CHAPTER 2

Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005

Introduction

2.1 While this is an omnibus bill containing seven schedules, only schedules 1 and 2 attracted any comment during the inquiry. According to statements made in the House of Representatives, schedules 3 to 7 are regarded as non-controversial and have bipartisan support.[1]

2.2 Accordingly, this report concentrates on Schedule 1 – Loss Recoupment Rules for Companies; and Schedule 2 – Conduit Foreign Income.

Schedule 1 – Loss recoupment rules

2.3 The tax loss recoupment rules allow companies to carry over losses incurred to future income years and claim a deduction in relation to those losses if they are able to satisfy either the Continuity of Ownership Test (COT) or the Same-Business Test (SBT).

Continuity of Ownership Test

2.4 To satisfy the requirements of the COT, a company must be able to show that the same people hold more than 50 per cent of the voting power and rights to dividends and capital during the relevant test period. Applying the COT requires a company to trace its ownership through companies, trusts and other entities to identify the people who ultimately hold (directly or indirectly) voting power and rights to dividends and capital distributions.[2]

2.5 If a company is unable to satisfy the COT, it currently has the option of falling back on the SBT.

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1 House of Representatives, *Hansard*, 12 October 2005, p. 6.

2 Explanatory Memorandum, p. 11.

Same-Business Test

2.6 The SBT is contained in section 165-210 of the *Income Tax Assessment Act 1997* (ITAA 1997). A company satisfies the SBT if throughout the test period it carries on the same business as it carried on immediately before the test period. However, the Treasury describes this as a difficult test to pass.

2.7 The company fails the test if, at any time during the test period, it derives assessable income from or incurs expenditure in relation to a business activity of a kind that it did not carry on before the test period; or from or as a result of a transaction of a kind it had not entered into in the course of its business operations before the test period. The company also fails the test if it started to carry on a business it had not previously carried on or entered into a different transaction type for the purposes of satisfying the test.

Amendments in the Bill

2.8 The Explanatory Memorandum (EM) for the Bill notes that it is often difficult for companies to trace through entities such as listed companies, superannuation funds and managed funds to establish who the ultimate individual owners of the company are. Establishing ultimate ownership can impose significant compliance costs, and if ultimate ownership cannot be established, the deductibility of losses may be uncertain.

2.9 The amendments in the Bill replace the existing COT in Division 166 of the ITAA 1997 with a modified COT. The second reading speech for the Bill describes the proposed changes to the COT in the following terms:

> These amendments extend the range of companies that are eligible to use the modified continuity of ownership test to include all widely held companies and eligible subsidiaries. The amendments will make it easier and more certain for these companies to apply the modified continuity of ownership test by relaxing the rules for tracing ownership under that test and by specifying the times at which these companies will need to test for continuity of ownership.[3]

2.10 According to the EM, the new COT rules simplify the application of the COT for companies that are widely held by providing tracing rules that make it unnecessary for an eligible company to trace the ultimate owners of shares held by certain intermediaries and small shareholdings.

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[3] House of Representatives, *Hansard*, 12 October 2005, p. 27.

2.11 The new modified COT will apply to widely held companies and companies that are more than 50 per cent owned (directly or indirectly) by widely held companies, certain entities that are treated as ultimate owners, non-profit companies or charitable bodies.

2.12 Companies applying the modified COT will be required to test for continuity of ownership at the end of each income year and at certain other specified times, rather than continuously as required by the current COT.

2.13 The new modified COT will contain the following tracing rules to assist the company in testing continuity of ownership:

- a direct stake of less than 10 per cent is attributed to a single notional entity;
- an indirect stake of less than 10 per cent is attributed to the top interposed entity;
- a stake of between 10 per cent and 50 per cent (inclusive) held by a widely held company is attributed to the widely held company as an ultimate owner;
- a stake held by an entity deemed to be a beneficial owner (a superannuation fund, approved deposit fund, special company or managed investment scheme) is generally attributed to that entity as an ultimate owner;
- an indirect stake held by way of bearer shares in a foreign listed company is attributed to a single notional entity in certain circumstances; and
- an indirect stake held by a depository entity through shares in a foreign listed company is attributed to the depository entity as an ultimate owner in certain circumstances.[4]

2.14 If passed without amendment, the bill will also remove the SBT for companies with a total income of more than $100 million in the year of recoupment. In the second reading speech, the Assistant Treasurer, the Hon. Mal Brough MP, explained the removal of the SBT in the following terms:

> The changes to the continuity of ownership test will reduce the need for large companies to rely on the same business test to be able to claim deductions for prior year losses. Large companies with diverse businesses have difficulty in satisfying the same business test. Therefore, the amendments will remove the same business test for companies (including consolidated groups) whose total income is more than $100 million.[5]

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[4] Explanatory Memorandum, p. 13.

