The Institute of Chartered Accountants in Australia

20 October 2005

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

The Institute of Chartered Accountants (ICAA) welcomes the opportunity to make a submission to the Senate Economics Legislation Committee in relation to its inquiry into the measures contained in the abovementioned Bill.

The ICAA is the leading professional accounting organisation in Australia, representing over 40,000 members in public practice, commerce, academia, government and the investment community. The ICAA's members are advisers to businesses at all levels, from small and medium sized businesses to the largest global corporations operating in Australia and overseas.

Our comments are limited to the following two schedules to the Bill, namely:

- Schedule 1 – this schedule amends the loss recoupment rules for companies by:
  - introducing a new modified continuity of ownership test (COT) to replace the existing modified COT in Division 166 of the Income Tax Assessment Act 1997;
  - removing the same business test (SBT) for companies whose total income is more than $100 million in the year of recoupment; and
  - removing certain anomalies and clarifying some aspects of the existing law.
- Schedule 2 – this schedule deals with foreign residents' income with an underlying foreign source (commonly referred to as the conduit foreign income measures).

Executive summary

In relation to Schedule 1 of the Bill, the ICAA strongly supports the adoption of a simplified COT for widely held companies and "eligible Division 166 companies" (referred to collectively as widely held companies). It also supports the ongoing consultation with Treasury to refine the rules for companies which have multiple classes of shares.

However, notwithstanding the consultation process, there are a number of issues which

The Institute of Chartered Accountants in Australia
ARBN 084 642 571 ABN 50 084 642 571
Incorporated in Australia, Members' Liability Limited
Level 14 37 York Street Sydney NSW 2000
GPO Box 3921 Sydney NSW 2001
Tel: 61 2 9290 1344 Fax: 61 2 9262 1512
www.icaa.org.au

remain of concern to us.

To overcome the impact of those concerns we recommend that the SBT be retained for all companies. However, in the event that access to the SBT is to be abolished for companies whose income exceeds $100 million, to mitigate the impact of our concerns we recommend that:

- loss carry-back rules be introduced for all companies; and

- the following companies be permitted to retain access to the SBT, regardless of income level:

  - joint venture companies; and
  - companies which do not benefit from the simplified COT rules as they are not widely held.

There are also a number of corrections and oversights which require amendment in the Bill.

The ICAA also strongly supports the introduction of the so-called conduit foreign income (CFI) proposals contained in Schedule 2 of the Bill. However, we recommend that the administrative penalty for over-declaring the extent to which distributions to foreign shareholders are CFI be set at the rate of dividend withholding tax which would apply had an ordinary unfranked dividend been declared to the foreign shareholders. To do otherwise would be inequitable.

Schedule 1 – Loss recoupment rules for companies etc

Background

The ICAA supports the adoption of a simplified COT for widely held companies. Without these changes it would be almost impossible for widely held companies to satisfy the existing COT rules. In our view, the proposed changes merely restore the operation of the COT to widely held companies in the manner that various governments always intended and the way it operated prior to the 1997 revision of these rules under the Tax Laws Improvement Project (the 1997 rewrite).

However, the ICAA does not support the removal of the SBT for large companies. The SBT 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. The appropriate legislative response to the difficulties large companies with diverse businesses encounter in satisfying the SBT is to improve the SBT – not to remove it entirely.

The ICAA has been associated with attempts to reform the company tax loss rules for over five years, i.e. from the time the problems from the 1997 rewrite became apparent.

Set out below is a summary of the current position and how it has come about:

- Companies can only claim deductions for prior year losses or for write-offs of bad debts where they satisfy:

  - the COT which requires a more than 50% continuity of ownership; or, failing that test
  - the SBT which requires that companies carry on, broadly through the loss period and the later recovery-of-loss period, the same business with no new business and no income of a type not received in the period before the disqualifying change of ownership.

- It is almost impossible for many public companies to prove the requisite level of continuity of their ultimate shareholders and compliance with the COT. This is because public companies cannot look to the ultimate owners of shares where:

  - shareholders do not have substantial shareholdings and no substantial shareholder notices have been filed;
  - shareholders are nominee companies; or
  - bearer shares are issued (common in many publicly held European companies which might hold shares in Australian companies).

- Before the 1997 rewrite the Commissioner of Taxation had a discretion to accept a widely held company as satisfying the COT.

