The Institute of Chartered Accountants in Australia

CORPORATE TAX ASSOCIATION

26 May 2005

The Hon Mal Brough, MP
Minister for Revenue & the Assistant Treasurer
Parliament House
Canberra ACT 2600

Dear Minister,

Recoupment of Company Losses - Need for refinement of the measures currently in consultation

Representatives of the Institute of Chartered Accountants in Australia (ICAA), CPA Australia and the Corporate Tax Association (CTA) (the professional bodies) are participating in the consultation about the Government decision to reform the law dealing with the recoupment of company tax losses, which was the subject of a Ministerial Press Release C021/04 by your predecessor, Senator Helen Coonan, on 7 April 2004.

These measures involve improving the tax loss recoupment rules for widely held companies under the Continuity of Ownership Test (COT) and to withdraw the Same Business Test (SBT) for companies with over $100 million turnover in respect of losses incurred after 1 July 2005.

As part of the ongoing consultations, on 10 May 2005 we met with Treasury to discuss the exposure draft law released in February 2005 and initial submissions made in response thereto. The meeting was productive and positive and was followed up with a further submission by us to Treasury on 18 May 2005 (copy attached) on various issues.

We now highlight five important issues concerning the planned changes for your consideration. We note that these may represent policy adjustments to the current Government decision.

1. Was the SBT limitation undertaken on the basis of proper costing?

In explaining the Same Business Test (SBT) limit, the media release stated "the Government recognises the practical difficulties that can arise when comparing the nature of large business across two points in time which may be several years apart. However, despite lengthy consultation with key business organisations, *no acceptable solution to improve the operation of the SBT has been identified*." (emphasis added)

We request that the costing for this measure be reviewed, perhaps with input from the professional bodies in a consultative confidential manner. We are not aware of what unacceptable methods were considered in the process of making the above decision as these were not discussed in the loss recoupment consultation process. We submit that the costing, if it implied that there will be loss trafficking and inappropriate tax outcomes in relation to widely held companies, may have constrained Government policy thinking. As noted in our attached letter:

> "We understand that Treasury expects the combination of the proposed changes to the modified COT, and the removal of the SBT for large companies, to be revenue-neutral. We do not share this

expectation. In our view the proposed changes to the modified COT simply 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 (TLIP). The removal of the SBT will only be revenue-neutral in cases where it has allowed such companies to escape the adverse consequences of the legislative policy failures arising from the 1997 TLIP rewrite. **In every other case, including that of an ordinary business transaction such as a merger, takeover or other company restructure, the removal of the SBT is likely to be strongly revenue-positive**."

2. Bad debt write-offs by widely held companies should not require COT test

We submit that **for widely held companies** there is no policy justification for bad debt deductions to be subject to the COT measures as currently applies.

To our knowledge there is no incidence of widely held companies being loss trafficked in order to achieve bad debt write-offs in inappropriate circumstances. While we recognise that there was trafficking in unrealised bad debts in private companies in prior years, this is not an issue for widely held companies.

To continue to have bad debt write-offs for public companies subject to the COT rule, now with the new elimination of the SBT rule in relation to larger widely held companies, is an unnecessary tax deadweight on the Australian economy, and will mean that any takeover of a larger widely held company or eligible Division 166 company will cause difficulties with claiming of legitimate bad debts. This is inequitable and a perverse outcome in that:

a) the relevant company will only have a debt after having recognised taxable income on which it will have suffered tax - where it has paid tax on revenue which in retrospect was illusory;

b) so, denying the company the claim for write-off of the subsequent bad debtor results in the highly unequitable outcome that not only is the company denied the tax benefit in relation to a loss, but its assets have been depleted by tax on an earlier non-existent gain.

Proposed Solution

Given the equity considerations highlighted above, widely held (eligible Division 166) companies as defined under the law should not have to satisfy the COT in relation to their bad debt write-offs. If it were considered that some integrity cap might be needed (which we doubt), a cap might be developed in consultation such as bad debt write-offs of debtors representing more than 50% of the company's value at the time of a COT failure.

3. Impact on joint venture companies – flow through or other adjustment if SBT withdrawn

We draw to your attention to the fact that the company tax loss package and its withdrawal of SBT will be a barrier to 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, particularly in large scale infrastructure projects, investing in long lived projects which might see early start-up losses.

The effect of the company tax loss decision in its current form is that, if enough of the investors at the early start-up loss phase sell out their interests, the project company will fail the COT test and (if it breaches the $100m annual revenue limit, for example is involved in a toll road or a utility or other large scale undertaking) it will not be able to carry forward its losses under the SBT test.

We believe that this policy 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.

Arguably some may suggest that the market will change its practices around this limitation and no policy adjustment is needed.

However, we note that earlier reviews, even the 1975 Asprey Report, suggested that there should be a loss carry back introduced in Australia, and we note that other countries when faced with similar scenarios of joint venture companies, introduced measures such as the UK loss pass through rules in their consortium

companies relief whereby the tax losses of certain highly specified consortium companies are able to be flowed through into the hands of their shareholders.

Proposed solution

The inappropriate treatment of joint venture companies arising from this current decision requires attention. We suspect that it is not realistic to have this reform considered in the process of implementing the current COT measures but we would request that this be escalated for Government attention. We have proposed in submissions, held by Treasury, proposals for:

a) certain companies (perhaps those conducting designated infrastructure projects which notify the ATO) to be eligible for the SBT to be continued or

b) serious consideration 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)
- 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.

4. Large private companies are denied SBT and have no improved COT

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

Proposed solution

SBT should only be limited for companies that benefit from the improved COT measures (that is, withdrawn only for eligible Division 166 companies).

5. Enhanced transitional measures for the SBT limitation

In the attached submission to Treasury, we highlighted that the transitional rules for the SBT withdrawal, if that is continued with, needed to be drafted equitably to protect losses which had economically been suffered prior to 1 July 2005 but were unrealised:

a) Provisions for doubtful debts where the debtors were worth less than their face value at 30 June 2005 but where the debtors had not been written off; and

b) Unrealised losses at 30 June 2005, for example in relation to assets or business undertakings where commercially the value of the asset had been written down but there had not been a CGT realisation event or the asset had not been sold at 30 June 2005

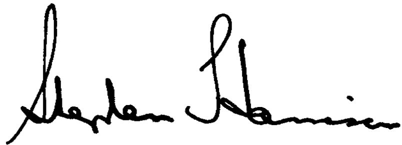
These transitional unrealised losses need to be treated for purposes of this measure as being losses incurred prior to the withdrawal of the SBT test.

Proposed solution in development

We believe that Treasury will include these measures in the transitional rules. They are important in order to prevent traps for companies which had gone about their business affairs in line with the pre-existing tax law and which ought not to be inequitably damaged by changes in Government policy.

Finally, we stress that the business community is keen to see the loss recoupment rules legislated or subject to a formal Government announcement soon, because companies which have balance dates of 30 June would like certainty to enable their 2005 audited financial statements to properly reflect the tax outcomes of their tax losses. Therefore, please advise if we can be of any further assistance. In this respect, please contact Ali Noroozi (ICAA) on 02 9290 5623, Frank Drenth (CTA) on 03 9600 4411 or Paul Drum (CPA Australia) on 03 9606 9701.

Yours faithfully,



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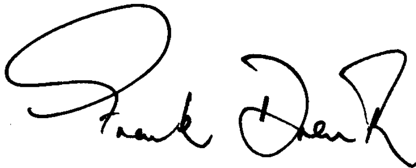

FRANK DRENTH
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Attachment: Copy of joint submission to Treasury of 18 May 2005