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Business Tax Working Group Secretariat
The Treasury
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By email: BTWG@treasury.gov.au

Business Tax Working Group – Interim report on the tax treatment of losses Ernst & Young Submission

Dear Sir/Madam

Ernst & Young is pleased to provide this submission in response to the Business Tax Working Group's (BTWG) paper 'Interim report on the tax treatment of losses' (the report).

We support the reference by the government to the BTWG to address barriers within the business tax system to businesses' ability to adapt and change to the structural changes in Australia's economy. We agree it is desirable that the reforms to the tax treatment of losses should be designed to increase productivity whilst also delivering tax relief to struggling businesses.

However, moving towards a symmetrical tax treatment of profits and losses for **all** taxpayers may not necessarily achieve these aims and may not be the best policy approach, given the requirement for revenue neutral outcomes in the terms of reference for the review and given the potential competition with delivering Australia's broader tax reform agenda. Also, given that the interim report is at a high level, further consultation will be needed before the BTWG finalises its proposals, and the resulting revenue-enhancing measures.

Our recommendations and responses to the various proposals are:

- Further consultation, including detailed examination of the costs and potential offsetting savings, should be conducted before the BTWG makes its final recommendations to government
- Concerning a possible removal of the COT and SBT and introducing an alternative integrity test (Element A):
    - We do not support re-engineering how the loss recoupment test rules apply to all taxpayers. It is important that reforms to the loss recoupment test regime must not disadvantage companies that would otherwise meet the continuity of ownership test (COT) and/or same business test (SBT)
    - The focus of reform should be on those particular taxpayers which have challenges in a restructuring economy under a strict interpretation of the current loss recoupment rules. Modifications to the loss recoupment rules or alternative loss utilisation mechanisms should be targeted to such taxpayers
    - As a fallback alternative for businesses which fail the SBT, a simple loss "drip feed" mechanism could be introduced which for example applies a statutory reference rate on a straight line basis at the option of the targeted taxpayer (this should not be a replacement of SBT for those that satisfy the test)
    - We do not recommend the introduction of a new dominant purpose test

  - Further refinement to the current loss recoupment rules should also be pursued, including to address cost of compliance concerns and other inequities with the tests, to apply to current and future losses
  - The tax consolidation available fraction (AF) rules contain real impediments to equitable use of losses. We recommend that:
    - the **pre-joining** capital injection and non-arm's length transactions adjustment rules should be repealed
    - the **post-consolidation** AF capital injection and non-arm's length transactions adjustment rules should only apply where there is a dominant loss usage motive
- Concerning the possibility of allowing tax refunds in respect of losses (Element B):
  - We agree that a broadly applied loss refund rule should not be developed
  - However consideration might be given to allowing loss refunds in limited special cases
- Concerning a possible time-limited form of loss carryback (Element C):
  - Loss carry back should be introduced that is limited to the franking account balance of the company
  - The carry back should be for a period of 2 years
  - The carry back should not be limited to any percentage or other portion of the loss
- The possible approach of applying an uplift factor to losses carried forward (Element D) should be considered further
- In respect of possible combinations of the different elements, a modified combination 3 should be adopted, comprising an optional "drip feed" loss utilisation alternative to SBT, loss carry back and loss uplift
- In respect of reform priorities for the 'black hole deductions' of s.40-880:
  - Shorter write off periods should apply for some expenditure including an immediate tax deduction in relation to business cessation costs and also in relation to unsuccessful ventures.
  - Section 40-880 includes a number of express exclusions that inappropriately frustrate the operation of s.40-880 as a provision of last-resort for business related expenditure not otherwise taken into account for income tax purposes: those provisions should be modified or repealed.
  - Some provisions in the ITAA may deal with specific types of business establishment and restructure costs (e.g. feasibility studies, lease termination costs) in some circumstances, where s.40-880 may apply (or should otherwise be able to apply) to those types of costs in cases where the specific provision does not apply: amendments are required to resolve consistency, priority, timing and characterisation issues in relation to such specific expenditures.
- An important priority is to review the rules for trust losses, in particular for unit trusts and fixed trusts. Trusts are a very common form of business entity in Australia and in our view the trust loss rules, designed to prevent trafficking in trust losses, raise many impediments to the legitimate carryforward of losses. So the review should be expanded to also consider the trust loss rules.

Our detailed submission is attached.

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We would be pleased to meet with you to discuss our submission.

In the meantime, should you have any questions in relation to this submission, please contact in the first instance either Andrew Woollard on (03) 8650 7511 or Tony Stolarek on (03) 8650 7654.

Yours faithfully

Ernst & Young

Appendix A

1 Revenue neutrality requirement means that further consultation is required before the BTWG loss review can make recommendations

As identified in the Ernst & Young submission to the October 2011 Tax Forum, Australian business tax reform is required in the short term to address some Australian tax impediments for businesses which restructure in a changing economy, to improve the position of Australian businesses which are affected by changed economic conditions and, under current tax rules, suffer real adverse tax outcomes.

