THE TAX INSTITUTE

30 November 2017

Ms Renee George
Australian Taxation Office
GPO Box 9990
BRISBANE QLD 4000

By email: CompanyCarryingOnBusiness@ato.gov.au

Dear Ms George,

Draft Taxation Ruling TR 2017/D7

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to draft *Taxation Ruling TR 2017/D7 Income Tax: when does a company carry on a business within the meaning of section 23AA of the Income Tax Rates Act 1986?* (**Draft Ruling**).

Summary

Our submission below addresses our main concerns in relation to the Draft Ruling. In particular:

- The scope of application of the Draft Ruling including the time periods to which the Draft Ruling applies and consideration of the development of an omnibus ruling;
- Some issues with the Draft Ruling; and
- Particular comments on some of the examples in the Draft Ruling.

Discussion

1. Scope of application of the Draft Ruling

The original scope of the Draft Ruling was limited to applying to section 23AA of the *Income Tax Rates Act 1986* (Cth) (**Rates Act**). However, the following statement was published on the ATO website on 2 November 2017:

Carrying on a business

The ATO has issued a draft Taxation Ruling on when a company carries on a business.

Early consultation on the Ruling has highlighted a question about the provision around which the advice should be framed. The draft Taxation Ruling addresses whether a company is carrying on a business for the purpose of identifying whether it is a base rate entity in section 23AA of the Income Tax Rates Act 1986 (ITRA 1986). This is relevant for determining whether it is subject to the 27.5% or 30% corporate tax rate in the 2017/18 and later income years. The reasoning expressed in the Ruling is, however, equally applicable to determining whether a company is a small business entity within the meaning of section 23 of the ITRA 1986 and section 328-110 of the Income Tax Assessment Act 1997 (ITAA 1997) for the 2015/16 and 2016/17 income years and therefore which rate is applicable to it in those income years.

In light of this and the proposed changes to the law, the Commissioner is proposing to finalise the draft Ruling in relation to section 23 of the ITRA 1986 and 328-110 of the ITAA 1997, rather than section 23AA of the ITRA 1986 as it is presently drafted.

Based on this, The Tax Institute's comments pertain to the Draft Ruling as if it has already been modified. We assume for this purpose that references to section 23AA of the Rates Act should instead be read as references to section 23 of the Rates Act and section 328-110 of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**).

a) Relevant time period

The first matter we raise is that the income years to which the Draft Ruling will apply will need to be made clear in the finalised ruling.

Section 23 as it currently stands in the law and which applies from 1 July 2017 onwards, refers to the concept of a 'base rate entity[1]'. 'Base rate entity' is currently defined in the Rates Act to include an entity if it carries on a business (within the meaning of the 1997 Act) and its aggregated turnover (within in the meaning of the 1997 Act) is less than $25 million. The *Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017* currently before Parliament amends section 23AA to remove the 'carries on a business' test with effect from 1 July 2017. Should this Bill be passed, the concept of 'carries on a business' will not be a relevant factor in section 23AA and consequently section 23 from 1 July 2017 (ie the 2018 income year onwards)[2].

Earlier forms of section 23 (see Appendix A) referred to the concept of 'small business entity', a concept which is defined in section 328-110 of the 1997 Act.

[1] The concept of 'base rate entity' was introduced into the Rates Act by *Treasury Laws Amendment (Enterprise Tax Plan) Act 2017* (Cth) with effect from 1 July 2017.

[2] *Treasury Laws Amendment (Enterprise Tax Plan No.2) Bill 2017* is also currently before Parliament. This Bill, if passed, will remove the concept of 'base rate entity' altogether from the Rates Act with effect from 1 July 2023 onwards.

Section 328-110(1) states:

> **Meaning of small business entity**
> General rule: based on aggregated turnover worked out as at the beginning of the current income year
>
> (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.

A significant element of this definition is whether a company carries on a business in the current income year or carried on a business in the income year before the current year in question. Therefore, whether a company qualifies as a small business entity and therefore whether it can qualify for the lower interest rate turns on how the concept of carrying on a business is defined.

Therefore, the concept of carrying on a business is relevant for the income years in which section 23 of the Rates Act referred to the definition of 'small business entity', being the 2015-16 income year and the 2016-17 income year and the definition of 'small business entity for these income years and onwards for the instances where that expression occurs in other parts of the tax law.

The table below summarises the income years we believe the Draft Ruling will apply to and for which purpose:

Income Year	**Purpose**
2015-16	Section 23 of the Rates Act (as it then was)
2016-17	Section 23 of the Rates Act (as it then was)
2015-16 onwards	Where the expression small business entity is used throughout the tax law and is defined by reference to section 328-110.

