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AUSTRALIA • NEW ZEALAND

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Dear Sir

Increasing access to company losses

Chartered Accountants Australia and New Zealand (**Chartered Accountants ANZ**) welcomes the opportunity to comment on the Exposure Draft legislation (**ED**) which contains proposed amendments to supplement the existing same business test (**SBT**) for companies and listed trusts with a similar business test.

We also thank you for the opportunity to discuss the proposed amendments with you and officers from the ATO.

Chartered Accountants ANZ is made up of over 100,000 diverse, talented and financially astute professionals who use their skills every day to make a difference for businesses the world over.

Our comments focus on the proposed amendments as they apply to prior year revenue losses of companies with, for ease of reference, a standard 30 June year end. However, we acknowledge that proposed amendments extend to other situations where the SBT applies. In the time available for comment, we have not considered whether the proposed amendments raise different issues in the context of those other situations.

References are to the Income Tax Assessment Act (**ITAA**) 1997 unless otherwise specified.

The Government's announcement

The Government's proposal to increase access to company losses was announced as part of its National Innovation and Science Agenda. The purpose of the amendments is to encourage companies to 'seek out new opportunities to innovate and grow', 'encourage entrepreneurship by allowing loss making companies to 'pivot' and seek out new opportunities to return to profitability', 'take the leap' and 'take sensible risks to get back in the black'.

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To achieve this objective it announced that under the new arrangements:

- the current 'same business test' will be relaxed to allow businesses to access past year losses when they have entered into new transactions or business activities
- a new and more flexible 'predominantly similar business test' will be introduced
- under this 'predominantly similar business test' companies will be able to access losses where their business, while not the same, uses similar assets and generates income from similar sources.'

This reform was considered as part of the 2012 Business Tax Working Group's review into losses, and was raised as an area for potential reform in the Government's tax discussion paper 'Re:think'.

For standard 30 June year end companies the proposed amendments apply to losses made in the 2016 and future income years. Current loss arrangements will continue to apply to existing carried-forward losses.

We observe that the proposed amendments do not appear to reflect the Government's announcement in that they do not relax the current SBT by removing the new business and new transaction tests. In the time available for comment we have not explored whether, at a practical level, this will narrow the circumstances in which companies failing the continuity of ownership test (**COT**) will be able to recoup prior year losses under the proposed new continuity of business rules.

Summary

We welcome any changes to the SBT which will facilitate, and not hinder, genuine and creative attempts to enhance profitability.

Our main observations on the proposed amendments are as follows:

- The breadth of the proposed changes falls short of many stakeholders' expectations in the light of the Government's statements in the National Innovation and Science Agenda.
- We do not consider that the proposed amendments will reduce compliance costs. There will be a need for the ATO to provide detailed guidance on the operation of the proposed amendments and an ongoing need for taxpayers to obtain expert advice and probably also private binding rulings to obtain certainty.
- Treasury should give further thought to the formulation of the similar business test to ensure that it achieves its intended objective.
- We do not agree that the current SBT, which is proposed to be retained for 2016 and future losses, should be subject to the integrity rules in Division 175. The SBT already has its own in-built integrity rules in addition to the general anti-avoidance rules.
- The ED should include an objects clause which clearly sets out the policy intent behind the similar business test in contradistinction to the SBT.

Submission

Our comments on the ED and accompanying Explanatory Material (**EM**) are set out below.

1. The similar business test

(a) Announcement versus proposed amendments

Chartered Accountants ANZ welcomed the Government's announcement that the SBT would be supplemented by a similar business test to give companies some latitude to make their businesses profitable without prejudicing their ability to recoup prior year losses.

However, we observe that the language used in Government's National Innovation and Science Agenda has led many stakeholders to expect that they would be bolder than simply *'allow[ing] losses to be claimed in more circumstances, where the business could not be said to be the 'same', but where the differences are minor and are such that it is appropriate for losses to be available.'*¹

The examples in the EM of where the similar business test is satisfied tend to reinforce this perception. They suggest that some changes which result in different sources of income to increase the profitability of a business are acceptable, but only if they are not so profitable as to swamp income from the same sources as the former business. They also take a fairly narrow view as to what constitutes the same source of income.

