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Attention: [Renee George \(via email:CompanyCarryingOnBusiness@ato.gov.au\)](mailto:ReneeGeorge@ato.gov.au)

1 December 2017

Draft Taxation Ruling TR 2017/D7

Dear Renee,

BDO welcomes the opportunity to provide feedback in response to Draft Taxation Ruling TR 2017/D7 ('Draft Ruling'), released by the Tax Office on 18 October 2017, which provides the Commissioner's preliminary views on when a company carries on a business within the meaning of Section 23 of the Income Tax Rates Act 1986 and Section 328-110 of the Income Tax Assessment Act 1997 (originally published as within the meaning of Section 23AA of the Income Tax Rates Act 1986, but to issue in relation to the abovementioned sections as advised by the Commissioner in a release on 2 November 2017).

Overall, we acknowledge that the comments in the main body of the Draft Ruling are reasonable. The issues that we have with the draft ruling relate to the form and content of the examples contained in Appendix 1 to the Draft Ruling.

This BDO submission identifies the following issues as outlined in the Appendix:

- The application of the Draft Ruling should apply to all legislative provisions in the Income Tax Assessment Acts 1936 and 1997 where there is a reference to a company carrying on a business. The application of the Draft Ruling should not be limited to Section 23 of the Income Tax Rates Act 1986 and Section 328-110 of the Income Tax Assessment Act 1997
- Example 1 of Appendix 1 be amended to not describe the company as a dormant company, and the position be clarified for a company which no longer trades but derives income.
- The footnote (No 84) of Example 3 be incorporated into the Draft Ruling as its own separate example, being a property investment company that outsources the management of the property to third party professional managers.
- Example 4 of Appendix 1 be expanded to include the situation where a company that invests in shares has outsourced the management of its share portfolio to third party professional managers.
- Example 6 of Appendix 1 be expanded to include the situation where a company with significant capital assets (in this case, a company that owns charter boats) has outsourced the maintenance and management of its fleet to third party professional managers.
- Example 5 of Appendix 1 be amended to incorporate examples that better accord with general practice where a company receives a distribution from a discretionary trust, and the company deals with its unpaid present entitlement in various ways. We recommend the Commissioner incorporate an example where the company has converted the UPE to a complying Division 7A loan, or the company maintains the UPE in a sub-trust arrangement in accordance with the Commissioner's sub-trust guidelines. In particular, include situations where the loans from the company are not secured.

Should you wish to discuss any of our comments, please feel free to contact me on +61 2 9240 9736, or via email: [Lance.Cunningham@bdo.com.au](mailto:Lance.Cunningham@bdo.com.au).

Kind regards,



Lance Cunningham  
BDO National Tax Director

Stated Purpose of the Ruling

Issue: The application of the Draft Ruling being limited to its stated purpose

At paragraph 2 of the Draft Ruling, it is stated:

“This draft Ruling does not consider whether a company carried on a relevant business within the meaning of provisions in the ITR 1986 or Income Tax Assessment Act 1997 (ITAA 1997). The question of whether a company is carrying on a business arises directly or indirectly in many different contexts of the income tax law, for differing purposes and with differing consequences. While similar considerations may be involved, the question must be considered in each context by reference to the particular provision in question and its purpose. Consequently, caution should be exercised in applying the reasoning expressed in this ruling in relation to other provisions of the law, and it should be borne in mind that this ruling does not bind the Commissioner in respect of those other provisions.”

BDO submits that, as the analysis of the Commissioner in the main body of the Draft Ruling is comprehensive and is supported by a number of judicial decisions, there is little merit in limiting the application of the Draft Ruling to those stated purposes of Section 23 of the Income Tax Rates Act and Section 328-110 of the Income Tax Assessment Act 1997. We submit that there is little contextual difference in the question of whether a company is carrying on a business, irrespective of the relevant legislative provision being applied.

Where the legislative provision requires the taxpayer company to be “carrying on a business”, the principles applied in this Draft Ruling should apply in all contexts. Any contextual differences in provisions specifically using that phrase would be expected to be immaterial, and there can be no merit in creating unnecessary additional compliance costs on taxpayers where the application of this Draft Ruling would enable better compliance from affected taxpayers.

BDO recommends that application of the Draft Ruling be extended to cover all aspects of income tax law where the legislation includes the require that taxpayer companies are “carrying on a business”.

