ERNST & YOUNG

120 Collins Street
Melbourne VIC 3000
Australia

GPO Box 67
Melbourne VIC 3001

Tel 61 3 9288 8000
Fax 61 3 9654 6166
DX 293 Melbourne

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The Secretary
Senate Economics Legislation Committee
Suite SG 64, Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Sir

## Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005 Submission by Ernst & Young on Schedule 1 Amendments

Ernst & Young is pleased to provide a submission to the Senate Economics Legislation Committee in relation to its inquiry into Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005 (the Bill). Our submission is limited to the proposed changes to the loss recoupment rules for companies as contained in Schedule 1 of the Bill.

Ernst & Young generally support the important reforms to the company Continuity of Ownership Test (COT) replacement Division 166 of the Income Tax Assessment Act 1997 provisions contained in the Bill.

There are also many other technical and other changes in the Bill to the general operation of the COT rules for widely held and non widely held companies that we fully support.

In this submission we raise concerns however in relation to the proposed introduction of restrictions on the use of the Same Business Test (SBT) and the inappropriate application of these rules in relation to certain scenarios.

## COT Division 166

The proposed replacement of the Division 166 COT rules is a welcome policy improvement to the current listed and 100% subsidiary of listed company provisions.

Ernst & Young have been involved for some years in seeking changes to COT, including through our representation on behalf of the Institute of Chartered Accountants in Australia on the National Tax Liaison Group, in response to client concerns and difficulties in meeting the tests. We were also represented in the subsequent consultations with Treasury concerning the proposals to reform the provisions and in the review of the exposure draft law.

Without the proposed changes it is almost impossible for most widely held companies to satisfy the existing COT tests.

These tests broadly require tracing to ultimate individual beneficial owners of the company including typically through layers of interposed entities and nominee holders of shares and other shareholdings where it is not possible or it is highly impracticable to identify those ultimate owners.

A significant factor in problems in testing COT resulted from changes to the law in the Tax Law Improvement Project rewrite of the provisions of the 1997 Act. Amongst other changes the law was re-written to rely on a series of objective tests and removed the Commissioner's discretion to accept that a widely held company had satisfied COT, which discretion had been expressly included in the original COT measures because it is difficult or impractical or sometimes impossible for widely held companies to trace their ultimate ownership through many shareholders.

In our view many of the proposed changes merely correct inappropriate outcomes from these changes and restore the law to its pre 1997 state. That being said, the proposals recognise the difficulties in and the compliance costs involved in testing COT through current structures of widely held companies and make a number of improvements in this regard.

As far as we are aware, trafficking in losses is not a feature of business for widely held companies. The amendments restore the position of companies to legitimately claim deductions for prior year loss and bad debts. We note that numerous anti-avoidance provisions and other integrity measures are already contained in the loss and bad debt rules to ensure they are not inappropriately used. The new Division 166 rules however introduce further integrity measures to address any new integrity concerns from the changes.

We note that the retention of the relatively low 50% change in ownership threshold means that the task of proving COT, albeit on a reduced basis, will still impact many widely held companies.

## Proposed restriction on SBT

The Bill contains rules for the withdrawal of the SBT for large companies, for losses incurred in years commencing on or after 1 July 2005. We raise a number of concerns in relation to the inappropriate impact from these proposals.

We are generally concerned whether the improvements in the replacement Division 166 justify the withdrawal of the SBT for companies with turnover greater than $100 million.

If the SBT withdrawal is to proceed we also raise below a number of specific concerns in relation to the inappropriate application of this withdrawal. These concerns have previously been raised with the Government and Treasury.

***Retention of the SBT***

The SBT was introduced by the Government in 1965 to allow losses and bad debts to continue to be deductible to a company following a merger or takeover which was carried out for sound economic purposes and with which there is 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.

In the second reading speech to the Income Tax Assessment Bill 1965 the Treasurer stated:

> "One amendment proposed will ensure that a major, or even a total, change in the shareholdings of a company will not operate to disturb a deduction for a prior year loss incurred by the company if, at all times in the year of income in which the deduction may be claimed, the

> company is carrying on the same business as it carried on immediately prior to the change in its shareholdings. For this purpose, a company is not to be treated as qualifying for the deduction if, after the change in its shareholdings occurred, it begins to carry on a business, or enters into transactions, of a kind that it did not carry on or enter into before the change occurred.
>
> The Government considers that this amendment will satisfactorily meet cases of mergers and takeovers of companies that are carried out for sound economic purposes and with which there is 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.".

