



THE TAX INSTITUTE

5 October 2018

Mr Mark Bertone
Australian Taxation Office
GPO Box 9977
MELBOURNE VIC 3001

By email: mark.bertone@ato.gov.au

Dear Mr Bertone,

Draft LCR 2018/D7: Base Rate Entities and Base Rate Entity Passive Income

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office in relation to the *Draft LCR 2018/D7: Base Rate Entities and Base Rate Entity Passive Income (Draft LCR)*.

Summary

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

- We have made comments in relation to certain definitions used in the Draft LCR;
- We have made comments in relation to some of the examples in the Draft LCR; and
- We have some minor comments in relation to some of the guidance documents referred to in Appendix 1 of the Draft LCR.

Discussion

1. General Comments

Overall, we consider that the Draft LCR provides reasonable guidance for circumstances involving changing rates which are quite complex.

a) Corporate distributions

Not all practitioners would have extensive knowledge associated with the nuances of the definition of 'non-portfolio dividend' in section 317 of the *Income Tax Assessment Act 1936* (Cth) (**1936 Act**) or 'distribution' in section 960-120 of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**) (which would include deemed dividends, say under Division

7A or section 47 of the 1936 Act). It would be useful, for ease of reference within the Draft LCR, if the Australian Taxation Office (**ATO**) could include a description of a 'non-portfolio dividend' in Table 1 at paragraph 8 and paragraph 33 of the Draft LCR.

We suggest that another example, following on from Example 1.3, showing that where a wholly owned company pays a non-portfolio dividend to a trust which then makes a corporate beneficiary specifically or presently entitled to that dividend, the dividend is not considered to fall within the definition of a non-portfolio dividend in the hands of the corporate beneficiary (consistent with the ATO view in Taxation Determination TD 2008/25).

b) Definition of rent

We note that the Draft LCR refers to Taxation Determination TD 2006/78 for the definition of 'rent' for the purpose of 'base rate entity passive income' (**BREPI**)¹. In our view, the ATO should also consider specifically what kinds of payments under a 'licence to occupy' arrangement² would be included in the definition of 'rent'.

c) Gains on qualifying securities

It would be useful for practitioners if the ATO could clarify that gains on 'qualifying securities' (as defined in section 159GP of the 1936 Act) are included as BREPI even if the gain instead arises under Division 230 of the 1997 Act (see s230-455(1)(e)(ii)).

d) Net capital gains

It would be useful for practitioners if the ATO could clarify that a discounted/concessional net capital gain from a trust (section 95³ net income) distributed to corporate beneficiary would be grossed-up in the hands of the company before applying capital losses and so forth.

2. Examples

a) Example 1.1

There is a reference to 'net rental income'. We are unclear whether this means rental income net of apportioned expenses or not. The test in section 23AA of the Rates Act compares BREPI to assessable income. It appears that BREPI is intended to be a gross amount (of rent, interest, etc) which is compared with assessable income rather than these amounts after taking into account deductions.

We put forward an example for the ATO's consideration. Assume for example a company earns \$250,000 of 'active income' and a trust earns \$850,000 of rent with \$100,000 of

¹ Section 23AB(1)(e) of the *Income Tax Rates Act 1986* (Cth) (**Rates Act**)

² Refer to paragraphs 62 and 63 of *Jakjoy Pty Ltd v FCT* [2013] AATA 526

³ 1936 Act

deductions. The trust makes the company presently entitled to 100% of the income of the trust. The company will have assessable income of \$1,000,000 (that is, \$250,000 + \$750,000). Does the ATO consider that the company's BREPI is:

- the rental income of the trust excluding the \$100,000 expenses ie the *gross* amount of \$850,000 (in which case its BREPI would be 85% ie \$850,000/\$1,000,000); or
- the rental income of the trust including the \$100,000 expenses ie the *net* amount of \$750,000 (in which case BREPI would be 75% ie \$750,000/\$1,000,000).

It would be useful if the ATO could confirm the analysis as this inconsistency in the components of the formula would appear unintended.

It would also be useful if the ATO could clarify what they mean when using the terms 'net' and 'gross' throughout the Draft LCR.

b) Example 1.2

It would be useful if the ATO could clarify the differing views on 'streaming' for trust law purposes, taxation purposes, and the base rate entity rules.

The ATO has said previously in the Decision Impact Statement for *Greenhatch v FCT* [2012] FCAFC 84 that:

"...the Commissioner views the approach of the Full Federal Court as consistent with the proposition that absent any specific rules elsewhere in the Tax Acts the proportionate share of the net income of the trust that is included in assessable income ... has no character beyond that inherent in the share of the net income as being a proportionate share of all net income".

Section 23AB states that BREPI includes "... an amount included in the assessable income of a partner in a partnership or of a beneficiary of a trust estate ... to the extent that the amount is referable (either directly or indirectly through one or more interposed partnerships or trust estates) to another amount that is base rate entity passive income ..."

The Draft LCR (including Example 1.2 and paragraphs 18 and 19) should clarify that, consistent with the ATO's view on the application of *Greenhatch*, that absent specific rules to stream amounts (for which the ATO has previously expressed the view that only capital gains and franked amounts can be streamed for tax purposes), BREPI will be a proportionate share of all income. This is irrespective of whether an amount can be streamed for trust law purposes.