- The 1997 rewrite of the law effectively removed the Commissioner's discretion and introduced a purported 'objective' test of when a company might satisfy the COT requirements. That test was formulated on the basis that the test might be satisfied if a company had evidence which rendered it reasonable to assume compliance with the COT rules. Unfortunately, it is practically impossible for most public companies to provide the objective evidence for the reasons mentioned above.

  Where a company could not prove that it had either passed or failed the COT, the view of the Australian Taxation Office (ATO) was that the company was technically prohibited from accessing the SBT. The ATO could provide no certainty to companies that they could reasonably assume that they had complied with the COT.

- To deal with the lack of certainty, as an interim step, a rule foreshadowed in the 2003 Budget was introduced allowing companies experiencing difficulties in relation to proving COT compliance to assume that they had failed COT and could rely on the SBT.

  This was an interim measure only and not acceptable as a long term solution because the SBT is very limiting and does not allow companies to develop their activities without the risk of failing the SBT. For example, the SBT is failed if a loss company:

  - commences a new business;
  - changes its business significantly so as to risk being seen to conduct the "same business"; or
  - receives income of a kind it has not previously received in its normal business operations.

- The measures contained in the current Bill have been the subject of discussion with the ATO and subsequently the Government for at least four years. They represent a long overdue adjustment to allow concessional COT tracing rules to enable widely held companies to legitimately claim deductions for prior year tax losses and the write-off of bad debts previously brought to account as income.

- The proposed new measures have been accompanied by stringent Treasury and Government concern about the integrity of the tax system and a desire to minimise loss trafficking opportunities. That is why the concessional COT tracing rules:

  - apply only to widely held companies; and
  - are accompanied by a limitation on the ability to use the SBT.

  These limitations create their own issues which are discussed below.

Operation of the rules where companies have multiple classes of shares

Widely held companies in today's capital markets might have a range of different share classes with different rights – for example ordinary shares, preference shares, non-voting shares. Such widely held companies might themselves operate in Australia or own shares in Australian companies. The Bill still does not deal fully with how to apply the COT rules in such cases and some further refinement of the rules is the subject of consultation with Treasury.

Abolition of SBT for companies whose income exceeds $100 million

The second reading speech in relation to the Bill gives the following explanation for removing the SBT for companies whose income exceeds $100 million:

> *Large companies with diverse businesses have difficulty 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.*

We do not understand this statement. The only logical response to the concern that large companies with diverse businesses have difficulty satisfying the same business test would be to:

- amend the same business test so that it is easier for such companies to satisfy; or
- introduce a different test that is easier for such companies to satisfy.

The changes to the simplified COT for widely held companies could never make it possible for a company that has been taken over, or that has merged with another company, or that has had another disqualifying change in its ownership, to satisfy the test. There remains a need for the SBT to ensure that companies do not lose access to their losses in such circumstances.

We, therefore, do not accept that the simplified COT for widely held companies, which reflects the way the rules were always intended to apply, should come at the expense of the SBT for companies whose turnover exceeds $100 million. It is obvious from a review of the legislative history of the COT and SBT rules that the latter was always intended as a "saving provision" for companies that suffer a disqualifying change in ownership in circumstances that do not involve loss trafficking (e.g. takeovers and mergers of companies that are carried out for sound economic purposes).

In this regard we attach as Appendix 1 the legislative history of the COT and SBT rules applicable to companies.

The abolition of the SBT will adversely impact loss companies which are the subject of a merger or takeover. This is despite the fact that it was introduced in 1965 precisely to avoid this outcome.

The abolition of the SBT also has the potential to adversely impact companies whose activities generate losses in the early years, e.g. newly formed mining companies or newly formed infrastructure companies. The longer the period between the incurrence of a tax loss and its recoupment the greater the likelihood that a company will fail the strict COT, and even the simplified COT which is to apply to widely held companies, prior to the recoupment of its losses.

In 1975 the Asprey Committee recommended the introduction of loss carry-back rules to allow losses incurred to be optionally carried back. In our view, the introduction of loss carry-back rules would to some extent mitigate against the proposed abolition of the SBT. However, we emphasise that the introduction of such rules would be very much a second-best option when compared to the retention and improvement of the SBT.

In our view, access to the SBT should be retained for all companies. However, in the event that access to the SBT is to be abolished for companies whose income exceeds $100 million:

- loss carry-back rules should be introduced for all companies; and
- the following companies should be permitted to retain access to the SBT, regardless of income level:
  - joint venture companies; and
  - companies which do not benefit from the simplified COT rules as they are not widely held.