If this is correct, the ATO will need to make it very clear in which time periods the Draft Ruling applies and for what particular purposes in those time periods. If this is not made clear, it will be difficult for taxpayers to know when they are able to rely on the Draft Ruling and for which particular purposes.

b) Scope of ruling

The scope of the initial draft of the Draft Ruling has already been changed to apply the Draft Ruling to both former versions of section 23 as it applied in the 2015-16 and 2016-

17 income years. This demonstrates a willingness by the ATO to ensure that the Draft Ruling applies in relevant circumstances.

However, The Tax Institute considers that the Draft Ruling should be expanded further, in effect becoming an omnibus ruling for guidance on the issue of what it means to carry on a business for all relevant purposes of the tax law. While we appreciate this will be an extensive exercise to undertake, we consider that the exercise would be worthwhile and would transform the Draft Ruling into a highly useful and reliable piece of guidance from the ATO. Given this would take some time to achieve, we suggest that the Draft Ruling be finalised for the purpose of the current scope of the ruling with the ATO undertaking to then immediately review and expand the scope of the ruling.

We also have some difficulty in reconciling the statements in paragraph 1 and paragraph 2 of the Draft Ruling as it currently stands. We observe that the *Income Tax Assessment Act 1936* (Cth) is not referred to and query whether this is intentional or an oversight. As the scope of the Draft Ruling has already been changed, we consider that these paragraphs will need to be reworked. Further, should the ATO decide to further expand the scope of the Draft Ruling, these paragraphs may no longer be relevant.

c) Taking a facilitative approach

We note that in her media release of 18 October 2017[3], the Minister for Revenue and Financial Services, the Hon Kelly O'Dwyer MP, noted that the ATO had advised it would adopt a 'facilitative approach' to compliance in relation to the application of the 'carrying on a business' test for the 2016-17 income year and that it would not select companies for audit unless their decision in relation to the test was 'plainly unreasonable'.

If this is the case, the ATO should formally capture this approach in some public guidance, perhaps in a Practical Compliance Guideline.

2. Issues with Ruling

a) Carve out for companies limited by guarantee – paragraph 3

We query why companies limited by guarantee have been carved out from the application of the Draft Ruling. Companies limited by guarantee can conduct businesses, even if their stated objective is not to make distributions to its members (shareholders).

b) Choice of language – 'overall impression'

The expression 'overall impression' is used in the Draft Ruling in paragraphs 10 and 44. This expression is vague. We consider that there are alternative expressions that could be used, for example 'weighing up of factors' which is an expression used in the case law and more accurately reflects what is being done.

[3] http://kmo.ministers.treasury.gov.au/media-release/102-2017/

c) Reliance on certain case law

The Draft Ruling is quite heavily reliant on the findings in cases such as *American Leaf Blending Co. Sdn Bhd v Director-General of Inland Revenue (Malaysia)* [1978] 3 All ER 1185; *Inland Revenue Commissioners v Korean Syndicate Ltd* [1921] 3 KB 258 and *Brookton Co-operative Society Ltd v FCT* (19810 147 CLR 441.

These, and many of the other cases upon which the Draft Ruling is reliant, were decided at a time when a company's Articles and Memorandum of Association might have been expected to cover virtually any conceivable 'business' as an 'object' of a company and would therefore have been indicative of what was the company's business.

Although those cases admittedly usually confirmed that the stated objects were not conclusive of what was the company's 'business', there are statements in those cases about the presumed 'business' nature of the activities of a company – for example, paragraph 15 cites *American Leaf* for the 'presumption' that a company receiving rent from property would be carrying on a business. In this case, the taxpayer argued that the renting out of property must be the business because the objects of the company included a 'business' of renting out property. While the Court considered that the taxpayer's argument was 'too broad' a proposition, it was not rejected entirely.

We query whether this presumption can or should be made given companies no longer have objects that would be expected to list all its 'businesses'.

In our view, the precedential value of these cases needs to be reassessed in light of the subsequent changes to the *Corporations Act 2001* (Cth). These cases may be found to have less weight than the ATO is currently giving them in determining when a company is carrying on a business.

3. Particular comments on specific examples

a) Share trader vs share investor – Example 4

We query the relevance of the distinction made in the example that a third party is not engaged by ShareCo to manage its portfolio of shares. Does the outcome of Example 4 change if a third party was engaged to manage ShareCo's portfolio of shares? If so, this should be made clear as should the consequence.

b) Example 5

In our view, Example 5 is somewhat unsatisfactory. We note the following in relation to this example:

- the example assumes that the UPE remains which suggests that the sub-trust arrangements covered by PS LA 2010/4 may be what is contemplated;
- it should be made clear whether a provision of financial accommodation/in substance Division 7A loan can or cannot be relevant;