[5] House of Representatives, *Hansard*, 12 October 2005, p. 27.

Schedule 2

2.15 According to the EM, Schedule 2 of the Bill provides tax relief for conduit foreign income. Conduit foreign income is generally foreign income received by a foreign resident via an Australian corporate tax entity. This measure ensures those amounts are not taxed in Australia when distributed by the Australian corporate tax entity to its foreign owners. Generally, the measure only applies to foreign income that is ordinarily sheltered from Australian tax when it is received by the Australian corporate tax entity.[6]

2.16 The second reading speech for the Bill explains further:

> Schedule 2 replaces the existing foreign dividend account provisions…These rules will allow Australian companies that receive foreign income on which no Australian tax is payable to pay dividends to foreign shareholders that are also free of Australian withholding tax.
>
> This measure will provide foreign investors who structure their foreign investments through Australian entities with more neutral Australian tax outcomes when compared to foreign investors who hold their foreign investments more directly. This will further enhance the ability of Australian entities with foreign investments to compete for foreign capital. It will also improve the attractiveness of Australia as a location for regional holding companies.[7]

Issues – Schedule 1

2.17 The major issue raised in evidence to this inquiry was the proposed removal of the SBT for corporations with income in excess of $100 million. Witnesses also raised the issue of loss-trafficking, and drew the Committee's attention to some possible technical corrections that may be required in the Bill.

Removal of the SBT

2.18 While acknowledging the extensive consultation that has taken place in relation to the proposed changes to the COT and welcoming them, a number of groups made submissions and gave oral evidence questioning the need to remove this test, and in some cases, opposing its removal.

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6 Explanatory Memorandum, p. 5.

7 Second reading speech, House of Representatives, *Hansard*, 14 September 2005.

2.19 Witnesses also expressed surprise that the withdrawal of the SBT was to be a trade-off for improving the COT. For example, as Mr Drenth of the Corporate Tax Association told the Committee:

> When the government finally announced broadly where it was heading, basically a trade-off between an improved continuity of ownership test and a $100 million same business test cap, I would have to say that took the Corporate Tax Association and probably many other external bodies somewhat by surprise. We had been talking about achieving greater certainty for both the continuity of ownership test and the same business test, but removing the same business test for large business altogether was not the kind of certainty we were asking for or expecting.[8]

2.20 Several submissions suggested that there were sound reasons why the SBT should be retained. In particular, submissions foreshadowed possible adverse impacts for infrastructure projects and companies subject to takeover if the SBT was denied to them.

2.21 The Minerals Council and the Corporate Tax Association (MC/CTA) and others described the current COT rules as 'quite unworkable' and welcomed the proposed changes, while observing that the proposed changes to the COT 'do not go much beyond the pre-1997 position that normal trading in the shares of a publicly listed company should not lead to COT failure or its consequences…'[9]

2.22 The MC/CTA advised that they supported the 'broad COT/SBT trade-off'[10], but submitted that the removal of the SBT would 'undoubtedly remove significant losses at the entity level as a result of future takeover and merger activity'.[11]

2.23 The MC/CTA submission linked what it described as a 'serious under-investment in critical infrastructure projects' and the SBT, arguing that there were sound policy reasons for preserving the SBT where a publicly listed group is subject to acquisition. The submission also advocated exempting large infrastructure projects from the $100 million SBT cap, noting that these typically experience large start-up losses that take some years to reverse, and typically involve start-up investors who tend to exit the project once it is up and running. Mr Dwyer of the Minerals Council elaborated on this theme at the public hearing:

> The fundamental point, I guess, goes to the trade-off between the modified continuity of ownership test and the implications of the $100 million cap on the same business test. It is quite possibly the case that the introduction of that cap will have an impact on particular infrastructure projects, including but not limited to the mining industry. As major infrastructure projects

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8 *Proof Committee Hansard,* 28 October 2005, p. 1.