Joint venture companies

The withdrawal of the SBT will be a barrier to the growth of joint venture companies, particularly in infrastructure and other major projects, where there is a business risk of changes of ownership.

It is common to see joint venture companies with, say, 2 – 5 shareholders, investing in long lived projects such as infrastructure which might see early start-up losses.

The effect of the Bill in its current form is that, if enough of the investors at the early start-up loss phase sell their interests, the project company will fail the COT. In these circumstances, if it also breaches the $100m annual income limit, it will not be able to carry forward its losses under the SBT.

We believe that this will result in 'loss traps,' will act as an impediment in the creation of company structures for purposes of projects with start-up losses (especially larger capital intensive infrastructure projects) and is a deadweight for Australia's growth, particularly at a time when the Government is making a concerted effort to improve the country's infrastructure.

It is possible that the market will change its practices around this limitation and no policy adjustment is needed. However, we note that earlier reviews, including the 1975 Asprey Report, suggested that there should be a loss carry-back rule introduced. Other countries, when faced with a similar problem, introduced measures such as the UK loss pass through rules in their consortium companies relief whereby the tax losses of specified consortium companies are able to flow through to shareholders.

In our view, the inappropriate treatment of joint venture companies, if not addressed in the current Bill, should be escalated for Government attention. We have proposed in submissions to Treasury that:

- certain companies, for example those conducting designated infrastructure or other projects, continue to be eligible for the SBT; or
- serious consideration be given to the proposals recommended by the Asprey Committee in 1975 for:
  - a consortium company flow-through loss relief (in the manner of the UK relief); or
  - loss carry-back rules on a general basis to allow losses incurred after a designated date, say 1 July 2005, to be optionally carried back against income generated from that date.

Non-widely held companies whose turnover exceeds $100 million

Companies that are not widely held cannot benefit from concessional COT tracing rules but may nevertheless be impacted by the withdrawal of the SBT where total income is more than $100 million. This is clearly inequitable.

When the SBT was introduced in 1965, the second reading speech stated that "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.

In our view, if access to the SBT is to be limited, it should only be for companies that benefit from the improved COT measures (that is, removed only for widely held companies and eligible Division 166 companies).

Technical corrections and oversights

Our comments above focus on our major concerns with Schedule 1 of the Bill. However, there are a number of technical corrections and oversights which also need to be addressed.

One of the more significant shortcomings is the absence of a section 170 amendment period override in the Bill. As the Bill contains provisions with retrospective application favourable to taxpayers, assessments may need to be amended to give effect to these provisions. The Commissioner has a discretion to amend assessments, however, that discretion may only be exercised within certain time constraints, generally four years. In our view, a taxpayer's ability to have an assessment amended to give effect to the provisions of the Bill should not be subject either to the Commissioner's discretion or the time constraints contained in section 170 of the *Income Tax Assessment Act 1936*.

There are others areas where the Bill requires amendment. For example, there is:

- an incorrect reference in s166-272(1)(b) to s166-235 instead of s166-240;
- a failure to adequately deal with certain mutual companies;
- a problem with the interaction of the commencement date of the SBT change in respect of bad debts with the transitional rule in section 172(2)(b) where the bad debt deduction forms part of the tax loss; and
- uncertainty as to why the concession available under certain tracing rules for the interposition of a new top holding company (e.g. in proposed sections 166-230(3), 166-260(4) and 166-260(4)) is not available in respect of the other tracing rules and, in particular, section 166-225.

Schedule 2 – Foreign residents' income with an underlying foreign source

The ICAA strongly supports the introduction of the so-called conduit foreign income (CFI) proposals contained in Schedule 2 of the Bill and has devoted significant time and resources to consultation with the Treasury on the design of these measures.

The CFI changes are a part of the Government's total package of international tax reforms designed to improve Australia's attractiveness as a location for internationally focused companies. We believe 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. This is an important consideration for non-residents when deciding to invest in/through Australia. This improved climate can, in turn, be expected to lead to other flow-on economic benefits in areas such as skilling and improved investment by non-residents through Australian companies.

In broad terms, the CFI proposals add to recent reforms such as those in *New International Tax Arrangements (Participation and Other Measures) Act 2004* exempting certain foreign income, for non-residents with holdings in Australian companies that derive CFI by removing Australian dividend withholding tax. The measures extend conduit taxation relief under the existing foreign dividend account to include branch profits, tax-exempt gains from the sale of an offshore subsidiary with an underlying active business and other foreign income sheltered from Australian tax by the availability of foreign tax credits (i.e basically, income that is not subject to tax in Australia in the hands of an Australian company).