Examples contained in Appendix 1 to the Draft Ruling

Issue: Example 1 - Dormant Company with Retained Profits

Paragraph 47 of the Draft Ruling considers the application of the guidelines to DormCo, a company that is described as a dormant company. In the facts provided in the example, DormCo has \$300,000 in retained earnings, which it holds in an interest bearing bank account. BDO is concerned at the description of the company as a dormant company, whereas the company is deriving income and cannot be described as being dormant (despite the fact that the company has no active trading business).

BDO recommends the description of the company as dormant be amended, or alternatively, the company be truly dormant by deriving no income.

Issue: Example 3 - Property Investment Company

Paragraph 50 of the Draft Ruling considers the application of the guidelines to InveproCo, a company that is described as owning a commercial property that it rents to a third party at a market rate. The description of the company’s activities indicate that the company has not outsourced the management of the property, with the directors undertaking all legal and property management tasks. The Commissioner concludes (correctly) that the company is carrying on a business.



In a footnote to the example (footnote 84), the Commissioner considers the situation that would exist if InveproCo was to outsource the management of the property to third party professionals. In the footnote, the Commissioner concludes (again, correctly) that the company is carrying on a business.

BDO consider, given that in practice, most companies that invest in commercial property would outsource the management of the property to a third party professional property manager, this would warrant a separate example be given, rather than a statement in a footnote that the outcome would not change if the company were to engage third party professionals.

BDO recommends the statement contained in footnote 84 that a property investment company that engages third party property managers, and which is carrying on a business, should be the subject of its own example.

Issue: Example 4 - Share Investment Company

Paragraph 53 of the Draft Ruling considers the application of the guidelines to ShareCo, a company that is described as holding a portfolio of listed shares. The company does not engage a third party to manage its portfolio, and it is noted that the company was formed for the purpose of investing in shares with the intention of earning income from dividends, and this impacted the selection of its portfolio. The Commissioner concludes (correctly) that the company is carrying on a business.

In Example 3 (discussed above), we note that the Commissioner concludes (correctly) in a footnote that a property investment company would still be carrying on a business even if the management of the property was outsourced to a third party professional property manager.

BDO consider that the same conclusion would be made in the circumstances of the share investment company described in example 4 that decides to outsource the management of its share portfolio to professional third party portfolio managers. In particular, we note that the directors of the company would make the decision to outsource the management of the portfolio to external professional managers on the basis that the returns produced by these third party managers would be superior to the returns they could produce themselves, and this decision is indicative of directors making decisions on behalf of the company to maximise the profits derived by the company (which is indicative of a company that is carrying on a business).

BDO recommends that example 4 be expanded to cover the situation where the share investment company outsources the management of its share portfolio to professional third party managers, concluding that the company is carrying on a business. In keeping with our recommendation to example 3 above, BDO also recommend this second iteration of example 4 constitute its own separate example.

Issue: Example 6 - Company Leases Multiple Boats to Unrelated Party

Paragraph 61 of the Draft Ruling considers the application of the guidelines to CharterCo, a company that is described as owning three passenger boats which it leases to an independent third party, having ceased to operate charter services because it lost its operator's licence. In the information provided in the example, the company manages all aspects of the operations, including finding lessees, carrying out minor repairs, and managing the administration of operating the boats.

The Commissioner concludes (correctly) that the company is carrying on a business. However, as we have identified above with other examples, the example fails to consider the situation where a company owns passenger boats, such as these in the example (or any substantial capital assets such as the boats in this example), and the management of the boats (or other substantial assets) has been outsourced to third party managers. As we indicated above in our commentary on the other examples noted, we believe that, based on the Commissioner's guidelines in the Draft Ruling, CharterCo would continue to be carrying on a business where management of the assets was outsourced.

BDO recommends that example 6 be expanded to cover the situation where the boat charter company outsources the management of its fleet to professional third party managers, concluding that the company is carrying on a business. In keeping with our recommendation to examples 3 & 4 above, BDO also recommend this second iteration of example 6 constitute its own separate example.

#### Issue: Example 5 - Family Company

Example 5 of the Draft Ruling, the company referred to as FamCo is a private family company that is a discretionary object of a family trust. The company is in receipt of a distribution of income from the family trust. This distribution is initially not paid by the trustee, leaving the amount as an unpaid present entitlement (UPE).

#### Possibility A

In paragraph 57, FamCo receives a distribution from the trust which remains as a UPE. The company has no other source of income other than the trust distributions, and it does nothing to demand payment of the UPE. The company also does not enter into any arrangement to provide it with any entitlement to any type of profit. On this basis, the Commissioner considers that the company is not carrying on a business because it has only a mere hope of receiving future appointments from the family trust and from no other source.

