The Institute of Chartered Accountants in Australia

CPA AUSTRALIA

CORPORATE TAX ASSOCIATION

Confidential

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Ms Anne McCarthy
Large Business Unit, Business Tax Division
Langton Crescent
Parkes ACT 2600

Dear Ms McCarthy

Recoupment of Company Losses

The purpose of this letter is to confirm the points that representatives of various professional bodies made at the "Recoupment of Company Losses" consultation session in Canberra on Budget morning (10 May 2005). The letter has the support of the professional bodies who have signed below.

We appreciate and wish to acknowledge the commitment by Treasury of senior officers such as Tony Regan, yourself and Andrew Orme to the consultation session and the positive tone with which your team (who are the third Treasury team managing this measure) approached the session.

This letter covers only matters relevant to the operation of the modified "continuity of ownership test" (**COT**) for widely held companies. For the record, the various bodies have expressed concern about the general withdrawal of the "same business test" (**SBT**) for larger companies but it is not appropriate to debate the issues in this letter. You will recall that our discussions also covered:

1. The application of the COT to bad debts; and

2. Some anomalous and undesirable consequences arising from the removal of the (**SBT**) as a saving provision for large companies.

We will cover these issues in a separate letter so that your work on the modified COT may proceed as quickly as possible.

Background

We attach (as Appendix 1) a short note that traces the history of the COT and SBT with particular focus on the application of these tests to widely held companies. The note clearly demonstrates that the COT was designed to address the risk to the revenue from trafficking in loss companies. The note also demonstrates that earlier governments and committees of review have understood and accepted that, if the COT is to be applied to widely held companies, **the Commissioner of Taxation must be given a discretion to relieve such companies from the strict requirements of the test**.

Such a discretion promotes the policy objective of balancing the risk to the revenue from loss-trafficking against compliance costs for taxpayers in two ways:

1. The discretion recognises the particular difficulties, and therefore increased compliance costs, that widely held companies encounter in tracing their ownership under the COT. It is therefore appropriate to relieve such companies from the strict requirements of the test.

2. The discretion recognises that it is much less likely that shareholders in a widely held company will be able to "traffic" in its losses. The compliance cost for such companies should therefore be **less**, not more, onerous than the compliance cost for other companies.

We submit that the legislated removal of the Commissioner's discretion in 1997 made the strict COT (in Division 165) particularly problematic and was a major driver for the proposed amendments to the modified COT. The proposal to remove the SBT as a saving provision for large companies (including many widely held companies) makes any failure of COT a significant business setback for any loss company and makes the discretion even more necessary than was previously the case.

Submission – need for urgent resolution and improved law

1. The proposed changes to the modified COT and the removal of the SBT as a savings provision for large companies will have a widespread impact on large business and international taxpayers. For this reason, and because it is important for potentially affected companies to have certainty as to the application of the changes, it is important for the law to be finalised as soon as possible.

   We therefore acknowledge that it would be impractical to rewrite the exposure draft legislation and the following submissions are intended to improve the draft legislation within the existing framework.

2. 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.**

3. We therefore make the following submissions in the expectation that they will not cause the combined effect of the changes to the modified COT, and to the SBT, to involve a net cost to the revenue.

4. The modified COT should include an "objects clause" (such as we attach at Appendix 2) that acknowledges the following aspects of these rules:

   (a) The COT is directed at trafficking in loss companies rather than mergers, takeovers or other corporate restructures that are carried out for sound economic purposes.

   (b) The COT was always intended to apply concessionally to widely held companies in recognition of the fact that:

      (i) they are less likely to be trafficked; and

      (ii) they face special difficulties in tracing their ownership.

5. The existing integrity measure in draft section 166-175 should be redrafted as a positive test which requires a widely held company to actually trace its ownership only when it is (as expressed in the consultation meeting) “blindingly obvious” that it is likely to have failed the COT. Such a test might have the following characteristics:

(a) A widely held company will be taken to satisfy the COT unless it either:

(i) knows that it has ceased to satisfy the COT; or

(ii) ought to know, on the basis of reasonable enquiries, that it has ceased to satisfy the COT.

(b) It should be possible for a widely held company to pass the modified COT even if it would not have the evidence available to pass the strict COT in Division 165. A widely held company should therefore be able to apply the concessional tracing rules for the purpose of determining whether it knows, or ought to know, that it has ceased to satisfy the COT.

