

January 2003

## Topical Issues in Corporate Tax Losses

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### Recommended Citation

Strange, Andrew (2003) "Topical Issues in Corporate Tax Losses," *Revenue Law Journal*: Vol. 13 : Iss. 1 , Article 6.  
Available at: <http://epublications.bond.edu.au/rlj/vol13/iss1/6>

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## Topical Issues in Corporate Tax Losses

### **Abstract**

The completion of the *Ralph Report* in 1999 and the subsequent implementation of the broad sweep of the Report have resulted in a flurry of new and amending tax legislation. Some of these changes impact on the treatment of tax losses of corporations. This article reviews the impact of these changes on corporate tax losses.

### **Keywords**

tax legislation, ralph report, corporate tax

## TOPICAL ISSUES IN CORPORATE TAX LOSSES

*By Andrew Strange\**

The completion of the *Ralph Report* in 1999 and the subsequent implementation of the broad sweep of the *Report* have resulted in a flurry of new and amending tax legislation. Some of these changes impact on the treatment of tax losses of corporations. This article reviews the impact of these changes on corporate tax losses.

### Introduction

The separate legal entity doctrine<sup>1</sup> establishes that a corporation has a separate legal personality from its members. It also has other characteristics which distinguish it from a natural person. The most relevant here is that it may exist in perpetuity. Tax losses generated by a corporation may therefore survive the demise of its members. Because members, especially corporate members, could access these losses in various ways, tax legislation has been long concerned to quarantine corporate tax losses to avoid revenue leakage. Historically, the principal means of doing so has been to apply the continuity of ownership and same business tests to control the use of tax losses by entities connected to the corporation. To the extent that such measures may prevent a corporation from offsetting past losses against current and future income, they have the effect of modifying the separate legal entity doctrine.

The general approach of the *Ralph Report*<sup>2</sup> in this area was to acknowledge that treatment of losses is a major non-neutrality in the business tax system. However, more generous treatment of losses - by the strict application of the separate legal entity doctrine or allowing immediate refunds for losses for example - would involve an unacceptable revenue cost and encourage tax avoidance.<sup>3</sup>

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1 *Salomon v Salomon & Co Ltd* [1897] AC 22.

2 *Review of Business Taxation – A Tax Redesigned* (1999).

3 Above n 2, 49-50.

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The policy issues arising from the treatment of corporate tax losses are further complicated by the capital gains tax regime which recognizes for tax purposes changes in asset and liability values. The *Ralph Report* specifically addressed 'loss cascading' and 'value shifting' where losses are duplicated between group companies or where 'loss assets' (those carrying an unrealized loss) are transferred within a group.<sup>4</sup> The thrust of the proposals was to achieve single recognition of losses. The principal means of achieving this was through the introduction of a consolidation regime and the abolition of loss transfer outside consolidation.<sup>5</sup>

Generally, the *Ralph Report* was sympathetic to the underlying concept of separate legal entity. It noted that while it led to duplication of losses it also led to duplication of gains, and that the problem was endemic to a system of entity accounting.<sup>6</sup> Its recommendations in this area were principally directed to the prevention of tax avoidance. It resisted, for example, the proposition to abolish the same business test to preserve carry-forward losses. The consolidation regime now adopted by Government implements a single enterprise approach to corporate groups – a step which the legislature has not been prepared to make in statutory corporations law.

The *Ralph Report* has now been largely implemented, principally by substantial amendment to ITAA 97.<sup>7</sup> Whether it has achieved its objectives of integrating and simplifying the business tax system is problematic. The losses section of the *Consolidation Reference Manual*<sup>8</sup> runs to 119 pages alone. In fairness a good deal of this material arises from the necessity for transitional arrangements to the new regime.

### Does the concept of ownership change?

The policy on the preservation of entity losses on sale of an entity is to disallow the losses. The rationale is that such losses have been recognized at the owner's level.<sup>9</sup> Consequently, the principal test in determining whether carry-forward tax losses are protected is the continuity of ownership test.<sup>10</sup> The definition of ownership is therefore critical. In addressing the issue of distributions, the *Ralph Report* adopted a new approach by distinguishing between debt and equity interests. The purpose is to

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4 Ibid 258-265.

5 Ibid 51.

6 Ibid 50.

7 *Income Tax Assessment Act 1997*(Cth).

8 Australian Tax Office, *Consolidation Reference Manual* (2002), <http://www.taxreform.ato.gov.au/contact/downloads/NAT6835.pdf>

9 R Vann 'Australia's Policy on Entity Taxation' (2001) 4(3) *The Tax Specialist* 120, 123.

10 Section 165-12 ITAA 97.

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define membership interests in such a way that those qualifying get returns from an entity which are frankable but not deductible, whereas debt interests may be deductible but not frankable. These provisions were introduced by the *New Business Tax System (Imputation) Act 2002* (Cth) and now constitute Part 3-6 of ITAA 97. The scheme also refers to share and non-share distributions which replace the concept of dividends in that context. The issue is whether this new approach impacts on the preservation of tax losses in the context of the detailed provisions of subdivision 165-A of ITAA 97.