Australia's tax rules are designed for businesses and taxpayers which have ongoing business activities and are able to use the stream of tax deductions which flow from their losses and outgoings. Many of the deductions are deferred to match the revenue streams anticipated.

However, where a business suffers a downturn or adverse business conditions, its revenue stream might be impaired or indeed cease, its asset values might fall, its expenses might remain high and be increased pending the business' recovery. For tax purposes:

- While some of those outgoings might be immediately deductible, others might be deferred for up to 5 years or might never be available until the relevant asset is sold
- Even where there are immediate tax deductions, the business might have insufficient income to fully utilise all of its tax deductions and will thus deliver a tax loss

So the tax benefit of losses is deferred; the business does not have the tax offset or tax benefit which a profitable business would have from immediate use of the tax deductions.

Furthermore, the business might never be able to claim its tax losses where it has a significant infusion of new capital to refinance it and changes its business activities.

Our submission summarised some options for short term action to:

- Improve the tax outcomes of restructure costs
- Improve the outcomes of restructures under the tax loss and bad debts rules
- Improve the competitiveness of Australia to attract business activity by reducing company tax rates, including potential examination of business expenditure tax options such as an Allowance for Corporate Equity (ACE)

We therefore welcome the first stage of the BTWG's review and the group's consideration of the loss and restructure rules.

However, given the terms of reference of the review require revenue neutral outcomes from its recommendations, it is impossible to fully analyse and determine positions on the proposals and potential alternatives without some guidance as to the cost to the revenue of each proposal and what offsetting savings measures may be needed.

The loss proposals must also measured against the benefits of and cost of other reforms including reducing company tax rates and examining other business tax expenditure options.

We strongly recommend further consultation including an examination of the costs and potential offsetting savings is needed before the BTWG makes its final recommendations to government and before the government takes policy action.

We submit that targeted changes and fine tuning of the tax loss rules, rather than wholesale removal of the COT and SBT for all taxpayers, should help to limit the cost to the revenue from the loss measures and therefore broaden the possibility of other reforms.

2 Losses Measures

2.1 Business decision-making and the impact of tax losses

Before responding to the detailed possible elements of the BTWG we outline some key impacts of tax losses on business in 2012 and how they impact on tax decision-making, responding the BTWG first consultation question.

1. For widely held companies, the COT rules were improved after the last Treasury review of the loss rules in 2006. The COT improvements for widely held companies, contained in Division 166, include the ability to look to notional shareholders and to assume COT compliance in respect of certain investors. So the COT rules have been streamlined for eligible widely held entities. However the Div 166 changes do not apply to numerous companies, eg:

   - private companies
   - companies which cannot meet the widely held ownership rules

   Therefore, companies ineligible for the COT concessions, which have incurred losses and which need to change their business, have severe restrictions in their capital-raising plans. Their capital raising plans cause the risk of their losses being ineligible unless the SBT is satisfied.

2. Satisfying the COT rules remains problematical for companies with different share classes with differential rights. However proposed limited retrospective reforms currently being consulted on may address this issue.

3. The same business test is actually a package of multiple tests, and failure of any element causes the SBT to be failed. The SBT package raises significant impediments where a company must alter its business, and the company has only one major business (as distinct from diversified companies or groups). The SBT can cause difficulties even for diversified companies which have incurred losses and need to make significant changes.

   The difficulties of the SBT were highlighted in a joint submission to Treasury in January 2006 in which Ernst & Young participated, in response to the then Assistant Treasurer's proposals to explore options for improving the operation of the SBT (however the reforms did not proceed)[1] as follows:

   > "The existing "SBT" requires that the loss company:
   >
   > a) must continue to carry on the **same business** as it carried on immediately before the change in ownership (s.165-210(1)).

[1] Attached as an Appendix, the joint submission of 31 January 2006 by Australian Chamber of Commerce and Industry, Australian Council for Infrastructure Development Limited, Corporate Tax Association, Energy Supply Association of Australia, Ernst & Young Australia. Institute of Chartered Accountants in Australia and Minerals Council of Australia

b) must not derive assessable income from a **business of a new kind** (s.165-210(2)(a)). For the purposes of the current year loss rules only, the loss company must also not incur expenditure in carrying on a **business of a new kind** (s.165-210(4)(a)).

c) must not derive assessable income from a **transaction of a new kind** (s.165-210(2)(b)). For the purposes of the current year loss rules only, the loss company must also not incur expenditure as a result of a **transaction of a new kind** (s.165-210(4)(b)).

d) must not commence a **business** before the change in ownership for the purpose of enabling it to pass the SBT after the change (s.165-210(3)(a)).

e) must not engage in a **transaction of a new kind** before the change in ownership for the purpose of enabling it to pass the SBT after the change (s.165-210(3)(b)).