- there is no indication of when the loan should be made;
- is the Division 7A benchmark interest rate a commercial rate of interest?
- the example states that the loan moneys are 'secured' against the trust assets. Is this essential?
- Possibility C is an extreme example.
- The ruling should expressly state whether or not typical loan situations that occur in relation to UPEs are or are not 'business' situations.

c) Example 7

There is extensive discussion in *Miscellaneous Tax Ruling MT 2006/1 "Entity carrying on an enterprise" for the purposes of entitlement to an ABN* at paragraphs 191 to 201 regarding the activities of a holding company and when a holding company may be carrying on an enterprise or business. In determining the outcomes of the proposed 'Possibilities' in Example 7, the ATO should have regard to this existing view in MT 2006/1 with regard to the cases referenced when a holding company may be carrying on a business and ensure there is consistency between the view contained in MT 2006/1 and the view in the Draft Ruling.

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,

Matthew Pawson
President

Appendix A

Applicable from 1/7/15 to 30/6/16

23 Rates of tax payable by companies

(1A) This section has effect subject to section 23A.

(1) The rates of tax payable by a company, other than a company in the capacity of a trustee, are as set out in the following provisions of this section.

(2) The rate of tax in respect of the taxable income of a company is:

(a) if the company is a small business entity for a year of income—28.5%; or

(b) otherwise—30%;

if subsections (3) to (5) and section 23A do not apply to the company.

(3) The rates of tax in respect of the taxable income of a company (other than a life insurance company) that is an RSA provider are:

(a) in respect of the RSA component—15%; and

(b) in respect of the standard component—30%.

(4) The rates of tax in respect of the taxable income of a company that becomes a PDF during a year of income and is still a PDF at the end of the year of income are:

(a) in respect of the SME income component—15%; and

(b) in respect of the unregulated investment component—25%; and

(c) in respect of so much of the taxable income as exceeds the PDF component—30%.

(5) The rates of tax in respect of the taxable income of a company that is a PDF throughout the year of income are:

(a) in respect of the SME income component—15%; and

(b) in respect of the unregulated investment component—25%.

(6) The amount of tax payable by a company (before applying any rebate, credit or other tax offset (within the meaning of the *Income Tax Assessment Act 1997*)) must not be greater than 55% of the amount (if any) by which the taxable income of the company exceeds $416, if:

(a) the company is a non-profit company; and

(b) the taxable income is not greater than:

(i) if the company is a small business entity for a year of income—$863; or

(ii) otherwise—$915.

(7) The amount of tax payable by a company (before applying any rebate, credit or other tax offset (within the meaning of the *Income Tax Assessment Act 1997*)) must not be greater than:

(a) if the company is a small business entity for a year of income—42.75%; or

(b) otherwise—45%;

of the amount by which the taxable income of the company exceeds $49,999, if the company is a recognised medium credit union in relation to the year of income.

Applicable from 1/7/16 to 30/6/17

23 Rates of tax payable by companies

(1A) This section has effect subject to section 23A.

(1) The rates of tax payable by a company, other than a company in the capacity of a trustee, are as set out in the following provisions of this section.

(2) The rate of tax in respect of the taxable income of a company is:

(a) if the company is a small business entity for a year of income—27.5%; or

(b) otherwise—30%;

if subsections (3) to (5) and section 23A do not apply to the company.

(3) The rates of tax in respect of the taxable income of a company (other than a life insurance company) that is an RSA provider are:

(a) in respect of the RSA component—15%; and

(b) in respect of the standard component:

(i) if the company is a small business entity for a year of income—27.5%; or

(ii) otherwise—30%.

(4) The rates of tax in respect of the taxable income of a company that becomes a PDF during a year of income and is still a PDF at the end of the year of income are:

(a) in respect of the SME income component—15%; and

(b) in respect of the unregulated investment component—25%; and

(c) in respect of so much of the taxable income as exceeds the PDF component:

(i) if the company is a small business entity for a year of income—27.5%; or

(ii) otherwise—30%.

(5) The rates of tax in respect of the taxable income of a company that is a PDF throughout the year of income are:

(a) in respect of the SME income component—15%; and

(b) in respect of the unregulated investment component—25%.

(6) The amount of tax payable by a company (before applying any rebate, credit or other tax offset (within the meaning of the *Income Tax Assessment Act 1997*)) must not be greater than 55% of the amount (if any) by which the taxable income of the company exceeds $416, if:

(a) the company is a non-profit company; and

(b) the taxable income is not greater than:

(i) if the company is a small business entity for a year of income—$832; or

(ii) otherwise—$915.

(7) The amount of tax payable by a company (before applying any rebate, credit or other tax offset (within the meaning of the *Income Tax Assessment Act 1997*)) must not be greater than:

(a) if the company is a small business entity for a year of income—41.25%; or

(b) otherwise—45%;

of the amount by which the taxable income of the company exceeds $49,999, if the company is a recognised medium credit union in relation to the year of income.