9 MC/CTA, *Submission 1*, p. 2. The ICAA made a similar observation.

10 MC/CTA, *Submission 1*, p. 4.

11 MC/CTA, *Submission 1*, p. 2.

> typically experience start-up losses that take some years to reverse, and that is due, in particular, to the very long construction phases that are involved, they would find themselves being susceptible to removal of the SBT. As many would be aware, these sorts of projects typically involve start-up investors who stay on during the planning and construction phase but would then tend to seek to exit the project once it is up and running. Projects that find themselves in that situation - and this would include the mining industry - would find themselves having to look very long and hard at the way in which they organise their affairs to take account of the changes that are proposed in the bill. They could find themselves facing some impediments to that investment.[12]

2.24 As an alternative, the MC/CTA suggested leaving the SBT cap in place and considering a 'carefully designed tax loss flow-through arrangement that would apply to certain designated infrastructure projects.' In a similar vein, the submission noted that the MCA had advocated the introduction of flow-through shares to address a range of impediments and distortions which it said were facing junior exploration companies in raising capital.[13]

2.25 The MC/CTA elaborated on the difficulties that currently face junior exploration companies, difficulties that they considered would be compounded if there was a likelihood that these companies would not have access to their losses:

> The MCA…has advocated the introduction of flow-through shares to address a range of impediments and distortions facing junior exploration companies in raising capital. Among these impediments is a tax related market failure which has meant that access to finance has been particularly difficult for these companies. The current circumstances of continued weakness in exploration spending, despite the strength of the commodity cycle, gives further foundation to our arguments in that context that the causes of the decline in minerals exploration expenditure are structural more so than cyclical.[14]

2.26 Ernst & Young also commented on Schedule 1 of the Bill, noting that it 'generally supported' the proposed reforms to the COT test. Like other submitters, Ernst & Young expressed dissatisfaction with the current COT, noting that without the changes, it is almost impossible for widely held companies to satisfy the COT. Ernst & Young described the 50 per cent change in ownership threshold as still 'relatively low', with the consequence that it will still have an impact on many widely held companies.[15]

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12 *Proof Committee Hansard,* 28 October 2005, p. 3.

13 MC/CTA, *Submission 1*, p. 4.

14 *Proof Committee Hansard,* 28 October 2005, p. 2.

15 Ernst & Young , *Submission 2*, p. 2.

2.27 Ernst & Young advised that it was concerned whether the proposed improvements to the COT justified the withdrawal of the SBT for companies with incomes above $100 million. It submitted that if the SBT was to be discontinued, it had a number of specific concerns, which it had previously raised with the Government and Treasury.

2.28 Ernst & Young noted that the SBT had originally been introduced in 1965 to allow losses and bad debts to be deductible following a merger or takeover carried out for sound economic purposes, and with which there was not associated any transfer of profitable business from one company to another so that income which would otherwise be taxed is derived free of tax (ie: no loss trading). Further, the Review of Business Taxation had also recommended its retention, subject to the removal of inter-entity loss multiplication.[16]

2.29 Ernst & Young submitted that it was not appropriate for companies not widely held that would not benefit from the proposed new COT rules to be impacted by the withdrawal of the SBT. It also submitted that the withdrawal of the SBT would adversely affect consortium joint venture companies, including those in the minerals sector, the petroleum sector, toll roads, transport and other facilities, and electricity generation and distribution.

2.30 The ICAA also argued against the removal of the SBT for large companies, noting that it was always intended to operate as a 'saving provision' in relation to the COT so that takeovers, mergers and other commercial transactions do not affect a company's access to its losses. In common with other submissions, the ICAA considered that it was inappropriate to remove the SBT:

> The appropriate legislative response to the difficulties large companies with diverse businesses encounter in satisfying the SBT is to improve the SBT – not remove it entirely.[17]

2.31 Like the MC/CTA, the ICAA commented that the proposed changes to the COT restored it to how it operated prior to 1997. The ICAA attributed at least some of the difficulties with the current COT to the 1997 changes, and in particular, the removal of the discretion of the Commissioner of Taxation to accept a widely held company as satisfying the COT.

2.32 The ICAA advised the Committee that to deal with the lack of certainty in relation to the COT, an interim rule had been introduced following the 2003 Budget allowing companies having difficulty complying with the COT to assume they had failed it and to rely on the SBT. However this is seen as unacceptable in the long term,

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16 Ernst & Young, *Submission 2*, pp. 2-3.