The tests mix two concepts, both undefined:

(a) the original concept of the 'same business' (which implies identity) and

(b) the concept of a business or transaction of a kind (which implies similarity).

It is widely accepted by the tax profession that these requirements of the SBT may be difficult to meet because they:

- do not properly deal with more complex company businesses and
- do not operate effectively in diversified companies which have adopted tax consolidation.

This may lead to the inequitable denial of losses where the policy of the test has not been achieved.

The ATO takes a strict approach to the various requirements of the tests, as set out in their Taxation Ruling TR 1999/9 (Income tax: the operation of sections 165-13 and 165-210, paragraph 165-35(b), section 165-126 and 165-132).

The construction of the tests is strict **with no latitude for small failures, especially for the new transactions test**, other than perhaps for trifling or negligible amounts that are noted in the ATO's ruling as being implicit in applying the tests but which are inadequate in practical circumstances."

While the ATO might administer the test reasonably in practice, in many cases, the legislative test is very problematical and courts have interpreted the very strictly worded legislation narrowly. So loss-making taxpayers have little latitude when considering branching out into new activities or new transactions to generate income to recover their losses. The joint submission covers the narrow interpretation by the courts.

3. Many major projects in a startup company, particularly in infrastructure and mining sectors, involve capital expenditure, capital allowances and funding costs with revenue deferred until the project reaches full production or full capacity or full patronage. These projects might involve planned ownership changes occurring before the project has fully utilised its losses, in which case the project company must rely on the SBT.

   In some cases the planned ownership change can be planned around, for example mining projects might be carried on as joint ventures of various shareholder companies each of which as their own taxable income to absorb its share of the joint venture losses.

But it may be impractical to carry on a major project such as an infrastructure project dealing with the public in a joint venture structure, and a company or indeed a unit trust might be used. So a company starting up a major project, with start up losses and planned ownership changes, has significant risks relating to its loss carryforward.

4. A major project carried on in a unit trust has even more significant risks. The trust loss rules were designed as integrity or anti-avoidance rules to prevent trust loss trafficking, and do not have a properly functioning COT (with tracing rules) and SBT. This was highlighted in the recent case of ConnectEast (constructor of the Melbourne EastLink toll road) case[2].

   In that case the equivalent trust SBT was not available to a trust wholly owned by **two listed widely held trusts** because there were two trust owners rather than a single listed trust owner of the loss trust. The black letter law could only apply where there was 100% ownership by a single trust of higher status. Therefore only the "unlisted widely held" trust rules were available for the loss trust, which do not have a SBT. Leaving aside the infrastructure loss reform issues, this case highlights a clear deficiency in the design of the trust loss rules.

2.2 Response to possible Element A: Remove COT and SBT and introduce "drip feed" mechanism/dominant purpose test

Although the removal of COT and SBT may have some immediate attraction, we are concerned that there is likely to be a significant potential cost to the revenue from this without replacing those tests with some other broad mechanism to limit loss utilisation. This cost will likely be significant even if the removal is limited to losses of years commencing on or after the start date of the removal, as suggested in the report.

We are very concerned about the possibility that any alternative test might constrain the carryforward of losses for taxpayers that would meet the current COT or SBT established tests, if the tests are replaced by new integrity measures. We highlight that it would be most inappropriate to introduce 'drip feed' or extend loss recoupment for businesses which under current rules would satisfy the tests.

The removal of COT and SBT would also have wider implications than outlined in the interim report, including for example the impact on the tax consolidation rules for transferring losses of a joining entity to a group and would therefore likely require a fundamental review of the tax consolidation loss rules.

Therefore:

- Rather than removing the tests for all companies or any broader changes to replace the COT and SBT with new integrity measures, in our view, the loss reform proposals should be targeted to assist those taxpayers in need.
- We recommend that the targeted reforms should include a simple to implement optional loss recoupment restriction as an alternative to the SBT, to apply at the option of the taxpayer. A new dominant purpose test should not be introduced.
- COT should also be further modified for testing prior year and future losses and the inequitable outcomes from the tax consolidation available fraction (AF) capital injection adjustment rules should also be addressed.

[2] (ConnectEast Management Ltd (as Trustee for the ConnectEast Investment Trust 2) v Commissioner of Taxation [2009] FCAFC 22)

2.3 Primary focus of proposed changes to the loss rules

We recommend that the proposed changes to the loss recoupment rules should be primarily intended to assist those categories of taxpayers that have difficulties in strictly applying the current loss tests and which do not have the dominant purpose of utilising losses, including companies which:

- have unexpected losses and, as part of their genuine efforts to turnaround their business to being profitable, have ownership and business activity changes
- are impacted by a restructuring economy that must respond to domestic and international market forces to change and adapt their businesses in order to grow;
- are small to medium businesses encompassing entrepreneurs and innovators ; and/or
- have planned losses incurred as part of their inherent business lifecycles of moving from one distinct phase of operations to another, which typically require introducing new owners to provide funding and changes to business activities before a period of profitability commences.

