessable income in BREPI test

Grouping rules apply to determine whether a company satisfies the aggregated turnover test: see s. 328-115(2) of the *ITAA 1997*.

In contrast, the proposed BREPI test in s. 23AA(c) of the *ITR Act* takes into account only BREPI and assessable income of the company for the current income year; it does not include the BREPI or assessable income of any other entity.

We are concerned that as the grouping rules are inconsistently applied across the Second and Third Conditions (i.e. the grouping rules apply to the aggregated turnover test but not to the proposed BREPI test), taxpayers may incorrectly assume the grouping rules apply in determining whether the company satisfies the proposed BREPI test, which could result in the wrong outcome and the wrong tax rate being applied.

**WE SUBMIT** that proposed s. 23AA (as amended) include a note to explain that the company's BREPI and assessable income be worked out without taking into account the BREPI and assessable income of any other entity (if that is the policy intent).

### (c) Operation of 'dealings' exclusion in aggregated turnover test

Section 328-115(3)(a) of the *ITAA 1997* provides that the **aggregated turnover** of an entity excludes:

amounts \*derived in the income year by you or a relevant entity from dealings between you and the relevant entity while the relevant entity is \*connected with you or is your \*affiliate;

It is not clear whether the term 'dealings between you and the relevant entity' extends to trust distributions received by a company, where the trust is connected with the company within the meaning of s. 328-125 and is therefore a relevant entity of the company.

**WE SUBMIT** that the EM clarify that if a trust is connected with a company — and therefore the trust's annual turnover is aggregated with that of the company to determine whether the company satisfies the Second Condition — that a distribution from the trust to that company be excluded from the company's annual turnover as a 'dealing' between the company and the trust. Otherwise, the amount could be included twice in the calculation of the company's aggregated turnover.

## 4. BRE AND BREPI CONCEPTS PROPOSED TO COMMENCE ON 1 JULY 2016

### *Bring forward of BRE concept to 1 July 2016*

The draft Bill proposes that the amendments commence on 1 July 2016 and that the concept of a BRE will be brought forward by one year so that the lower corporate tax rate of 27.5 per cent will apply from 2016–17 to an entity that is a BRE (rather than an SBE).

While this will make the law consistent from 2016–17 to the 2017–18 and later income years, it will have another consequence. Currently, companies determine their eligibility for the 27.5 per cent rate in 2016–17 based on the SBE concept which uses either current year or previous year turnover in working out whether the company satisfies the aggregated turnover test: see s. 328-110(1)(b) of the *ITAA 1997*.

Under the proposed amendments, companies would need to determine their eligibility for the 27.5 per cent rate in 2016–17 based on the BRE concept, which uses only current year turnover: see paragraph (b) in s. 23AA of the *ITR Act*.

Accordingly, if the proposed amendments become law, a company that carries on a business with a turnover of at least \$10 million in 2016–17 but less than \$10 million in 2015–16 would no longer be able to rely on its 2015–16 turnover to access the 27.5 per cent rate in 2016–17; it would instead be taxed at 30 per cent based on its 2016–17 turnover.

Such a company may have already lodged its 2017 tax return, which would necessitate:

- amending the lodged tax return;
- the company paying an additional 2.5 per cent tax (which the company is unlikely to have budgeted for); and
- time spent by tax agents to amend affected tax returns — this would result in an administrative burden and increased compliance costs on taxpayers, and on tax agents who may not be able to recover all of their costs incurred in attending to the amendments on behalf of their clients.

*Proposed BREPI concept commencing on 1 July 2016*

Further, the draft Bill proposes that the new BREPI concept, and the new definition of **corporate tax rate for imputation purposes** in s. 995-1(1) of the *ITAA 1997* (which includes the proposed BREPI test in working out the maximum franking rate), apply from the 2016–17 income year.

Some companies have already advised their shareholders of over-franked dividends in the 2016–17 income year because of the enacted changes to the calculation of maximum franking credits in accordance with the ATO's guideline **PCG 2017/D7**. They may now find that their franking rate in fact should be based on 30 per cent not 27.5 per cent as a result of the proposed BREPI test applying from 1 July 2016. This outcome would arise if — for 2015–16 — a company's aggregated turnover is less than \$10 million but its BREPI is at least 80 per cent of its assessable income (for an example, see the discussion in **3.(a)** above).

This may necessitate the company advising its shareholders for the second time of a revised franking credit. This could affect the tax position of shareholders who have claimed, or are able to claim, those franking credits in their 2017 tax returns.

Where shareholders have already lodged their returns:

- they would need to amend their returns which may result in a different tax outcome; and
- necessary amendments to tax returns already lodged by these shareholders would give rise to additional compliance costs which may not be fully recoverable by tax agents.

**WE SUBMIT** that, to avoid confusion and resulting amendments of lodged tax returns of numerous companies and shareholders, and the need to revise franking credit notifications, the commencement of the BRE and BREPI concepts should be 1 July 2017 instead of the proposed date of 1 July 2016. Any alleviation of the burden of taxpayers having to consider the SBE concept for 2016–17 and the BRE concept from 2017–18 would be outweighed by the cost of amending lodged 2017 tax returns that would be affected by the bringing forward of the BRE concept by one year.

Consequentially, **WE SUBMIT** the commencement of the proposed new definition of **corporate tax rate for imputation purposes** (incorporating the additional assumptions) should also be delayed until 1 July 2017.

If you would like to discuss any aspect of this submission, please contact me on (03) 9660 3500.

Yours sincerely



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