

KPMG submission

Exposure Draft

*Tax and Superannuation Laws
Amendment (2016 National Innovation
and Science Agenda) Bill 2016: Access to
losses*

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Executive Summary

On 7 December 2015, as part of the Government's broader initiatives on the National Innovation and Science agenda, the Government announced:

- The current 'same business test' will be relaxed to allow businesses to access prior year losses when they have *entered into new transactions or business activities*. This will encourage entrepreneurship by allowing loss-making companies to seek out new opportunities to return to profitability.
- A new and more flexible 'predominantly similar business test' will be introduced.
- Under the '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."

However, we are concerned though the current Exposure Draft does not fully reflect the announcement of 7 December 2015 in particular with regards to the removing the new transaction test and the business activities test in the same business test. The current same business test is still relevant for losses incurred before 1 July 2015 but are recouped after that date and also operate in parallel to the new similar business test for losses incurred on or after 1 July 2015.

In addition, we believe the application of the new similar business test where the 3 indicia must be taken into account is still quite restrictive for loss making businesses seeking out new opportunities to enable them to return to profitability based on the examples in the Explanatory Materials and its application uncertain in the absence of further ATO guidance.

We recommend how the proposed rules could be structured are as follows:

- The similar business test applies for losses incurred on or after 1 July 2015 with the integrity measures. There should be accompanying ATO guidance on how this test applies in practice to reduce the need for taxpayers to seek an ATO ruling. Working through the examples in the existing TR 1999/9 would be a starting point to retest the similar business test but also the new rules tested in light of more modern practical examples.
- If the same business test is to operate in parallel to the similar business test for losses incurred on or after 1 July, repeal the new transaction test and the new business activities test.
- For losses incurred before 1 July 2015 but recouped after 1 July 2015, the same business test applies but with the removal of the new transaction and activities test.

Detailed comments

1.0 General

- 1.1 KPMG welcomes the opportunity to comment on the Exposure Draft (ED) of *Tax and Superannuation Laws Amendment (2016 National Innovation and Science Agenda) Bill 2016: Access to losses* and associated Explanatory Memorandum as published by Treasury on 6 April 2016.
- 1.2 We welcome the Government's announcement of 7 December 2015 proposing to reform the current same business test so that it is more in line with Government's innovation initiatives to encourage entrepreneurialship and ensuring our tax laws do not deter loss making companies from seeking out new opportunities to return to profitability.
- 1.3 We are concerned though the current Exposure Draft on the new similar business test is still quite restrictive and its application uncertain in the absence of ATO guidance.
- 1.4 Our concern on the current limitations of the new tests in the Exposure Draft relate to the indicia that you need to take into account in applying the similar business test and also the operation of the new integrity measures. We elaborate on our concerns below.

2.0 Original announcement

- 2.1 When the reform to the company loss recoupment rules were first announced in December 2015, the Government, as part of the National Innovation and Science Agenda announced it would reform the current company loss recoupment rules so that companies would not be prevented from recouping losses because of the current 'same business test' when they seek out new opportunities to innovate and grow.
- 2.2 On 7 December 2015, the announcement provides:

“Under the new arrangements:

 - The current 'same business test' will be relaxed to allow businesses to access prior year losses when they have *entered into new transactions or business activities*. This will encourage entrepreneurship by allowing loss-making companies to seek out new opportunities to return to profitability.
 - A new and more flexible 'predominantly similar business test' will be introduced.

- Under the ‘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.”

2.3 The way the Exposure Draft has been drafted is that:

- For losses incurred on or after 1 July 2015, the same business test still operates but now taxpayers have the choice of applying the similar business test or the same business test. There is a question as to why the same business test provisions continue to operate if it is unamended despite the original announcement. Moreover, there seems to be additional integrity measures imposed when applying the same business test i.e. not only do taxpayers need to get through the existing new transaction test and the business activities test, they also now under the Exposure Draft proposals are subject to Division 175 integrity measures.
- For losses incurred before 1 July 2015, the same business test will continue to apply. There has been no proposed modification to the current same business test in the Exposure Draft.