2.3.1 - to rectify problems with COT compliance

There are many circumstances when the COT test may be breached as part of turnaround efforts. For example, technical breaches may occur where a company had a series of capital raisings from shareholders over an extended period of time, to replenish its capital following business losses. While each raising might not in itself cause a change of underlying ownership, because COT must be tested over all years from the start of year in which losses are incurred to the end of the income year in which the losses are sought to be recouped, the cumulative dilution of the initial ownership over many years may eventually cause a failure, in particular where there are multiple new investors and/or current investors do not participate. There is no consideration given for any intervening years of continuity before the COT breach.

The recent reforms of the COT rules for widely held entities (contained in Division 166), which include the ability to look to notional shareholders and to assume COT compliance in respect of certain investors, have simplified the COT rules for eligible widely held entities. However the Div 166 changes do not apply to numerous companies, eg:

- private companies
- companies which cannot meet the widely held ownership rules

2.3.2 - to rectify SBT failure because the rules are too restrictive

Where the COT is failed the alternative SBT test may be challenging in such cases, as many turnarounds also involve changes to business operations and offerings. The multiple requirements of the three same business tests combined with the ATO's "strict" approach to applying the tests often make it difficult or, in some cases, impossible to comply with the tests to allow prior year losses to be deducted.

2.3.3 - to deal with start-up losses followed by anticipated ownership changes

As mentioned above, where a company operating a new business has start-up losses followed by anticipated ownership changes, ie "planned initial losses", the combination of the COT and SBT rules has long been a cause of concern, for example, for exploration companies. Exploration is extremely risky and we understand that less than 1% of all exploration activity ultimately gives rise to a profitable operating mine. If an exploration company does find a resource, then almost invariably the next step is to obtain further capital in order to fund the development of the mine. This may involve an IPO/capital raising,

complete sale of the company to a party with funds, or full or partial sale of the asset. In many cases this could cause COT failure. It might also cause SBT failure on a strict narrow interpretation of those rules. We would take the position that moving from exploration to mining should not of itself cause SBT failure as the explorer is a miner and mining activities continue, and the ATO appropriately does not take issue with this position. However we highlight that the SBT legislation could be interpreted more restrictively by some, even in cases as conventional and legitimate as these.

In our view the risk of the imperfect SBT needs action.

Similar comments may also apply to start-up technology companies.

Such taxpayers should not be unnecessarily restricted or harshly penalised by the denial of their losses (particularly where the losses are true economic losses created by reductions in the assets of the taxpayer). They should also not be treated less favourably to other taxpayers that might be able to better structure to ensure the losses of a venture are used, including for example in industries where joint venture structures allowing "flow through" of losses can be utilised.

2.4 COT and SBT should not be replaced by other integrity rules

In our experience, the COT and SBT can be applied and met by many loss companies (in particular when applying the Division 166 concessional COT and testing time rules for many widely held and 'eligible Division 166' companies). It is therefore vital that any reforms to the loss recoupment test regime must not disadvantage such companies.

However further refinements to the current loss recoupment rules should also be pursued, including to address cost of compliance concerns and other inequities with the tests more generally, without the need to necessarily replace all those rules.

2.5 Our proposals

2.5.1 Reducing the restrictions in the SBT test

One option is to revise the SBT to mitigate the stringent requirements in the rules to carry on an identical business and not engage in any new business or new transaction. The three SBT tests might for example be replaced with a "substantially the same business" test. This potential for reform was raised in a joint submission to Treasury in January 2006 in which Ernst & Young participated, in response to the then Assistant Treasurer's proposals to explore options for improving the operation of the SBT (however the reforms did not proceed), a copy of which is attached as an Appendix (see section 2.2 of that submission).

A "substantially the same" test would allow an entity to carry on a new business or new type of transaction, provided it did not result in a substantial change in the business activity that was being carried on by prior to the change in ownership. However, as noted in the submission, the legislation would need some sort of de minimis rules to ensure it is clear that a reasonable degree of change is allowed and further rules for acquisitions and divestments to allow some business expansion.

The SBT could also take account of planned future business changes by the loss company.

2.5.2 An optional 'drip feed' for losses instead of SBT

We recommend that as an alternative to the SBT loss recoupment test, an optional restriction on the yearly utilisation of losses should be available at the taxpayers' optional election. This should not be a replacement of the SBT for those taxpayers that can satisfy the tests.

Potential alternative loss restriction mechanisms are considered below.

We recognise the difficulties in drafting and applying new law targeted at only particular groups of taxpayers without introducing extensive and burdensome new tax provisions and potential significant compliance costs. We do not believe there is any current law which could be utilised or adapted for this purpose.