In their development, the measures have been the subject of much review and scrutiny over a long period of time. In fact, extension of conduit foreign income treatment was originally recommended by the Ralph Review of Business Taxation in its Report back in July 1999.

Expansion of the foreign dividend account to provide a withholding tax exemption for all conduit income that an Australian company distributes was proposed. At that time, the government deferred implementing these changes pending a broader review of Australia's international tax arrangements.

The Review of International Taxation Arrangements (RITA) subsequently considered this matter, amongst others, with the Treasury's consultation paper being released in August 2002. The ICAA's submission of October 2002 to the Board of Taxation on RITA supported the conduit income proposals. In its report to the government of February 2003, the Board of Taxation also recommended that they be implemented.

We note that the improvements to the double tax agreements with the UK and the USA (providing in some instances that there be no DWT chargeable, broadly where there is an 80% or more holding, or otherwise a limit of 5% for company shareholdings of 10% or greater), means that the CFI measures will have reduced or removed application in these specific situations. However, this only affects residents of these countries that benefit from these treaty rates. In all other cases, the CFI measures are required to remove the tax impediment (in the form of dividend withholding tax) encountered by non-residents when investing through an Australian resident intermediary company.

Section 288-80 - Administrative penalty for over declaring conduit foreign income (CFI)

The ICAA has concern in one adjunct area of the Bill in regard to administrative penalty for over declaring CFI.

Under section 288-80, the penalty rate for a company that over declared its distributions to foreign shareholders to be CFI is effectively 15%. If the entity over-declares the conduit foreign income in relation to a distribution, the penalty is 15%, notwithstanding the dividend withholding in various cases would only have been 5% under the terms of the US and UK treaties.

This should not generally be an issue for US or UK shareholders with an 80% or more interest in the Australian company which will have a zero dividend withholding tax under the DTA.

However, the penalty rate is grossly inequitable for US or UK holders of non-portfolio interests in the equity of the Australian companies that do not qualify for the exemption under the US or UK treaties but would qualify for a reduced DWT rate of 5% if an unfranked dividend had been declared. With the potential extension of 5% DWT rates to other treaties, this is an important issue to address.

The ICAA recommends that the administrative penalty should be set at a rate which aligns to the DWT rate which would be suffered, having regard to treaty limitations, had an ordinary unfranked dividend been declared to the relevant non-resident holder. The explanatory memorandum should therefore make it clear that the penalty will be remitted (under section 298-20 of the *Taxation Administration Act 1953*) where the company paying the distribution can show that the amount of withholding tax that would otherwise have been withheld would have been at a rate less than 15%.

We would welcome the opportunity to participate in any public hearing into this Bill in order to elaborate on the abovementioned points which, in the short time frame for submissions, have not been dealt with in any detail.

In the meantime, should you wish to discuss any issues further, please do not hesitate to contact Ali Noroozi on 02 9290 5623.

Yours faithfully

STEPHEN HARRISON
Chief Executive
Institute of Chartered Accountants in Australia

History of the COT and SBT

The loss recoupment rules impose on companies a "continuity of ownership test" (**COT**) and a "same business test" (**SBT**). A company cannot claim various kinds of tax loss or deduction unless it satisfies the COT or, failing that, the SBT.

The COT was first introduced in **1944**. It applied only to private companies and required a 25% continuity of ownership. The purpose was to prevent trafficking in loss companies. The explanatory memorandum to the relevant legislation stated:[1]

> There is in existence, evidence showing that in order to avoid income tax, some people are acquiring the shares of companies which have sustained losses in previous years and have ceased to carry on business but have not formally gone into liquidation.
>
> In one instance, a company which had suffered losses entered into an arrangement with its creditors to accept 12s. 6d. in the Pd1 in full satisfaction of their claims. After payment of this amount the company had no assets and it ceased to function. It was never formally liquidated, however, and its shares were acquired by other persons for a nominal price. No existing shareholder, director or officer of the company had any connexion with the company in the years in which the losses were made. The company and, therefore, the existing shareholders are entitled to the benefits of the existing provisions of section 80 in respect of losses of past years.
>
> Whilst a company is an entity separate and distinct from its shareholders, the shareholders are the real owners of the business carried on by the company and there is no justification for the allowance of a loss sustained by an entirely different set of shareholders in earlier years.

