client alert | explanatory memorandum

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CURRENCY:

This issue of **Client Alert** takes into account developments up to and including 23 October 2017.

Consultation paper: combating phoenix activities

The Federal Government has released a consultation paper on company and tax law reforms to combat phoenix activities. Phoenixing occurs when individuals or entities strip assets from an indebted company and transfer them to another company to avoid paying the first company's liabilities.

The following proposals are under consideration:

- The ATO, or whichever agency is best placed to do so, could operate a singular "phoenix hotline" so that any information reported by the community about phoenix concerns could be shared with all members of the Government's Phoenix Taskforce.
- It is proposed to amend the *Corporations Act 2001* to establish a specific phoenix offence, prohibiting the transfer of property from one company to another if the main purpose of the transfer was to prevent, hinder or delay the process of that property becoming available for division among the first company's creditors. Rebuttable presumptions of insolvency would apply, and such a transaction would be void against a liquidator (so that the assets could be clawed back in liquidation).
- The promoter penalty laws could be extended to apply to promoters of illegal phoenix activity to assist in disrupting the phoenix business model, and in particular to facilitators who advise or aid and abet illegal phoenix activity. One option would be to expand the scope of the promoter penalty law to apply not just to "tax exploitation schemes", but also to activities designed to avoid taxation obligations, including by rendering a company unable to pay its obligations. Another option is to create a new provision outside of the existing promoter penalty laws, similar to the provision on the promotion of illegal early release of superannuation benefits.
- The director penalty notice regime could be extended to include companies' outstanding GST obligations. Directors of these companies would be personally liable to pay a penalty equivalent to the amount of unpaid GST. The proposed expansion would apply to all directors.
- There could be a limitation on a sole director's ability to resign from office without either first finding a replacement director or winding up the company's affairs. This could be enacted by amending the Corporations Act to deem such a resignation ineffective.

New passive income test for lower corporate tax rate

The recently introduced *Treasury Laws Amendment (Enterprise Tax Plan Base Rate Entities) Bill 2017* ensures that a company will not qualify for the lower company tax rate if more than 80% of its assessable income is passive income.

The Bill modifies the requirements that must be satisfied for a corporate tax entity to qualify as a "base rate entity" by replacing the "carrying on a business" test with a passive income test. More specifically, the Bill amends the *Income Tax Rates Act 1986* to ensure that, from the 2017–2018 income year, a corporate tax entity will qualify for the lower corporate tax rate for an income year if:

- no more than 80% of the its assessable income for that income year is base rate entity passive income; and
- the corporate tax entity's aggregated turnover for the income year is less than the aggregated turnover threshold for that income year.

The amendment will apply from the 2017–2018 income year. In the 2016-2017 income year, a company will need to be carrying on a business and have a turnover under $10 million to qualify for the 27.5% tax rate.

Meaning of "passive income"

An amount of assessable income will be considered "base rate entity passive income" if it is:

- a distribution by a corporate tax entity (other than a non-portfolio dividend);
- franking credits attached to such a distribution;

- a non-share dividend;
- interest;
- a royalty;
- rent;
- a gain on a qualifying security;
- a net capital gain; or
- an amount that is included in the assessable income of a partner in a partnership or a beneficiary of a trust estate to the extent that the amount is referable to another base rate entity passive income amount.

An amount that flows through a trust to a corporate tax entity (ie directly from the trust to the corporate tax entity) will retain its character for the purposes of determining whether the amount is base rate entity passive income of the corporate tax entity. That is:

- if an amount derived by a trust is, for example, a dividend (other than a non-portfolio dividend) which passes directly from the trust to a beneficiary that is a corporate tax entity, then the amount *will* be base rate entity passive income of the corporate tax entity because the trust distribution is directly referable to the dividend of the trust;
- if an amount derived by a trust is, for example, trading income which passes directly from the trust to a beneficiary that is a corporate tax entity, then the amount *will not* be base rate entity passive income of the corporate tax entity because the trust distribution is directly referable to the trading income of the trust.

Imputation changes

The Bill makes consequential amendments to the operation of the dividend imputation system.

Under the imputation system, the amount of franking credits that can be attached to a distribution cannot exceed the "maximum franking credit" for the distribution. The maximum franking credit is worked out with reference to the "corporate tax gross-up rate" and the "corporate tax rate for imputation purposes".

Corporate tax entities usually pay distributions to members for an income year during that income year. However, a corporate tax entity will not know its aggregated turnover, the amount of its base rate entity passive income, or the amount of its assessable income for an income year until after the end of that income year. The Bill therefore provides that a corporate tax entity must assume, for the purposes of working out its corporate tax rate for imputation purposes for an income year, that:

- its aggregated turnover for the income year is equal to its aggregated turnover for the previous income year;
- its base rate entity passive income for the income year is equal to its base rate entity passive income for the previous income year; and
- its assessable income for the income year is equal to its assessable income for the previous income year.