The type of arrangement outlined in Possibility A is something that would not be observed generally in practice. The arrangement with regards to the UPE as outlined in the example would be in breach of the Commissioner's requirements to deal with UPEs in the context of Division 7A. FamCo would not generally be expected to maintain an arrangement as described in the example, other than if the company itself had no distributable surplus (which is not indicated in the example).

BDO recommend the Commissioner reconsider the facts in Possibility A, as this type of arrangement would not be practical in most situations or alternatively, indicate in the example that FamCo does not have a distributable surplus.

#### Possibility B

In paragraph 58, FamCo receives a distribution from the trust which remains as a UPE. The company enters into a written loan agreement on commercial terms with the trustee. Under this agreement, the company loans the money back to the trust in return for a commercial interest rate, with the loan secured against the assets of the trust. The Commissioner concludes that the company is carrying on a business, as its activities consist of investing its assets in a business-like manner with both a purpose and prospect of profit.

We agree with the Commissioner's conclusion that the company is carrying on a business in these circumstances. However, the facts provided in the example do not make it clear what type of arrangement the Commissioner is considering. The example suggests but does not specifically mention that the arrangement has been documented as contemplated in the Commissioner's requirements to deal with UPEs under TR 2010/3 and PS LA 2010/4. Further, the fact that the arrangement in the example is interest bearing also suggests that the arrangement has been put into place to comply with the Commissioner's requirements in relation to Division 7A.

However, the Commissioner does not indicate whether the situation is meant to be a complying Division 7A arrangement, or whether it is an income producing arrangement where the directors of the company paid no direct reference to the requirements of Division 7A. Specifically, the arrangement is secured against the assets of the trust. In practice, this arrangement is unusual and it is not a requirement in the Commissioner's guidelines for complying Division 7A UPE arrangements for the loan to be secured.

Further, the Commissioner has not indicated what is meant by a commercial rate of interest. Is this the benchmark rate (under Division 7A), the interest rate for companies to comply with the Commissioner's sub trust UPE arrangements, or some alternative interest rate.



BDO recommend that the facts in Possibility B be clarified to indicate whether this example is designed to comply with Division 7A. Further, BDO recommend the Commissioner include a separate example indicating whether a company which receives a discretionary distribution from a trust, and which retains that amount as a UPE, where that UPE has either:

- Been converted to a Division 7A complying loan; or
- Been retained in a sub-trust arrangement which complies with the Commissioner's requirements in relation to sub-trusts in TR 2010/3 and PS LA 2010/4.

BDO further recommends that the Commissioner conclude that both such arrangements would indicate the company is carrying on a business. In both situations, the directors of the company have decided they will receive a favourable rate of return by investing the assets of the company (UPE) rather than by collecting the cash representing the UPE and investing it in a term deposit (at a lower rate of interest).

#### Possibility C

In paragraph 59, FamCo receives a distribution from the trust it receives as a cash payment from the trustee. The company distributes some of the cash to its shareholders, and it retains the balance. The cash is invested in the bank by the company in a non-interest bearing account. The Commissioner concludes that the company is not carrying on a business.

BDO submit that this example is not practical, as the directors of the company would generally be expected to invest the cash in an interest bearing bank account, rather than investing the cash in a non-interest bearing account. In the event that the directors of the company invest their excess cash in an interest bearing account, as the directors have taken the decision to derive income from the investment of the company's excess cash, BDO submit that the company would be carrying on a business.

This conclusion would seem to be in keeping with the Commissioner's arguments in the Draft Ruling, especially as the company would have multiple sources of income, and the directors will have taken a decision to derive additional income for the company.

However, this conclusion does not necessarily reconcile with the Commissioner's conclusions in example 1 to the Draft Ruling. As noted above, the Commissioner concludes that a company that has no other source of income other than interest derived on its surplus cash in an interest bearing bank account is not carrying on a business.

BDO recommends that the Commissioner clarify the position in Possibility C where the company is receiving interest income from the investment of its surplus cash in an interest bearing account.

BDO recommends that the various limbs of Example 5 be amended to better accord with the general practice of companies that have UPEs with discretionary trusts. In particular, the Commissioner must make it clear that companies that have UPEs with discretionary trusts where the UPEs are either converted to a complying Division 7A loan, or the UPEs are held on sub-trust in compliance with the Commissioner's requirements, are carrying on a business.