In **1961** the Ligertwood Committee on Taxation criticised the original COT and recommended that it be repealed. However, the Committee also said that if (contrary to its recommendation) the Government decided to retain the COT, it should extend the test to public companies and strengthen it in other ways (eg. by increasing the required continuity of ownership to 40%). The Government chose the latter option. The Government also gave the Commissioner of Taxation a discretion to apply a modified (and clearly less onerous) test to public companies:[2]

> In the case of a public company a deduction for a loss may be allowed if the Commissioner is satisfied that it is reasonable to assume that shares carrying the rights were owned by the same persons throughout the year of income and the year in which the loss was incurred. This provision recognises that in the case of public companies with many shareholders, very numerous sales of shares may make it virtually impracticable for the company to establish with accuracy whether shares carrying the appropriate rights have, in the two years concerned, been beneficially owned by the same persons.
>
> The difficulties in establishing that position are increased by the fact that many shares are registered in the names of trustees of deceased estates, unit trusts etc. and the company concerned may be without means for determining the beneficial owners. The Commissioner will, of course, be free to obtain such information as is available to the company and he will then be able to consider the position in the light of any other records in his possession.

---

1 Refer to the notes on clause 10 in the explanatory memorandum to the *Income Tax Assessment Bill 1944*.

2 Refer to the notes on clauses 16 and 17 in the explanatory memorandum to the *Income Tax and Social Services Contribution Assessment Bill (No.3) 1964*.

In **1965** the Government introduced the SBT as a saving provision in relation to mergers and takeovers that did not involve trafficking in loss companies:[3]

> 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 Government of the day clearly expected that most normal commercial transactions would satisfy the SBT. Even the supplementary "new business" and "new income" tests were apparently only intended to apply in trafficking situations:[4]

> Paragraphs (c) and (d) of sub-section (1.) will not operate to deny a deduction for a prior year loss where a company merely expands the business that it carried on before the change in its shareholdings occurred. The paragraphs are designed to deny such a deduction in such circumstances as where the "loss" company and a company that takes it over enter into transactions which have, as their purpose or effect, the transfer of income from the takeover company (or an associated enterprise) to the "loss" company, e.g., an arrangement under which the takeover company pays a service fee to the "loss" company until the prior year loss has been fully deducted for income tax purposes.

In **1973** the Government increased the required continuity of ownership to 50% and, for the first time, applied both the COT and SBT to bad debts.[5]

In **1975** the Asprey Taxation Review Committee identified the absence of loss carry-back rules as a major cause of trafficking in loss companies:[6]

> The absence of any provisions for carry-back of losses is partly responsible for the practice, described in paragraph 16.142, of selling the shares of 'loss companies'. The Committee, in Chapter 16, expresses its agreement with the measures that have been adopted to control this practice. The proposal to allow a carry-back of losses, in removing the unfairness which the practice sought to overcome, strengthens the case for the measures directed against the sale of loss companies.

The Asprey Committee made the following specific recommendations for changes to the treatment of company losses:[7]

> The objective that the seller of shares in a loss company seeks to further is to obtain the tax equivalent of those losses immediately. Other ways of doing this which do not involve any unfair advantage will be available if recommendations of the Committee in regard to carry-back of losses and transfer of losses are adopted. The Committee has recommended in Chapter 8 that carry-back of losses be allowed. It has also

---

3 Refer to the Treasurer's second reading speech in relation to the *Income Tax Assessment Bill 1965*.

4 Refer to the notes on clause 21 in the explanatory memorandum to the *Income Tax Assessment Bill 1965*.

5 Refer to the Treasurer's second reading speech in relation to the *Income Tax Assessment Bill 1973*.

6 Refer to paragraph 8.162 of the report of the Asprey Taxation Review Committee (31 January 1975).

7 Refer to paragraph 16.144 of the Asprey Report (*supra*).

> recommended in this chapter that the law allow a loss to be moved from one company in a group to another in the same group. In addition, it has suggested that losses of companies electing to be taxed as partnerships be allocated to shareholders.

Unfortunately, the Government of the day chose to implement only the Committee's recommendation to allow group companies to transfer losses to each other. The "unfairness" therefore continued.

In **1997** the Tax Law Improvement Project (TLIP) rewrote the COT and the SBT. Consistently with TLIP's general approach, it also replaced the Commissioner's discretion with a number of concessional COT tracing rules.

Now, in **2005**, the Government proposes to improve these concessional COT tracing rules but also remove the SBT for large companies.