If the corporate tax entity did not exist in the previous income year, its corporate tax rate for imputation purposes for an income year will be the lower corporate tax rate of 27.5%.

ATO guidance: what is "carrying on a business"?

The ATO has issued Draft Ruling TR 2017/D7 to give guidance on whether a company is carrying on a business for the purpose of s 23AA of the *Income Tax Rates Act 1986*.

Section 23AA defines a "base rate entity" as an entity that carries on a business and has an aggregated turnover below the relevant threshold ($25 million for 2017–2018). A company that satisfies this definition is entitled to the reduced corporate tax rate (27.5% for 2017–2018).

The draft ruling addresses whether a company incorporated under the *Corporations Act 2001* (other than a company limited by guarantee) carries on a business in a general sense. It emphasises that it is not possible to definitively state whether a company is carrying on a business for s 23AA purposes. As this is a question of fact, the ATO says the answer ultimately turns on an overall impression of the company's activities, having regard to the indicators of carrying on a business.

However, the ATO is prepared to state that limited companies and no-liability companies are likely to be carrying on a business if they:

- are established and maintained to make a profit for their shareholders; and
- invest their assets in gainful activities that have both a purpose and prospect of profit.

Importantly, the draft says that a limited or no-liability company can be carrying on a business even if its activities are relatively limited and primarily consist of passively receiving rent or returns on its investments and distributing them to its shareholders.

The draft provides the following examples of companies that the ATO accepts as carrying on a business:

- a property investment company that lets out and manages a commercial property;
- a share investment company;
- a family company with income consisting only of an unpaid trust entitlement, which it reinvests – the ATO says if the company does not reinvest the unpaid present entitlement (UPE) or receives its entitlement in cash, it will not be carrying on a business;
- a company that leases multiple boats to unrelated parties; and
- a holding company that only holds shares in a subsidiary, where it invests the shares and also manages the company group.

On the other hand, the following example companies are not considered to be carrying on a business:

- a dormant company with retained profits, on which it derives small amounts of interest; and
- a company engaged solely in the preliminary activity of investigating the viability of carrying on a particular business.

Total superannuation balances: reporting obligation modified

The ATO has agreed to modify the reporting obligation for total superannuation balances, in recognition that some funds may not be in a position to report the correct accumulation phase value (APV) for 30 June 2017.

The concept of an individual's "total superannuation balance" is used to determine eligibility for various super concessions, including the $1.6 million balance limit for making non-concessional contributions, Government co-contributions, the spouse contributions tax offset, carry-forward of unused concessional contributions and the self managed superannuation fund (SMSF) segregation method. An individual's total superannuation balance at a particular time is broadly the sum of the APV, an adjusted balance for any pension transfer balance account and roll-over superannuation benefits in transit, less any structured settlement contributions.

Modified reporting obligation

The ATO notes that the APV is net of exit and administration fees payable on accessing the superannuation interest, and therefore needs to be taken into account in the valuation. However, some funds will not be in a position to report the correct APV for 30 June 2017 because they cannot exclude exit and administration fees from the reported value. This is due to varying interpretations of APV within the industry based on historical member account balance reporting. These fees are generally not material amounts. If the 30 June balance reported in the member contribution statement (MCS) is not the APV, the ATO says that funds should report the APV separately in a transfer balance account report (TBAR) around the same time as MCS lodgment.

Therefore, the ATO will provide a modified reporting obligation for the 30 June 2017 APV in the TBAR for the transition year. Funds will not be required to report an APV for 30 June 2017 if the difference between MCS account balance and APV is limited to the sum of exit and administration fees that would apply if the account was to cease at 30 June 2017.

Pension transfer balance account reports: due dates

A legislative instrument registered on 27 September 2017 sets out the way in which superannuation providers (and life insurance companies) are required to report transactions to enable the ATO to determine if an individual has exceeded their $1.6 million pension transfer balance cap.

Due date for reporting TBAR events

The instrument requires a transfer balance account report (TBAR) to be lodged no later than 10 business days after the end of the month in which the relevant reporting event occurred, or by such later date as the Commissioner may allow.

Self managed super fund admin concession until 1 July 2018

The explanatory statement to the instrument notes that an ATO administrative concession will be provided for self managed superannuation funds (SMSFs) to support their transition to event-based transfer balance cap reporting. To this end, the ATO released a position paper for consultation on 18 August 2017, proposing to allow SMSFs to defer their reporting until 1 July 2018. Going forward from that date, the position paper has put forward two options for how often SMSFs should report such events. The Commissioner also intends to provide an administrative concession for all other providers to allow them to lodge their first TBAR no later than 14 December 2017.

Reporting events

Superannuation funds and life insurance companies are required to report the following events for retirement phase income streams that result in a credit or debit in an individual's transfer balance account:

- superannuation income streams in existence just before 1 July 2017;
- superannuation income streams that commence or begin to be in the retirement phase on or after 1 July 2017;
- commutations;
- compliance with a commutation authority issued by the Commissioner;
- certain limited recourse borrowing arrangement payments;
- personal injury (structured settlement) contributions;
- superannuation income streams that stop being in the retirement phase; and
- any other relevant transactions.