17 ICAA, *Submission 3*, p. 2.

'…as the SBT is very limiting and does not allow companies to develop their businesses without the risk of failing [the test]…'[18]

2.33 The ICAA warned that even with the proposed changes to the COT, it would still not be possible for a company that had been taken over or merged with another company to satisfy the COT, and that there remains a need for companies to continue to have access to the SBT to ensure that they do not lose their losses in such circumstances.

2.34 In common with a number of other organisations, the ICAA submitted that companies such as newly formed mining or infrastructure companies, whose activities generate losses in their early years of operations, would also be potentially adversely affected by the loss of the SBT. This was also seen as a barrier to the growth of joint venture companies, particularly those associated with infrastructure development or other major projects. Loss of the SBT was also seen as inequitable for companies with incomes in excess of $100 million that are not widely held. The Australian Chamber of Commerce and Industry (ACCI) made a similar point in its submission.[19]

2.35 While expressing a clear preference for the SBT to be retained, the ICAA put forward a range of possible amendments if the SBT is to be abolished. These may be found in the ICAA's submission.

2.36 Like a number of other submissions, the CPA Australia (CPA) submission also opposed the removal of the SBT for large companies, advising that it did not consider the link between removing the SBT and simplifying the COT to be 'either necessary or appropriate'.[20]

2.37 The CPA maintained that while many companies are forced to rely on the SBT because of uncertainties with the COT, it does not follow that the SBT is a 'supporting' test for the COT, but rather, is an alternative test to allow for actual expenditure and losses to be recognised in circumstances where the COT has demonstrably failed. The CPA submitted that the stated reasons for restricting access to the SBT do not provide 'a sufficient policy justification for such a significant and potentially widely impacting change'.[21]

2.38 The CPA also raised concerns that the modified COT would still not be satisfied in circumstances such as takeovers, significant joint ventures where one party sells their interest, where a closely held business is listed on the stock exchange, where an initial investor in a privatized asset sells their interest to another owner, and where an existing business funds growth through a capital raising. The CPA submitted that the proposal to remove the SBT requires reconsideration:

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18 ICAA, *Submission 3*, p. 3.

19 ACCI, *Submission 4*, p. 2.

20 CPA, *Submission 5*, p. 1.

21 CPA, *Submission 5*, p. 2.

> We strongly submit that the proposed removal of the SBT requires further and wider consideration, in order that the full ramifications of the proposal can be properly considered in the context of a 'stand alone' and significant change in policy, rather than merely as a consequential and necessary 'trade off' to the improvements to the COT.[22]

2.39 At the public hearing held on 28 October 2005, Treasury representatives confirmed that concerns about litigation had been a factor in the decision to restrict access to the SBT:

> In terms of rationale, if you look at the same business test it is a very strict test and one that for large enterprises is very difficult to satisfy. The problem is that many businesses may assume they pass the test, but in fact on a strict interpretation of the test, they do not. So, you have scope for a great deal of litigation and uncertainty and that scope gets greater the larger a company gets.[23]

2.40 Treasury also confirmed that restricting access to the SBT was a trade-off for making the COT easier to pass, and they expected that many of the companies who currently cannot pass the COT will be able to do so in future:

> …it is part of a trade off and that is that the technical deficiencies of the continuity of ownership test have been remedied and it has been made easier to pass. The purpose of the legislation is a bit of a trade off between making the COT more generous and making sure that more companies are able to get through and utilise their losses under that test, and removing the uncertainty of the same business test by removing that test above a certain level, where we think that in effect you are talking about companies which are diverse and will have a great deal of difficulty satisfying a strict same business test.[24]

2.41 The Committee explored whether there should be complementarity between the COT and the SBT. Officers responded that this was not necessarily the case, as the two tests deal with different aspects of the loss issue.

2.42 The Committee also sought information from officers about whether improvements in the COT that make up the bulk of the Bill were dependant upon the SBT restricting provisions also remaining in the Bill. Officers confirmed that the two provisions were independent, and the COT improvements could go forward regardless of the SBT provisions.

2.43 Treasury does not appear to have conducted any analysis of the extent to which the changes in this bill would affect companies that currently rely on the SBT,

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22 CPA, *Submission 5*, p. 3.

23 *Proof Committee Hansard,* 28 October 2005, p. 13.