We therefore further recommend that as a cost of compliance saving measure the alterative "drip feed" method should be made available to all taxpayers as an elective choice to the current SBT rules.

As outlined above there are many companies that would meet the COT or SBT and would therefore be entitled to potentially utilise all their losses who would not make the optional loss restriction election. However some others might use the new rule as a safe harbour alternative to the cost of testing SBT, recognising the uncertainty of applying SBT in many cases.

The optional mechanism would likely as a matter of course be utilised by many in the targeted groups of taxpayers above.

The optional loss restriction rule might be further restricted to cases where there is no loss trading purpose under the current Division 175 ITAA 1997 integrity rules.

We also provide some further comments on the proposals in the report below.

Drip-feed loss utilisation mechanisms

The use of a "drip feed" mechanism to limit the utilisation of annual losses has merit in cases where a company does not satisfy the COT and SBT. But we do not recommend adoption of the current tax consolidation AF calculation "drip feed" approach ("current consolidation AF rules') as the calculation mechanism.

The current consolidation AF rules are complex, require multiple calculations and market valuations of the loss company and acquirer company which results in large costs of compliance and additional scope for disputes with the ATO.

Adopting the tax consolidation approach of applying the AF to assessable income of each year to set the loss utilisation limit of an entity not in tax consolidation would appear to require:

- calculations of the market value of all acquirers or on-going shareholders and
- market valuations of the loss company

to set the relative AF. Applying such an AF would also not seem to determine a sensible limit on loss utilisation as the losses would be used only against the future income of the loss company rather than of the acquirer companies as occurs in the tax consolidation rules (the transferred losses are used against the income of the whole of the consolidated group acquirer including any of the loss making company).

An alternative "drip feed" rule could be developed based upon for example:

- applying some reference rate to the market value of the loss company. The US "section 382" rules apply a government bond rate to the market value of the company if a company fails their COT rule; however we do not recommend the US model (see below); or
- deducting the losses on a straight line basis at a statutory rate, for example over a 5 year write off period (our preferred approach)

Under the US "drip feed" rules losses are limited following a specified change in ownership, to a yearly amount calculated as the fair market value of the stock of the loss corporation immediately before the ownership change multiplied by the applicable long-term tax-exempt rate (which was 3.55% at December 2011). The US rules have an "anti-capital stuffing" rule to reduce the value of the stock by any capital contributed as part of a plan whose principal purpose is to avoid or increase any limitation calculated under the section. This anti-avoidance rule appears simpler and more appropriate than the Australian tax consolidation capital injection rules which require acquirers to examining the "capital injections" and non-arm's length transactions of the target loss company for 4 years prior to the acquisition date and to adjust the AF calculation without any regard to the purpose of the capital injection and/or non-arm's length transactions.

However in our view the US approach would not be an acceptable alternative as:

- it requires potential extensive costs of compliance in obtaining market valuations and
- would typically produce inappropriate very low loss utilisation rates due to:
    - the valuations of the loss company would usually be depressed because of those losses (other than perhaps for some listed companies if the securities exchange price could be used as the market value) and
    - the low rate used in the US which is in our view uncommercial.
- Such a 'drip feed" restricted to the income a single unconsolidated company would result in inappropriately low loss utilisation, unlike the tax consolidation AF rules which apply to income of the whole consolidated group.

We recommend that a simpler "drip feed" method could be introduced which is based on deducting the losses on a straight line basis over a more meaningful statutory period of say 5 years. This method would be simple to implement and apply each year and would avoid any potential significant costs of compliance of any valuation based approach.

3 Other comments on report proposals

3.1 Remove COT and SBT and replace it with a "drip feed" loss utilisation mechanism

The interim report suggests a loss limitation might apply (if COT and SBT are removed) only where an entity is acquired 100% by another entity. We are concerned that such a rule would only apply in very limited cases and would have significant potential revenue cost if there were no further integrity measures.

This is because it is already common for companies to join a tax consolidated group where they are acquired 100% (ie in a tax consolidation environment it is common for entities to be acquired by the head

company of a tax consolidated group and joining the group is required in 100% ownership cases) and as you are aware in these cases the losses transferred to the group are already subject to the available fraction rules (and additional loss transfer testing). So an additional 100% rule outside tax consolidation may therefore have limited application other than acquisition cases not involving a corporate acquirer (ie the loss company is acquired by a trust which is not eligible to form a tax consolidated group).

It would therefore appear likely that the alternative available fraction "drip feed" loss restriction method would need to apply more widely than only in 100% change in ownership cases in order for it to represent an appropriate integrity measure to limit the potential cost to the revenue from the proposed removal or watering down of COT and/or SBT, subject of course to what other acceptable trade off savings in other tax areas are identified by the working group.