Fringe benefits tax: should an Uber be treated as a taxi?

The ATO has released a discussion paper on the FBT meaning of "taxi" in light of the Federal Court decision (*Uber BV v Federal Commissioner of Taxation* [2017] FCA 110) that UberX drivers are required to be registered for GST on the basis that they supply taxi travel.

The taxi travel FBT exemption, which was introduced in 1995, limited exempt travel to taxis to ensure that the travel was provided by an arm's length supplier at commercial rates. The ATO's current position is that the exemption is limited to travel in a vehicle licensed by the relevant state or territory to operate as a taxi. It does not extend to ride-sourcing services provided in a vehicle that is not licensed to operate as a taxi.

However, as a result of the *Uber* decision and proposed changes to licensing regulations in a number of states and territories, the ATO considers it appropriate to review its interpretation of the definition of "taxi" in the *Fringe Benefits Tax Assessment Act 1986* (FBT Assessment Act).

The ATO's discussion paper poses a number of consultation questions, including:

- Should a "motor vehicle that is licensed to operate as a taxi" be interpreted to mean a motor vehicle that is statutorily permitted to transport a passenger at his or her direction for the payment of a fare that will often, but not always, be calculated by reference to a taximeter?
- Should the FBT definition of "taxi" be interpreted to include not just vehicles licensed to provide taxi services, including rank and hail services, but [also] ride-sourcing vehicles and other vehicles for hire?

The ATO accepted comments on the discussion paper until 24 October 2017.

Tax treatment of long-term construction contracts

Draft Taxation Ruling TR 2017/D8 explains the methods that taxpayers can use to return income derived, and recognise expenses incurred, in long-term construction projects (that is, projects that straddle two or more income years). TR 2017/D8 is a "refresh" of IT 2450 (the original ruling on this matter) and makes no changes to the ATO's views.

One of two methods of accounting may be adopted.

The first method is the basic approach, which is essentially the accruals method. Under this method, assessable income for an income year includes all progress and final payments received in the year, plus any amounts billed or billable to customers in the year for work carried out and certified as acceptable for payment. Amounts retained under a retention clause should not be included in assessable income until the taxpayer either receives them or is entitled to receive them from the customer. Losses or outgoings incurred during the income year are deductible to the extent permitted by law.

The second method is the estimated profits basis. This method is similar to the one laid out in AASB 15 *Revenue from Contracts with Customers*, which will be compulsory from 1 January 2018. Under the estimated profits basis, the ultimate profit or loss on a project can be spread over the years required to complete the contract. However, the ATO requires the basis of spreading to be fair and reasonable and in accordance with accepted accountancy practices. The "ultimate profit or loss" is in effect the notional taxable income expected to arise under the contract, which can be adjusted from year to year according to expectations existing at the close of each income year. Only those costs that are identified as likely to be incurred over the period of the contract and which are properly deductible may be taken into account in calculating notional taxable income.

Once a particular method is chosen, the ATO expects the taxpayer to apply it consistently for the duration of the contract. The same method should also be applied to all similar contracts that the taxpayer enters into.

Accounting methods that are not acceptable to the Commissioner include the “completed contracts” basis (which brings profits and losses to account on completion of a contract) and the “emerging profits” basis.

Foreign equity distributions to corporate entities

The ATO has issued two taxation determinations on the application of the foreign equity distribution rules in Subdiv 768-A of the *Income Tax Assessment Act 1997* (ITAA 1997) where the recipient is a corporate partner in a partnership or a corporate beneficiary of a trust.

Under Subdiv 768-A, a foreign equity distribution is treated as non-assessable, non-exempt income (NANE income) if the recipient is an Australian corporate tax entity that holds a participation interest of at least 10% in the foreign company making the distribution. This treatment applies whether the distribution is received directly from the foreign company or indirectly through interposed partnerships or trusts.

The ATO’s view is that a partnership or trust can hold a direct control interest in a foreign company for Subdiv 768-A purposes, so that an Australian corporate tax entity can have an indirect participation interest in the foreign company via the partnership or trust.

Specifically, TD 2017/21 states that a corporate partner in a partnership can have a participation interest in the foreign company for the purpose of satisfying the 10% participation test.

Similarly, TD 2017/22 provides that a corporate beneficiary of a trust can have a participation interest in the foreign company for the purpose of satisfying the 10% participation test. This aspect of TD 2017/22 differs from the draft (TD 2016/D7), which expressly stated that a corporate beneficiary of a discretionary trust can have a participation interest in a foreign company. However, the finalised determination notes that because a discretionary trustee will usually only exercise its discretion concerning the trust income and corpus at the end of the income year, a beneficiary would not have an entitlement at the test time if the foreign equity distribution is made before year-end.

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