The answer is that although 'ownership' or more correctly 'membership interest' now has a broader definition where distributions are concerned, the definition of 'ownership' in respect of the preservation of carry-forward tax losses is still largely defined in the terms originally set out in ITAA 1997.<sup>11</sup> These are contained in s 165-12 ITAA 97 which has the following elements: s 165-12(1) – ownership test period 'from from the start of the loss year to the end of the income year'; s 165-12(2) voting power - 'there must be persons who had rights to more than 50% of the voting power in the company at all times during the ownership test period'; s 165-12(3) rights to dividends - 'there must be persons who had rights to more than 50% of dividends at all times during the ownership test period'; s 165-12(4) rights to capital distributions - same as for dividends. These tests are further refined by the application of primary and alternative tests which have the effect of requiring that more than 50% of control as defined above is in the hands of the same persons in respect of the same shares<sup>12</sup> during the ownership test period.<sup>13</sup>

The purpose here is to defeat arrangements designed to circumvent the continuity of ownership rules by interposing other corporate entities in the ownership chain or by entering into share warehousing arrangements. The subdivision also refers specifically to the beneficial ownership of shares in a company.

These rules, particularly the 'same share' test, set the ownership continuity requirements at a higher level than applied under the equivalent provisions of ITAA 36<sup>14</sup> and have been subject to criticism.<sup>15</sup> The requirement to trace the ownership of the same shares in order to preserve carry-forward tax losses will have a greater impact on public companies, even though ITAA 97 makes special provision to

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11 P Koit 'Interaction of the New Debt-equity Borderline With the Loss Continuity Test and Imputation' (2001) 16 *Australian Tax Forum* 67, 76.

12 Section 165-165 ITAA 97.

13 Subdivision 165-D ITAA 97.

14 *Income Tax Assessment Act 1936* (Cth).

15 T Baxter, 'Tax Loss Provisions: Lost in a Maze' (2000) 35(4) *Taxation in Australia* 186, 189.

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ameliorate this.<sup>16</sup> The ownership continuity requirements, as now drafted, reflect an objective of the *Ralph Report* to avoid the duplication of tax losses.<sup>17</sup> However, it cannot be said that the provisions of ITAA 97 discussed above embody a different concept of 'ownership' than that which has conventionally applied.

The continuity of ownership changes are technical in nature but add complexity to the preservation of carry-forward losses.<sup>18</sup> Effective tax planning will require detailed consideration of these rules when there is a change of company ownership or a new share issue. Tony Baxter correctly concludes the introduction of the 'same share' test<sup>19</sup> was not necessary to counter avoidance, as ITAA 97 Division 175 makes adequate provision for this.<sup>20</sup>

### The same business test

If carry-forward tax losses cannot be preserved under the continuity of ownership test, they may still be accessible if the requirements of the same business test<sup>21</sup> are satisfied. The present statutory provisions arise from the enactment of ITAA 97, but have not overcome criticisms of previous provisions. The elements of the test set out in ITAA 97 subdivision 165-E are: (1) the corporation must carry on the same business during the continuity period which starts at the start of the ownership test period until the 'test time' (i.e. when the continuity period ends); (2) it satisfies the various same business continuity tests set out in s 165-210 ITAA 97. Specifically, the subject company cannot cease trading or undertake a new business activity during the continuity period. In effect, the test comprises a positive test and a number of negative tests.

Winnie Ma concluded that the use of indeterminate phrases such as 'business', 'business of a kind' and 'business operations' in the ITAA 97 provisions meant that a number of problems remain unresolved.<sup>22</sup> For example, the treatment of multiple businesses as one business and the extent to which past activities can be taken into account.<sup>23</sup> Those that would prefer to have the separate legal entity doctrine relatively

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16 Division 166 ITAA 97.

17 Above n 1, 256.

18 S Carpenter 'Changing The Concept of Ownership' (2000) 4 (2) *The Tax Specialist* 106, 109.

19 Section 165-165 ITAA 97.

20 Above n 14, 196.

21 Section 165-13 ITAA 97.

22 W Ma, 'The Continuity of Business Tests for Carrying Forward Losses' (1998) 8 *Revenue Law Journal* 141.

23 Ibid 170.

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unfettered<sup>24</sup> and those that would wish to see the same business test abolished<sup>25</sup> both find the test unsatisfactory. Longhouse, a tax officer, argues that the same business exception which allows the preservation of carry-forward losses 'serves no policy purpose and is likely to impair necessary economic restructuring of business.'<sup>26</sup>