2.4 The expectation from the announcement was that the same business test was to be relaxed and the new transactions and business activities test to be repealed or relaxed, but this has not been reflected in the current Exposure Draft.

2.5 Making the same business test even more restrictive seems to be counterintuitive to the Government’s announcement as part of the National Innovation and Science Agenda and we query whether the current drafting is intended.

3.0 The similar business test

3.1 The legislation provides the business continuity test is passed if a business carried on during the relevant test period is ‘similar’ to the business carried on before the relevant test time.

3.2 ‘Similar’ is not specifically defined in the draft legislation but the provisions provide that without limiting the matters to be taken into account in determining whether a similar business is carried on, the following must be taken into account:

- Assets test: the extent to which the assets (including goodwill) that are used in the current business to generate assessable income were used in its former business to generate assessable income.
- Sources test: the extent to which sources from which its current business generated assessable income were also the sources from which its former business generated assessable income.
- Similarly placed business test: whether any changes to its former business are changes that would reasonably be expected to have been made to a similarly placed business.

3.3 Notwithstanding the examples provided in the EM, there is still uncertainty as to the threshold of when a business carried on is similar but not the same.

3.4 This is an area that would benefit further ATO guidance with more practical examples which should be released when legislation is finalised to provide taxpayers certainty on the application of the reformed rules.

3.5 Some of the examples in EM would seem to suggest the application of the similar business test is quite narrow and we question whether it would be much difference to the same business test. This then raises the question as to whether the 3 indicia are the right indicia to take into account. The sources test focusses on how a business goes about generating the income. If a business decides to reorganise its operations to creative efficiencies (i.e. move from manual labour to digital processing for example) to provide the same services to an existing or expanded customer base, although the sources from which income has generated has changed, we believe it shouldn't be penalised from using its tax losses. This would be more akin to organic growth of a business.

3.6 Take the example in Example 1.3. The taxpayer Peach & Ice Co fails the similar business test. Before a change in ownership, this company brewed, bottled and sold ice tea. It had a manufacturing plant and marketed the iced tea under its brand name, selling its product to supermarkets, caterers and takeaway shops. After the change in ownership Peach & Co stopped manufacturing of bottled ice tea and instead bought bottled ice tea from another producer which it distributes and resells. Brand name

changes, customer base changes (i.e. sells to caterers and takeaway shops but not supermarkets) and it becomes more profitable as a result. However, towards the end of the example it says “the conclusion will be different if Peach & Co continued to use its brand name of the label of its iced tea products and continues to sell its products to all of its previous customers”.

3.7 If Peach & Co is not profitable with its existing brand name and selling to the same customer base and needed to change its processes to create efficiencies, should it be penalised by denying them its losses? Wouldn't the change constitute organic growth in this case? To what extent does the change constitute similar but not the same business? This is an area where further ATO guidance is needed.

3.8 Perhaps the indicia should not only focus on a taxpayer's inputs (i.e. assets, source inputs) but also its source outputs i.e. the services the business provides so that if you are still providing a similar service it should not matter how you have gone about it to make it more profitable. This would also be more in line with encouraging entrepreneurialship.

4.0 Recommendation

An alternative suggested model for the operation of these reform measures is:

- 4.1 The similar business test applies for losses incurred on or after 1 July 2015 with the integrity measures. There should be accompanying ATO guidance on how this test applies in practice. Working through the examples in the existing TR 1999/9 would be a starting point to retest the similar business test but also the new rules tested in light of more modern practical examples.
- 4.2 If the same business test is to operate in parallel to the similar business test for losses incurred on or after 1 July, repeal the new transaction test and the end the new activities test.
- 4.3 For losses incurred before 1 July 2015 but recouped after 1 July 2015, the same business test applies but with the removal of the new transaction and activities test.