24 *Proof Committee Hansard,* 28 October 2005, p. 13.

acknowledging that this was not statistically possible. However, officers did acknowledge that there are a number of companies that do currently satisfy the SBT which would be adversely affected by the changes in the Bill:

> There would certainly be companies who are above that limit who are relying on the same business test to claim losses. Whether or not they satisfy it is another issue.[25]

Loss trafficking

2.44 A number of submissions referred to the possibility that losses might be subject to loss-trafficking as a reason for restricting the SBT to companies with earnings of less than $100 million. All of the submissions and evidence that mentioned this issue were dismissive of this possibility, advising the Committee that widely held companies are rarely trafficked.[26]

2.45 Mr Baxter of the ICAA advised that it was more likely that loss trafficking would be attempted in smaller companies:

> Below that level, [$100m] as you note, the test is still available. The irony of that is that it is actually much more likely that a company will be trafficked below that level, not above. That has always been acknowledged, even at the start of the legislative history in 1944 when it only applied to private companies.[27]

Technical oversights

2.46 The ICAA drew the Committee's attention to a number of technical corrections and oversights in the Bill which it maintained need to be addressed. These are included at page 6 of the ICAA submission.

Issues – Schedule 2

2.47 All submissions received by the Committee during this inquiry that commented on Schedule 2 welcomed and supported the introduction of the conduit foreign income (CFI) proposals contained in the Schedule.

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25 *Proof Committee Hansard,* 28 October 2005, p. 16.

26 See for example Corporate Tax Association evidence at *Proof Committee Hansard,* 28 October 2005, p. 3, Ernst & Young evidence at p. 6, ICAA evidence at p. 9.

27 *Proof Committee Hansard,* 28 October 2005, p. 10.

2.48 The ICAA commented for example that the CFI measures 'should in the long run encourage the development of regional headquarters in Australia and enhance the general competitiveness of Australian businesses by removing the tax burden on CFI when distributed to non-residents'.[28]

2.49 The ICAA advised the Committee that it did, however, have one concern about administrative penalties for over-declaring CFI. The ICAA noted that the penalty rate for over-declaring distributions to foreign shareholders is effectively 15 per cent. This is despite the dividend withholding rate would only have been 5 per cent under the terms of the double tax agreements with the USA and the UK.

2.50 The Committee did not pursue this matter with Treasury witnesses, but nonetheless draws the ICAA's comments to the Government's attention.

Committee conclusions and recommendations

2.51 It appears to the Committee that the major reason for removing the SBT is to avoid prospective litigation. Companies which fail the new COT test may attempt to satisfy the requirements of the SBT, a test which Treasury describes as being very difficult to satisfy; and will consider that they have in fact done this, when in Treasury's and the ATO's view, they have not. This may lead to litigation, which Treasury and the ATO understandably wish to avoid.

2.52 While sympathetic to this view, the Committee is not persuaded that there are sufficiently well established grounds for withdrawing the SBT for companies with an income in excess of $100 million as a trade-off for improving the COT.

2.53 The Committee is concerned that withdrawing the SBT may have adverse effects on important infrastructure and other projects, and on companies subject to takeovers and mergers. Further, it has not been sufficiently established that companies that currently rely on the SBT will be able to satisfy the improved COT.

2.54 The Committee considers that it would be prudent to allow the changes to the COT to be put in place for a period to allow an objective assessment to be made of whether they will function as effectively as expected; and whether there are any companies who are legitimately continuing to use the SBT because the improved COT continues to be unavailable to them. If this is the case, and industry representatives agree that their concerns about the imposition of the proposed SBT cap have proven unfounded, the Government may then wish to consider introducing further legislation in relation to the SBT.

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[28] ICAA, *Submission 3*, p. 6.

The Committee recommends that the Bill be passed with the following amendment:

> **Schedule 1: omit item 76, which amends Section 165-212A of the *Income Tax Assessment Act 1997*;**

The Committee further recommends that before proceeding with the Bill, the Government consider the possible technical corrections and oversights identified at page 6 of the Institute of Chartered Accountants of Australia submission and bring forward any necessary amendments; and

The Committee further recommends that before proceeding with the Bill, the Government consider and respond to the concerns expressed in the submission of the Institute of Chartered Accountants in relation to the level of administrative penalties in schedule 2 for over-declaring conduit foreign income.

Senator George Brandis
Chair