THE TAX INSTITUTE

THE MARK OF EXPERTISE

21 April 2016

Mr Tom Reid
Division Head
Law Design Practice
The Treasury
Langton Crescent
PARKES ACT 2600

**By email:** lawdesign@treasury.gov.au

Dear Mr Reid,

**National Innovation and Science Agenda – Increasing access to company losses**

The Tax Institute welcomes the opportunity to make a submission to the Treasury in relation to *Tax and Superannuation Laws Amendment (2016 National Innovation and Science Agenda) Bill 2016: Access to losses* (**Exposure Draft**).

**Summary**

Our submission below addresses our main comments in relation to the Exposure Draft. In particular:

- While the Tax Institute welcomes the Government's intention to relax the Same Business Test to promote innovation, the scope of this Exposure Draft is insufficient to meet its policy intent.
- The Exposure Draft would be difficult to apply in practice due to the uncertainty of the terminology used. In particular, the Tax Institute submits that the reasonable expectation factor be removed.
- The Exposure Draft includes an integrity rule which we submit is unnecessary given existing anti-avoidance rules and the policy intent of the measure.

**Discussion**

*Insufficient to meet policy intent*

The Tax Institute commends the Government's intention to address the longstanding issue of the narrowness of the Same Business Test. However, the scope of the Exposure Draft is insufficient to address its policy intent. The Same Business Test was introduced in 1965 and

operates where there has been a failure of the Continuity of Ownership Test. The Same Business Test was originally introduced so that the deductibility of carried forward losses could be maintained in the case 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*".[1]

In 2011, the Business Tax Working Group reiterated that the purpose of these rules is to "*address the scenario where there is no economic substance to the transaction* [where one company is sold to another] *other than gaining access to accumulated losses, potentially acquired at a discounted value.*"[2] This Group went on to recommend that the test be modified so that it better aligns with the modern business environment.[3] It considered that the tests should not impede businesses from innovating or from adapting to changing economic circumstances.

In 7 December 2015, the Treasurer announced that the National Innovation and Science Agenda (which the proposed test in the Exposure Draft is a part of) "*will encourage smart ideas to encourage innovation, risk taking and build an entrepreneurial culture in Australia*". The proposed test in particular was said to "*allow a startup to bring in an equity partner and secure new business opportunities without worrying about tax penalties*".[4] This policy intent is confirmed in paragraph 1.1 of the Explanatory Memorandum.

There are a number of features in the Exposure Draft outlined below which go beyond what is necessary to maintain integrity of the tax treatment of losses and risk stifling innovation.

*Uncertainty*

The Same Business Test is narrow and difficult to apply and we welcome the Government's intention to relax the test. One example we recently heard was from a large listed company with significant carried forward losses which will be reluctant to undertake commercial changes to the business due to the operation of the test.

Although the Exposure Draft seeks to address such perverse outcomes, the proposed test may be equally difficult to apply due to its uncertainty. We suggest that the proposed test should be more specific and contain a "bright line" test. For example, the proposed test could contain a safe harbour test based on percentage of new assets or percentage of income from new sources. The use of the word "similar" is particularly uncertain when coupled with the objective test in proposed section 165-211(2)(c).

[1] Treasurer's Second Reading Speech in relation to the introduction of former section 80E in Income Tax Assessment Bill 1965 which became Act No. 103 of 1965 as quoted by Edmonds and Graham JJ in *Lilyvale Hotel Pty Ltd v FCT* [2009] FCAFC 21 at para 6.
[2] Business Tax Working Group *Interim Report on the Tax Treatment of Losses* 20 December 2011 at para 45.
[3] Business Tax Working Group *Final Report on the Tax Treatment of Losses* 13 April 2012 Recommendation 3.
[4] Treasure Scott Morrison Media Release "Tax and business incentives to boost economic growth & jobs" 7 December 2015.

*Objective test requires subjective enquiry*

We submit that the factor in proposed section 165-211(2)(c) should be removed. Proposed section 165-211(2)(c) requires the taxpayer to consider what other "similarly placed" businesses would "reasonably" have been expected to do. This factor stifles innovation and has no bearing on the integrity concern stated above of transactions with no economic substance where a profitable company purchases another company to gain access to accumulated losses.

Although the word "reasonably" in this factor would suggest that this is an objective test, the words "similarly placed" suggest that the test would require a subjective analysis. This would require consideration and proof of what the business would have done which is likely to add significant compliance costs to comply with the test.

This factor suggests that the innovations created by a business and the use of those innovations should be predictable to a reasonable person, which may be unrealistic in examples such as Example 1.2 in the Explanatory Memorandum. In that example, the use of a highly unique intellectual property asset developed by the business in a new product would result in the failure of the similar business test if the company ceases to sell the old product as well. Such a result stifles rather than encourages businesses from best use of the intellectual property they have developed.

This issue is particularly relevant to businesses in the start-up phase who have not yet started to generate income and are exploring options for creating commercially exploitable products from their innovations. Such businesses are also not in a position to incur significant costs on advice regarding the operation of these rules.

The Exposure Draft should instead focus on whether there is a reasonable connection between the innovation and the growth of the existing knowledge and intellectual property assets of the business, which is sufficiently covered by the factors in proposed sections 165-211(2)(a) and (b).

*Additional integrity rule*

Although the "similar business test" is purported to be more flexible than the "same business test", it is subject to a further integrity rule which makes it more difficult to apply. Items 9 to 11 of the Exposure Draft have the result that taxpayers who wish to apply the "similar business test" will have to consider the operation of the integrity rules in Division 175 whereas those taxpayers who wish to apply the "same business test" are carved out of those rules. We submit that this is an unnecessary change given the operation of the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act 1936*.

*Date of application*

Given the Government's intention to relax the Same Business Test is to allow companies to seek out opportunities to innovate and grow, we suggest that retrospective application be considered to allow businesses with existing carried forward tax losses to innovate and grow. We understand there are a significant number of businesses that are still utilising

carried forward tax losses as a result of the global financial crisis who may be hesitant to adjust their businesses in case they fail the Continuity of Ownership Test and have to rely on passing the Same Business Test. We recommend consideration be given to allowing the "similar business test" to be applied retrospectively so that it may be applied by such businesses.

Further, the extensive application of Division 175 (which extends beyond "injected" income to any income derived because the losses were available) will make the application of similar business test very complex. The imposition of this further complex test will discourage companies from relying on the similar business test and will influence them to instead rely on the same business test with the concomitant reluctance to innovate for fear of losing the losses.

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If you would like to discuss any of the above, please contact either me or Tax Counsel, Thilini Wickramasuriya, on 02 8223 0044.

Yours sincerely,

**Arthur Athanasiou**
President