3.2 Remove COT and SBT and replace it with a new loss trading integrity rule

The interim report suggests a loss trading transaction purpose integrity rule could apply instead of COT and SBT.

However there are already many loss integrity rules that seek to combat the inappropriate use of losses and to combat trading in companies for their losses and tax deductions including the rules in Division 175 of the ITAA 1997 which might already be sufficient: if they are considered inadequate then other existing rules might be used as a basis for integrity testing in this regard.

If some new test were to be recommended, despite our views, it would need to be applied objectively on a facts and circumstances approach, which would likely lead to similar problematic issues with interpretation and practical application as are experienced under the current SBT.

A dominant purpose test should also not replace COT which is likely to provide far greater certainty to taxpayers.

4 Further refinement to loss tests and tax consolidation changes

4.1 Further refinement of COT

Although COT can be met in many cases there is scope to further modify the rules to streamline them and address some continuing issues for companies. These modifications should apply to current prior year losses without restriction as well as to prospective year losses.

The COT could be further simplified and streamlined so that it is targeted at real takeovers rather than underlying majority changes of ownership over time.

A range of technical changes could also be developed in addition to the current proposals to deal with companies with multiple classes of shares and the 2011-12 Budget proposals.

These could include addressing additional practical problems of tracing shareholdings through interposed entities and nominee and similar arrangements in particular under the Division 165 non-widely held provisions.

The continuity requirement could be reduced to also help address these issues including for non-widely held and eligible Division 166 companies. In our view a continuity requirement of 40% would also eliminate many issues where adequate underlying ownership information cannot be obtained by companies.

4.2 Tax consolidation AF capital injection and non-arm's length transaction adjustments

The review should also address inequitable outcomes and concerns with the tax consolidation loss rules including the tax consolidation capital injection and arm's length available fraction (AF) adjustment rules.

The BTWG should consider these issues as the Board of Taxation's post-implementation review into certain aspects of the tax consolidation regime is not considering the AF rules as part of that review (consideration of loss issues is limited to leaving cases and in respect of potential concessions for small business groups forming a group with wholly owned subsidiaries).

The AF adjustment rules may apply broadly in two circumstances where:

- [Pre-joining] There is an increase in market value of the joining entity as the result of an 'injection of capital' ("capital injection") into the joining entity or an associate of the joining entity or a non-arm's length transaction event in the four years prior to an entity joining a group
    - this reduces the modified market value (MMV) numerator in the calculation of the AF by the difference between the MMV at the joining time and what it would have been if none of the events had occurred, measured at either the time the joining entity joins the group or immediately after each event
- [Post consolidation] There is an increase in market value of the group as the result of a capital injection/non-arm's length transaction event into the group at any time after joining (adjustment event 4)
    - this reduces the AF by multiplying it by fraction calculated immediately after the event as:

$$\frac{\text{Market value of the company (group) just before the event}}{\text{Market value of the company (group) just before the event + Amount of the increase}}$$

The term 'injection of capital' is not defined and may be very broad (see ATO taxation ruling TR 2004/9).

We note that there are a series of other adjustment events and circumstances in which the AF may be reduced.

The AF adjustment rules may result in the inappropriate restriction of the use of losses by an acquirer group, as outlined further below. The rules may also require significant work to perform the necessary calculations with resulting increased costs of compliance including in respect of obtaining valuations of joining entities and the consolidated group. The ATO has provided only limited administrative valuation short cuts for post consolidation cash injections or where the group is a listed company.

4.2.1 Pre-joining adjustment

The pre-consolidation joining AF adjustment rules should be removed.

a) Although the AF pre-joining AF adjustment rules are said to be intended to prevent a loss entity from inflating its market value before it joins a consolidated group in order to obtain a higher

AF[3], there is no purpose element to the application of the pre-joining adjustment provisions. All capital injections and non-arm's length transactions may therefore contribute to the adjustment (other than in limited cases as accepted by the ATO in their taxation ruling TR 2004/9 for example in respect of "initial capitalisations") even if the event occurred before the tax losses were incurred. The absence of a purpose test is confirmed by the ATO in their ruling.

The lack of a purpose test is major flaw in these rules and causes them to operate inequitably.

b) The AF rules are also said to be designed to ensure that the use of transferred losses by the consolidated group is restricted, to approximate the same rate they would have been used by the joining entity had it remained outside the group – subsection 707-305(3). However the assumption in the AF calculation, that the relative value of an entity is an appropriate proxy for determining the rate of utilisation of losses, is an imprecise measure and outcomes can differ greatly based on the income generating capacity of the particular group joined.

While the Modified Market Value (MMV) adjustment rules might have been appropriate in some formation cases (in particular on the commencement of the tax consolidation regime) they are not appropriate in post-consolidation acquisition cases.

c) In practice it is often difficult to obtain the necessary information to apply the AF adjustment rules in a third party acquisition. This requirement may also increase the costs of compliance by potentially requiring additional market valuations to be obtained.