(b) The new rules are unlikely to reduce compliance costs and increase certainty

We also observe that while the new similar business test, supplemented by ATO guidance, is intended to *'provide companies with more certainty and a reduced need to seek expert advice or ATO rulings'*², we do not believe that this will be case. This is because:

- the new test still requires a company to determine whether its current business is 'similar' to its former business; and
- a factor which must be considered in determining this is the extent to which income from the current business is from the 'same' source as income from the former business.

Statutory requirements that businesses be the 'same' or 'similar' have been plagued with uncertainty not only in Australia but also in other jurisdictions, e.g. Canada and the US. In addition, there is a need to determine whether any changes are ones which a similarly placed business would make. In our view, the proposed similar business test will pose at least as many difficulties as the current SBT.

(c) The Exposure Draft and Explanatory Material

More specifically we make the following comments on the ED and EM:

- (i) Proposed subsection 165-211(1) - A company will satisfy the business continuity test if its current and former businesses are 'similar' as that term is ordinarily understood having regard to all relevant facts and circumstances. In essence, this is the test.

The first two factors which the ED specifically requires to be taken into account in determining this issue are ones which would be taken into account in any event. In our view the third is not. So, if a business makes a change which, based on existing jurisprudence, would result in the current and former business not being similar, we do not think the fact that the change is one which would reasonably be made to a similarly placed can influence that outcome³.

¹ 'Increasing access to company losses' <http://www.treasury.gov.au/Policy-Topics/Taxation/NISA/Access-to-company-losses>

² See footnote 1.

³ We have accepted that the conclusions in the examples as to whether the current and former businesses are similar accords with existing case law.

If we are wrong then the question arises as to what the similar business test is trying to achieve by requiring that regard be had to whether any changes made are ones which would reasonably have been made by a similarly placed business.

One possibility is that it is to allow a company to satisfy the continuity of business test if, after an ownership change, its current business is similar to its former business having regard to all relevant factors, including, in particular, the first two factors. However, a current business should not be treated as dissimilar to a former business simply because of changes made where those changes are ones which would reasonably have been expected to be made to a similarly placed business.

However, this would mean that, in Example 1.3, Peach & Ice would satisfy the continuity of business test which the example concludes it does not.

Another possibility is that the continuity of business test will be satisfied if:

- There is an appropriate degree of continuity of/similarity with the former business as evidenced by factors including the extent to which assets of the former business continue to be used and the extent to which it continues to derive income from the same sources; and
- Any changes to the former business are ones which might reasonably be expected to be made to a similarly placed business.

So, using the fact pattern in Example 1.1, if the sale by Furnish Art of the mattresses it developed was highly profitable it would satisfy the continuity of business test because it continued to use the assets of its former business (or an appropriate portion of them) and to derive income from the sale of furniture. The fact that income from the sale of mattresses swamps the income generated from the ongoing sale of furniture would not be relevant.

However, this would mean that, in Example 1.2, RePoly would not satisfy the continuity of business test.

In the light of the above comments we recommend that Treasury:

- Consider whether the ED as drafted allows the third factor to influence whether a current and former business are 'similar' as that term is ordinarily understood and if so, how; and
- Insert an objects clause which clearly sets out the policy intent of the new business continuity test and, in particular, the similar business test.

- (ii) Proposed subsection 165-211(2)(b) - Should the second factor look to the extent to which the sources from which a current business generated assessable income were the same or similar to the sources from which its former business generated assessable income? It is after all a similar business test.

In Example 1.3 we would have thought that the source of Peach & Ice's income from selling bottled ice tea should be the same or at least similar to the source of income in the former business. In our view, the focus when looking to the source of income should not be the supply chain which, in a dynamic business environment, is likely to be disrupted

- (iii) Proposed subsection 165-211(c) - The third factor looks simply to whether any changes made to a former business are ones which a person would reasonably be expected to make to a similarly placed business.