The Review of Business Taxation also recommended as follows:

> **"Recommendation 6.9 Duplication of realised losses**
> **Retain same business test**
>
> (b) That the same business test be retained, subject to the removal of inter-entity loss multiplication."

and discussed the SBT at follows:

> "The same business test allows a company whose majority underlying ownership has changed to carry forward its tax losses where the company continues to carry on the same business — even after the shareholders of the company sell the company to other taxpayers to realise the loss reflected in the value of the company's shares. In these circumstances, however, loss duplication may be temporary where the losses are applied to reduce subsequent profits earned in the company. The duplication would be reversed if the profits freed from tax by the losses are distributed or if the company is sold. The Review considers that the problems arising from the potentially temporary duplication of losses do not justify the adverse impact on continuing individual shareholders of denying the loss carry forward in cases where businesses satisfy the same business test."

In our view, the withdrawal of the SBT needs to be rethought.

In our view the proposal appears to be based on some unknown concern by Treasury or others about loss trafficking in companies. However, no information has been provided to support loss trafficking involving widely held companies and it is notable that:

- there is no costing for this withdrawal proposal; and
- there is no policy discussion underpinning this measure.

***Application to Non Widely Held Companies***

It is not appropriate for companies that do not benefit from the replacement Division 166 COT rules to be impacted by the withdrawal of the SBT. Such non widely held companies are doubly disadvantaged with no concessional COT tracing rules and with the SBT now withdrawn.

We accept that a typical non widely held company, such as private company, will know the identity of its shareholders. However, consortium companies as discussed below will not be able always to trace their ultimate ownership or to satisfy the COT rules.

***Consortium Joint Venture Companies***

The withdrawal of SBT impacts consortium joint venture companies, common in relation to projects undertaken in relation to infrastructure.

For example a company which is owned 50% each by a widely held company and an infrastructure fund held by superannuation funds will find that if either of the two shareholders sells their investment that it will fail the COT and (depending on its turnover) will have no SBT available to it. It is common for such a change in ownership to occur during the life of a project.

Such consortium companies are common in relation to the mining sector and utilities and affected companies will include those in:

- The mineral sector
- The petroleum sector
- Toll roads, transport and other transport facilities
- Electricity generation and distribution.

The withdrawal of SBT for companies carrying on infrastructure and projects of that nature may therefore greatly effect such projects and their investors.

***Companies with Significant Prior Year Capital Expenditure***

The withdrawal of the SBT will adversely impact companies that have incurred significant capital expenditure in previous years, where losses after 1 July 2005 merely represent the previous years' capital expenditure becoming deductible capital allowances.

Such companies may not be able to restructure, from 1 July 2005, major projects and commercial relationships already in place, or a restructure would involve very large costs under the various state stamp duty regimes or for income tax purposes. The losses of such companies might not represent economic losses. That is, to the extent that their capital allowances represent a delayed tax recognition of expenditures of earlier years, it seems inequitable to us to leave those companies trapped for tax purposes.

**Submission**

We submit that the policy in respect of the proposed SBT withdrawal needs review.

We submit that if the proposed SBT withdrawal measures are to proceed they should be modified so that they do not apply in respect of taxpayers that are not eligible to use the Division 166 COT modifications.

The proposed SBT withdrawal should also not apply in respect of taxpayers that conduct infrastructure and similar projects. Alternatively, consortium company relief provisions similar to those in the United Kingdom to allow limited flow through of losses to the consortium members in the loss years should be introduced for consortium joint venture companies conducting infrastructure and similar projects.

We submit that a transitional measure should allow the SBT to continue to apply to losses attributable to capital allowances arising from assets acquired before commencement date of the law.

Finally, we also submit that the $100 million threshold should be appropriately indexed over time.

We are concerned however that any changes to the SBT withdrawal provisions should not delay the passing of the COT changes to ensure business has certainty in their affairs including in preparing their income tax returns for 2005 and earlier years. It may be necessary to withdraw the SBT aspect of the Bill and delay its application date for a year to allow time for adjustments to be made in consultation with industry and professional bodies.

If you require any further information in respect of this submission, would you please contact Andrew Woollard on (03) 8650 7511, Tony Stolarek on (03) 8650 7654 or Brian Lane on (03) 8650 7250.

Yours faithfully,

Tony Stolarek

Tony Stolarek
Partner