So, the inherent problems with applying a value derived rate to the income of a group are also increased where the value calculation is indiscriminately reduced by the capital injection/non-arm's length transaction mechanism.

Acquirers are more reluctant to recognise the value of any losses which may be transferred to the group on acquisition where there is a risk of the 4 year rule applying.

Where the adjustment rules apply then to the extent that the acquisition is part of a merger transaction where the previous owners in the loss company have a continuing stake in the consolidated group acquirer (for example in a scrip for scrip takeover) then those shareholders are denied some recognition for the losses incurred by the acquired entity.

The EM to the May 2002 Bill notes that in addition to the specific AF adjustment rules, the general anti-avoidance provisions of Part IVA of the ITAA 1936 may apply where values relevant to the calculation of an AF are manipulated as part of a scheme entered into with the sole or dominant purpose of increasing an AF (or otherwise increasing the rate of utilisation of losses by a consolidated group) (Paragraph 8.102). In our view it is more appropriate to apply these rules to cases of manipulation of the AF rules rather than applying the current rules.

4.2.2 Post consolidation AF adjustment

The post-consolidation AF adjustment rules should be modified so that they only apply where there is a dominant loss utilisation purpose.

[3] (paragraph 8.91 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002)

The rationale for post-joining AF adjustments is stated to be that these events increase the income generating capacity of the group which reduces the proportion of income a loss entity can be regarded as generating[4].

There is again no purpose test to the application of the rules. The rules may also result in increased costs of compliance where the ATO's short cut methods are not available.

In practice we have seen the impact of the AF adjustment rules discourage restructures, recapitalisations and other actions by groups that might have assisted them to recover from downturns.

The rules also might be seen to encourage debt financing over equity (where available) as debt funding does not impact available fractions (unless the non-arm's length transaction rule applies).

The rules are counter to the aims of the loss recoupment rules to allow companies with continuing majority underlying ownership to deduct their losses, because the equity raised (which triggers the adjustment events) is likely to be **from existing shareholders** rather than new equity participants.

4.3 Response to Element B: Loss refunds

We agree in principle that a broadly applied loss refund would not be supportable due to the potential cost to the revenue and potential volatility in tax collections between income years.

However we recommend that this reform should be considered in more limited cases for example in some start-ups.

We note that start ups do not immediately benefit from removal of COT and SBT or from loss uplifts.

4.4 Response to Element C: Time limited loss carry back

We support a loss carry back that is limited to the franking account balance of the company.

We recommend a period of 2 years carry back. We agree this gives better smoothing and that a longer period would increase volatility in tax collections.

For example due to timing issues there might be taxable income in an early year before the losses are generated especially where the company commences towards the end of its first income year. This could also potentially be limited to small to medium businesses (although we see difficulties in defining who it may apply to.)

Mechanical issues including with the timing of payment of tax and the operation of the franking account rules (including the potential application of integrity measures and other potential adjustments) will need to be considered.

We do not agree with the proposal that the extent of the carryback could be limited to any percentage or other portion of the loss – this would create inequities between taxpayers and complications in the system.

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[4] (Paragraph 8.93 of the Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002)

4.5 Response to Element D: Apply uplift factor to losses

We support this proposal which and we believe it should be straight forward to implement. We note that such an uplift is also proposed in the infrastructure company loss proposals which should provide a template for broader rules.

We note the standalone reduced cost of this option due to the continued uncertainty of the use of any uplifted losses, however we recommend it is implemented in conjunction with A and C.

Also if the measure is limited to losses incurred for years after the commencement of the changes then for many companies there may be a significant period before such uplifted losses could be accessed following the utilisation of losses of older pre-commencement years.

The measure will also create cases of future profits exceeding the balance of franking credits so to the extent that these are paid out as unfranked dividends there will be some claw back of the cost to revenue.

The uplifted amount should be calculated on a compounding basis so that losses retain their real value.

However the long term (ten-year) Government bond rate suggested in the report is less than the commercial cost of funds for a typical company and we note that the uplift in the Minerals Resources Rent Tax for various purposes is LTBR plus 7%.

4.6 Combinations of elements

We support a modified combination 3 –optional alternative to SBT, loss carry back and loss uplift.

The combined options are need to provide the broadest long term benefit to business. For example start ups may need Element D initially and then A and potentially C later in their business cycle.

However if it becomes a choice between combinations 1 and 2 (with the optional alternative to SBT) we note combination 2 may likely assist M&A activities more than combination 1.

5 Black hole provisions

5.1 Timing of deductions

We support a shorter general write off period for s.40-880 of three years instead of the current five year deduction period. As there are very limited circumstances where eligible expenditure would provide an enduring benefit to the business (as illustrated by the 41 examples provided in the Australian Tax Office guidance in Taxation Ruling TR2011/6), there is little policy justification for an extended deduction period.