The view taken in the EM (paragraph 1.30) is that a reasonable person would only make changes to a similarly placed business which have some 'organic connection and continuity' with the former business or changes which are 'natural one(s) that a reasonable person, looking at the former business would have been able to predict'. Changes which simply make good commercial sense, which take advantage of a good opportunity or the idiosyncratic circumstances and connections of the company and its owners will not satisfy the third factor.

In relation to the examples, the move from on selling mattresses to developing and manufacturing for sale Furnish Art's own mattresses was a change which might reasonably have been made to a similarly placed business, its effect being to 'supplement the former business as a subsidiary or ancillary business rather than replacing it' (at p11). So too was ceasing to manufacture bottled iced tea under the Peach & Ice brand and instead becoming a distributor of another brand of tea to shed costly production costs. But exploiting the intellectual property of the former business of RePoly to manufacture and sell an additional product was not.

We observe that the words used in the ED are very broad and we assume that Treasury is satisfied that they are sufficient to achieve the outcomes described in the EM.

In relation to the third factor we ask that Treasury:

- In relation to the RePoly example, reconsider whether its conclusion – which we think was reached with some difficulty - is appropriate. In our view, being alive to opportunities to exploit existing intellectual property would be on the radar of any company, particularly a start-up. We are therefore surprised by the conclusion.
- Consider expanding Examples 1.1-1.3 to cover in detail the alternative fact pattern presented at the conclusion of each example. Currently the EM suggests what the likely outcome of the similar business test might be in the changed fact pattern but does not say why. This is particularly important in relation to the third factor.

- (iv) The EM would benefit from an example or additional commentary on when the source of income from a current business will be the same as its source in the previous business. At present the EM indicates that source of income derived by a company from a take-away fish and chip shop and an Italian restaurant are different (paragraph 1.27). However, in the examples the changes made to the former business result in income which is different.

In our view the consultation would have benefited had draft ATO guidance been issued simultaneously with the ED.

2. The integrity rules in Division 175 should not apply for SBT purposes

As the ED is drafted, the integrity provisions in Division 175 will be switched on for 2016 and subsequent year losses being recouped using not only the proposed new similar business test but also the SBT which will continue to apply in its current form. This is despite the fact that the SBT has its own inbuilt integrity provisions in the form of:

- The new business and new transaction tests which it is proposed be retained;
- The anti-avoidance provision in subsection 165-210(3) which prevents companies satisfying the SBT where they commencing a business/enter into a transaction before an anticipated ownership change to facilitate subsequent satisfaction of the SBT; and
- The general anti-avoidance provisions in Part IVA of the ITAA 1936.

We understand from our telephone discussion that the reason for the additional layer of integrity rules is so companies which believe they pass either the SBT or, at a minimum, the similar business test do not need to determine that issue with precision to know whether Division 175 is relevant to them. Instead, Division 175 will be relevant to the recoupment of all 2016 and subsequent year non-COT losses.

We do not support this approach. In our view, the nature of the SBT and the proposed similar business test is such that most companies will be aware of which test they are seeking to satisfy. Those seeking to rely on the SBT should not be subject to any additional integrity rules which are unnecessary and will only add to compliance costs.

3. The need for ATO guidance

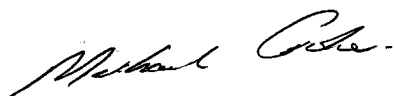
We understand from material on Treasury's website that it has been working closely with the ATO to progress not only the preparation of draft legislation but also guidance material for reforms to the SBT. We agree that ATO guidance in the form of Law Companion Guides or other products will be needed to supplement the EM and explain in more matters including the following:

- The circumstances in which a business will be regarded as similar, including the relevance of the three factors in the legislation to which regard must be had and the sort of other factors which may be relevant in particular circumstances.
- The integrity provisions in Division 175 which we suspect have received little attention in the past but will play a larger role in relation to the loss recoupment rules.

We would be pleased to assist the ATO develop guidance material around the similar business test.

Should you wish to discuss our submission please call Susan Cantamessa on 02 9290 5625 or email her at susan.cantamessa@charteredaccountantsanz.com.

Yours sincerely



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