6. The Commissioner should be given a relieving discretion to treat a widely held company as having satisfied the modified COT notwithstanding that the company does not actually satisfy, or cannot prove that it satisfies, the test. We attach as Appendix 3 some comments on the legal foundation and precedents for such a discretion. This discretion will help to "future-proof" the modified COT against circumstances not envisaged in the consultation process which would otherwise result in ongoing demands for technical corrections, by allowing the Commissioner to treat new entities, securities, markets and trading practices in a way that is consistent with the underlying policy objectives of the test. The Commissioner should be required to exercise the discretion in a way that is consistent with the objects clause (refer to point 3 above and Appendix 2), and having regard to the following specific factors:

(a) Whether the widely held company is unable to demonstrate compliance with the modified COT as a result of a merger, takeover or other corporate transaction that was carried out for sound economic purposes.

(b) Whether the new shareholder(s) in the widely held company acquired their shares for the sole or dominant purpose of securing access to its losses.

(c) The extent of any continuing shareholdings in the widely held company (which would otherwise be unfairly affected by the operation of the COT).

7. The concessional tracing rules reflect the policy objective we referred to above (of balancing the risk to the revenue from loss-trafficking against compliance costs for taxpayers). We therefore submit that the four general categories of "tracing-stoppers" in the draft should more clearly reflect the underlying policy rationale (perhaps as an opening clause in each of the relevant provisions):

(a) *Shareholders that it is impossible to trace through (eg. bearer shares, depository entities).* It would clearly be inappropriate to require widely held companies to incur pointlessly the compliance cost of attempting to trace through such shareholders.

(b) *Shareholders that it is impractical to trace through (eg. other widely held companies).* It would again be inappropriate to require widely held companies to incur the substantial compliance cost of tracing through such shareholders.

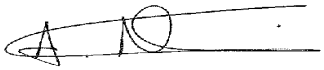
(c) *Shareholders who hold too small a stake to be likely to engage in loss trafficking (eg. those who hold less than 10%).* It would be inappropriate to require widely held companies to incur the substantial compliance cost of tracing through such low-risk shareholders.

(d) *Shareholders that are unlikely to engage in loss trafficking (eg. regulated entities).* It would be inappropriate to require widely held companies to incur even a modest compliance cost to trace through such very low-risk shareholders.

8. A single notional shareholder should be regarded as holding all the shares in a company that are held by tracing-stoppers.

We would welcome an opportunity to discuss the above with you and your team.

Yours faithfully,



ALI NOROOZI
Tax Counsel
Institute of Chartered Accountants in Australia

PAUL DRUM FCPA
Senior Tax Counsel
CPA Australia

FRANK DRENTH
Executive Director
Corporate Tax Association

cc. Mr Phil Lindsay, Senior Tax Adviser, Office of the Minister for Revenue & the Assistant Treasurer

Appendix 1 **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 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.

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]

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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*.

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

> 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.

Unfortunately, the Government chose not implement the Committee's recommendation to allow taxpayers to carry back their losses. 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.

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[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).

Appendix 2 **Draft Objects Clause**

Inclusion in the Guide – s.166-135

It is difficult or impossible for an eligible Division 166 company to demonstrate a continuity in its ownership under Division 165 having regard to its greater number of direct or indirect shareholders, trading in those shares in Australia or overseas, varying types of shareholding interests and the operation of securities laws and practices making it difficult or impossible to identify the ultimate ownership.

Proposed objects clause - s.166-136

1) An object is to modify the way in which the continuity of ownership rules of Division 165 work in Division 166 so that an eligible Division 166 company can satisfy the modified Division 166 rules by reference to information that it already has available.

2) Another object is to ensure that the Division 166 ownership tracing rules:

   a) Allow an eligible Division 166 company to determine its ownership and satisfy the tracing rules by reference to information that it could reasonably be expected to have in its possession, including disclosures arising from international securities laws and practices of securities markets.

   b) Make it unnecessary for an eligible Division 166 company to trace the ultimate ownership in relation to certain shareholders.

   c) Recognise that, where the market practices of major securities markets do not allow tracing of ultimate shareholding ownership by a Division 166 company, that it is inappropriate to impose tracing requirements which cannot be satisfied; and

   d) Provide that the various modifications should be read together to improve the ability of an eligible Division 166 company to comply with the rules. This will allow an eligible Division 166 company to improve the certainty of the outcomes under these rules and to enhance its ability to make business decisions, recognising that the company will not have the benefit of the same business test to allow the utilisation of its losses, except in limited circumstances.

3) The rules operate similarly in relation to claims for certain bad debts of Division 166 companies.

Comments for the Explanatory Memorandum in respect of the objects clause

Losses are available where a company can demonstrate a substantial continuity of ownership in the relevant period. These rules recognise that actual continuity of ownership may be difficult to prove in some circumstances. There are also circumstances where there will be taken to be substantial continuity of ownership for the purposes of the test without the need for detailed proof or tracing.