We recommend that an immediate tax deduction be available under s.40-880 in relation to business cessation costs and also for unsuccessful ventures. This would overcome the inequitable deduction wastage that can arise where there is no future income to offset business cessation deductions over 5 years. An immediate deduction for expenditure in relation to unsuccessful ventures (e.g. due diligence costs in relation to an acquisition or divestment that does not proceed) is also necessary, even in cases

where there may be other continuing or alternative sources of income, in order to provide a more appropriate timing for tax relief in such circumstances.

5.2 Inappropriate exclusions

Section 40-880 includes some express exclusions that inappropriately frustrate the operation of s.40-880 as a provision of last-resort for business related expenditure not otherwise taken into account for income tax purposes.

The exclusion of expenditure in relation to a lease or other legal or equitable right in s.40-880(5)(d) is particularly problematic and is a continuing source of frustration for business taxpayers. The justification for that exclusion, namely the expected Government review of expenditure in relation to leases and rights[5], is no longer valid given that review has not eventuated and is not expected in the foreseeable future. Expenditure in relation to a lease or other legal or equitable right, that is not included in the cost base of a CGT asset (which would then be excluded under s.40-880(5)(f)) should not be excluded from s.40-880 and s.40-880(5)(d) should be modified or repealed to achieve that outcome.

The exclusion of expenditure that forms part of the cost of land in s.40-880(5)(c) should also be repealed as its application is effectively limited to expenditure incurred by an entity other than the owner of the land[6]. However, from a policy perspective we cannot see any justification for the application of the exclusion in relation to land, in circumstances where a deduction would be available under s.40-880 in relation to expenditure relating to other forms of tangible or intangible property.

5.3 Interactions with specific provisions

Some provisions in the ITAA may deal with specific types of business establishment and restructure costs in some circumstances, where s.40-880 may apply (or should otherwise be able to apply) to those types of costs in cases where the specific provision does not apply. This gives rise to a range of issues including:

- whether the specific provision should be extended to cover a broader range of circumstances in relation to specific types of expenditure
- if s.40-880 is to have residual application in some cases, there should be some guidance either in the law (note) or issued by the ATO that more clearly sets out the boundaries of when the specific provision will apply and when s.40-880 applies
- inconsistent timing of recognition of expenditure.

The inconsistent treatment of feasibility costs is a good example of a specific type of expenditure that commonly gives rise to difficulties. The income tax treatment of feasibility costs (which are capital in nature) varies depending on whether they relate to a project or a business. In Example 11 in TR2011/6 "James spends $5,000 on a feasibility study and the preparation of a business plan for the operation of 10 accommodation cabins" it is unclear whether in this case there is a "project" for the purpose of the project pool rules in s.40-830, otherwise this may qualify as a business for the purpose of s.40-880. The treatment of such costs under the two provisions can markedly differ, especially in relation to failed projects (immediate balancing deduction) as compared to failed business (deduction over 5 years).

[5] See paragraphs 224 to 229 of TR 2011/6 which provides an overview of the historical context for the exclusion of s.40-880(5)(c).
[6] See paragraphs 220 of TR 2011/6

We believe there is merit in a specific provision applying to capital expenditure on feasibility studies, in relation either a business or a project, with:

- immediate deduction for a failed business or project or
- deduction spread either over the life of the project or the general deduction period under s.40-880.

6 Other issues – trust loss rules

As mentioned above, there are significant problems in the trust loss rules, particularly those involving unit trusts which carry on businesses.

Consideration of application of trust loss rules (Schedule 2F ITAA 1936) should be addressed as part of the BTWG review and should not be delayed.

We think this is appropriate as, although the Government has commenced the second phase of the review of the taxation of trusts, the November 2011 Treasury discussion paper does not consider the trust loss rules but instead refers to the BTWG review of losses and seems to suggest that the trust loss rules should be considered in this forum and not part of any imminent stage of the trust rewrite process.

In fact the trust loss rules are not currently scheduled for any further consideration by Treasury as part of the trust review.

Changes to the trust loss rules should include:

- A SBT should apply more broadly to "fixed trusts" (currently a SBT applies only for listed widely held fixed trusts)
- The tests for listed and other widely held trusts should not be dependent on fixed trust status but tests more akin to continuity of underlying ownership of units and interests should be introduced
- The concessional rules for listed and widely held trusts should be improved broadly in line with the concessional widely held and eligible Division 166 company rules rewrite in Division 166 including to:
    - allow for further deemed ownership (fixed entitlement status) by other widely held and special entities
    - to introduce less than 10% notional ownership (fixed entitlement) tests
    - to replace the abnormal trading tests with simpler rules
    - to replace Commissioner of Taxation discretions with clearer tests
- Trusts should have an alternative loss "drip feed" mechanism available to them in circumstances similar to the above.