A suggested amendment to Example 1.2 could be (edits in red):

24. Company 1, Sub Trust 1 and Bob are beneficiaries of the Busy Trust. The net income of Busy Trust consisted of the following amounts:

- \$500,000 net business income;

- \$100,000 net franked dividend income;
- \$300,000 net unfranked dividend; and
- \$200,000 net rental income.

25. Pursuant to the terms of the trust deed, the trustee of Busy Trust resolved to make Company 1 presently entitled to its net business income and specifically entitled to the net franked dividend income, Bob presently entitled to the net unfranked dividend, and Sub Trust 1 presently entitled to the net rental income.

26. For tax law purposes, as Company 1 was presently entitled to \$500,000, it was presently entitled to 50% of the net income of the trust.

27. Although Company 1's share of net income is \$500,000, that amount is not referable solely to business income. The effect of Division 6 of the 1936 Act is that Company 1's share of net income is attributable to:

- \$250,000 of business income, which is not BREPI;
- \$150,000 of unfranked dividend income, which is BREPI; and
- \$100,000 of rental income, which is BREPI.

28. Company 1 is also specifically entitled to \$100,000 of franked dividend income, which is BREPI.

29. Company 1 had no other income apart from the Busy Trust. Of the \$600,000 of income from the Busy Trust to which Company 1 was presently or specifically entitled, 58% is referable to BREPI and Company 1 qualifies for the lower corporate tax rate.

We also note that the Commissioner's view in the *Greenhatch* Decision Impact Statement is inconsistent with earlier guidance – for example, Taxation Ruling IT 2680 concerning the application of Division 11A – and the Commissioner also noted in the Decision Impact Statement “[t]he Commissioner is intending to provide guidance in the form of public rulings as to his views on the tax effectiveness of streaming of relevant income to non-residents (specifically foreign income, and dividend, interest and royalty income attracting the rules in Division 11A of Part III of the ITAA 1936 and Subdivision 12-F of Schedule 1 to the Taxation Administration Act 1953), and the streaming of income on which foreign tax has been paid.”⁴ No guidance has been forthcoming and it would be appreciated if we could separately receive any indication of the status of this guidance.

It would be useful if the ATO could also clarify that this example of ‘streaming’ and income retaining its character is relevant for the purposes of BREPI. It would also be useful if the ATO could clarify that the trust deed in this example permits the streaming to occur (and allows for the financial accounts to identify the business and rental income separately and for the trustee resolutions to identify the separate parts of the income.) The statement ‘for trust law purposes’ (in paragraph 25 and comments in paragraph 18)

⁴ The Decision Impact Statement for *FCT v Bamford* [2010] HCA 10 made similar statements “...issues which remain uncertain include ... the manner in which Division 6 interacts with other provisions which rely on a beneficiary's present entitlement to the income of a trust (for example, Division 11A)”.

allows this inference to be drawn, however the Draft LCR would benefit if this was clarified.

Also, taxpayers might rely on this example to, for example, stream interest income that is subject to withholding tax (we note the ATO has previously expressed the view that only capital gains and franked amounts can be streamed for tax purposes (see above)). Clarifying the example in this respect would then be consistent with the comments in paragraph 19 which makes note of amounts other than franked distributions and capital gains being shared between beneficiaries proportionately.

c) Example 1.4

Example 1.4 is an example concerning passive income from a sub-trust. It would also be useful if the Draft LCR included an example with business income being distributed from a sub-trust to compare the outcomes.

d) Example 1.5

Paragraph 44 in the Draft LCR implies the ATO has formed a view under section 328-120 of the 1997 Act that passive rental income distributed to Succotash Pty Ltd is “ordinary income” derived by the company “in the ordinary course of carrying on a business”. That is, that amount is the annual turnover of Succotash Pty Ltd. Is this a correct conclusion?

e) Example 2.2

It would be useful if the ATO could clarify that the corporate tax rate that applies is 27.5% and this should be included in paragraph 53. It would also be useful if the ATO amended paragraph 55 as follows to clarify the example and adopted similar language to that used in paragraph 49 (suggested edits in red):

55. Emu Co has a 2017-18 corporate tax rate for imputation purposes of 27.5%. This is because ~~its~~ **it is assumed its** aggregated turnover, **BREPI and assessable income are the same as the previous year, being \$24 million assessable income for the 2016-17 income year of which 55% was BREPI, in order** ~~and base rate passive income,~~ to calculate its corporate tax rate for imputation purposes in the 2017-18 income year. **This** is below the \$25 million dollar threshold, and less than 80%.


Similar comments are applicable to Example 2.3.

3. Appendix

- The reference to *Taxation Ruling TR 2004/17 Income tax: indemnification of royalty withholding tax* should be moved from the box against 'Interest' to the box against 'Royalties'.
- We query the inclusion of the reference to *Draft Consolidation Taxation Ruling TR 2002/14DAC3 Income tax: taxation of retirement village operators* in the box against 'Rent' and whether this ruling is relevant to the concept of 'rent' in the Draft LCR. Irrespective, we think the reference should have been referred to as TR 2002/14A3.

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,

A handwritten signature in black ink, appearing to read 'Tracey Rens', with a stylized flourish at the end.

Tracey Rens
President