The objects clause will underpin the interpretation of the provisions as per 15AA of the Acts Interpretation Act. The objects clause outlines the broad principles underpinning the simplified/concessional tracing rules.

These are also the principles by which the Commissioner will be guided in exercising his discretion

The rules operate to provide the certainty and appropriate business outcomes for widely held companies, recognising that the same business test will not be available for various such companies subject to section 165-212A.

The object is for the rules to be interpreted having regard to information reasonably available or which ought to be reasonably available to a Division 166 company without requiring costly, uncertain, incomplete and time-consuming researches by the company which might not provide certainty as to its ultimate ownership in any event. It is recognised that the operation of these objectives will mean that in some circumstances a Division 166 company will satisfy Division 166 where, if there was the capacity or information available to trace its ultimate ownership to every shareholder or holder of a share interest, that the company would not satisfy the provisions of Division 165.

The substantial continuity of ownership test will be satisfied unless there is no significant and readily ascertainable change in ownership of a widely held loss company. The amendments recognise that there may be some transfer of the underlying economic benefit of losses as a consequence of trading in shares and other equity interests in the loss company. Such trading where it occurs in the ordinary course of trading of shares of a Division 166 company should not cause the company to fail substantial continuity of ownership. This is recognised in the concessional rules relating to deemed beneficial owners and notional shareholders.

The concessional (deemed beneficial owner) tracing rules recognise that there can be practical difficulties in tracing underlying ownership of shares. Sometimes it is impossible or very costly to trace ownership at a particular point in time, either because systems are not in place to monitor or collect the information, the persons holding the information are not obliged to provide it, or the costs of compiling the information are very high. The amendments recognise that it is not appropriate to impose an obligation under the law that is difficult or impossible to satisfy and that compliance costs must be reasonable.

The objects clause and Division have the effect that the Division 166 company cannot disregard information relating to its ownership which is available to it or ought reasonably to be available to it.

Appendix 3 **Comments on a Relieving Discretion**

Precedents in recent tax reforms for a relieving discretion

A precedent for the form of discretion which we discussed is in the debt/equity rules at Division 974 which contain many discretions for the Commissioner. The discretions are listed conveniently at subsection 974-10(5), for example the discretion at subsection 974-15(4) for the Commissioner to effectively choose to treat two related schemes as one scheme or two.

The debt-equity regime is a particularly good example of how those discretions could be designed, as it specifically provides:

(a) that the objects of Division 974 must be taken into account in exercising each of the discretions (see subsection 974-10(5)); and

(b) a formal mechanism by which taxpayers can apply for the making of a discretion (see subsection 974-112(3); and

(c) a taxpayer capacity to seek review of the discretion under Part IVC of the ITAA.

Another precedent is the trust loss regime at Schedule 2C which was introduced after Divisions 165 and 166, and was legislated using the TLIP style; for example, it uses guides, diagrams, notes and examples. It has numerous "relieving" discretions; for example, consider section 272-5 where the Commissioner is empowered to treat an interest as carrying a fixed entitlement even though the interest does not.

An additional issue raised in our discussions about introducing relieving discretions was that Attorney General advice may be necessary.

We submit that the "relieving" discretions that we asked for do not involve a delegation of legislative power, and would be the subject of the objections process in the Taxation Administration Act 1953. They should not create specific concerns from the Attorney General's department, no more so than the discretions mentioned above.

Proposed form of discretion for the Commissioner of Taxation

Section 166-145

Commissioner's determination

(7) The Commissioner may determine that it is the case, or it is reasonable to assume, that the conditions in this section are met, having regard to the following factors:

(a) the objects of Division 166;

(b) the concessional tests in Division 166;

(c) whether the taxpayer considers that, based on reasonable attempts and enquiries that have been made to test whether the conditions in this section are met, that the conditions cannot be satisfied without this discretion;

(d) Whether the widely held company was unable to demonstrate compliance with the modified COT as a result of a merger, takeover or other corporate transaction that was carried out for sound economic purposes;

(e) Whether the new shareholder(s) in the widely held company acquired their shares for the sole or dominant purpose of securing access to its losses; and

(f) The extent of any continuing shareholdings in the widely held company (which would otherwise be unfairly affected by the operation of the COT).

(8) The Commissioner may make a determination under sub-section (7):

(a) on the Commissioner's own initiative; or

(b) on an application made by an entity to the Commissioner for a determination.

(9) The application in sub-section (8):

(a) must be in writing; and

(b) must set out information relevant to deciding whether to make the determination.

(10) A taxpayer who is dissatisfied with a determination covered by this section may object against the determination in the manner set out in Part IVC of the Taxation Administration Act 1953.