Leaving aside the disregard for the separate legal entity doctrine, the second part of the statement is dubious. The availability of tax losses may act as an incentive to maintain as a going concern a business which has experienced loss making performance, but which is capable of revival under competent management. The same business test already precludes the preservation of tax losses where the business activity has ceased. The Court has also taken a narrow approach to the application of the same business test to preclude tax losses being utilized in a shell company into which similar activities are injected.<sup>27</sup> The *Ralph Report* took a different view from Longhouse. It noted that the same business test may result in the temporary duplication of losses, but that the same mechanism can equally lead to the temporary duplication of gains which would result in revenue being collected twice off the same gains. Although the *Review* noted that this type of problem is endemic in a system of entity taxation, 'it did not justify the adverse impact on shareholders of denying the loss carry-forward in cases where businesses satisfy the same business test but the majority ownership has changed.'<sup>28</sup>

There is no authoritative case law on the same business test since the enactment of ITAA 97 and the more recent amendments. Tax Ruling TR 1999/9 essentially replicates the Commissioner's views set out in TR 95/31 based on the previous legislation ITAA 36 ss 80E, 50D, 63C and 80F. In draft form TR 95/31 took a very narrow view of what constituted the 'same business'. This approach was ameliorated in the final form of the Ruling which recognized that business activities did not have to be identical to be the 'same' business.<sup>29</sup> Generally it follows the decided cases such as *Avondale*<sup>30</sup> for the definition of 'same' business and *J Hammond Investments Pty Ltd*

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24 Above n 14, 189.

25 G Longhouse, 'The 'Same Business' Test and Cleopatra's Ark' (1999) 28 *Australian Tax Review* 4.

26 Ibid 12.

27 *Avondale Motors (Parts) Pty Ltd v FC of T* 71 ATC 4101.

28 Above n 1, 50-51.

29 T Slater, 'Valuable Gains from Your Losses (1997) *Taxation Institute of Australia* WA State Convention 1997.

30 Above n 27.

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*v FC of T*<sup>31</sup> for the new transactions test. *Rolls Royce Motors Ltd v Bamford*<sup>32</sup> accepted that a business may change through organic growth.

These judgments and rulings do not necessarily give guidance over the concerns raised by Winnie Ma. She has set out a model for applying ITAA 97 s 165-210 as follows:<sup>33</sup>

Step 1:

Identify all activities carried on before the 'test time' (ie the ownership change) (a) The same business test (SBT) is failed upon cessation of all activities before the test time. (b) The anti-avoidance test is failed upon the addition of new activities to existing activities for tax-avoidance purposes.

Step 2:

Identify all activities carried on in the recoupment year (ie the year in which the losses are offset by taxable income).

Step 3:

Compare 1 and 2 to establish if the identity of the overall business is maintained:

- (1) (a) If there are new activities in 2, is there assessable income or deductible expenditure?  
(b) Are these activities of a kind in 1? If no there is a failure of either the new business or new transaction tests.
- (2) Are the activities in 1 retained?  
(a) If yes identify the type and extent of changes.  
(b) If no identify the type and number of discarded activities.

This appears to be a useful working model for the application of s 165-210 ITAA 97. A good strategy to preserve carry-forward losses under the same business test would be to quarantine the losses in an entity and undertake new activities in a separate entity that satisfied the requirements of the same ownership test. No doubt there would be a range of justifiable transactions between the two entities such as management fees, to accelerate the utilization of the first entity's losses.

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31 77 ATC 4311.

32 (1976) 51 TC 319.

33 Above n 22, 171-2.

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Whatever the difficulties in the application of the same business test, the maintenance of this test to preserve carry-forward tax losses is justified where the ownership of the business entity has changed hands.

As discussed above, the same ownership test has been rendered more restrictive by the continuity of ownership requirements and the introduction of the same share test.

The use of losses by new shareholders, with no previous connection to a business and who may be prepared to pay a premium to obtain access to the losses, is difficult to justify for policy reasons aimed at preventing revenue leakage and distortions of economic activity. The latter is probably as important as the revenue leakage issue, if the impact of attitudes toward compliance by taxpayers and the potential for the proliferation of tax avoidance schemes is taken into account.

A stated objective of the *Ralph Report* proposals was the enhancement of economic performance through a well functioning taxation system which operated fairly, efficiently and transparently.<sup>34</sup> The same business test recognizes the separate entity doctrine and retains the potential to maintain economic activity that might otherwise fail. The view expressed by the *Ralph Report* referred to above is preferred to the antipathetic attitude expressed by Longhouse.

### **Duplication of losses**

As previously noted, one of the concerns of the *Ralph Report* was the duplication of losses between entities. This article will focus on two measures introduced into the taxation legislation following political consideration of the Report. ITAA 97 subdivision 165-CC concerns corporations which have unrealized revenue and or capital losses and which are undergoing a change of control. ITAA 97 subdivision 165-CD requires adjustments to be made to the tax values of significant equity and debt interests held in a loss company by an entity (but not individuals) where there is a change of ownership or control.

### **New Subdivision 165-CC ITAA 1997**

This subdivision applies to a change in ownership after 11 September 1999. The purpose of the provision is set out in s 165-115 ITAA 97:

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34 Above n 2, 2.

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If a change occurs in the ownership or control of a company that has an unrealized net loss the company cannot to the extent of the unrealized net loss have capital losses taken into account, or deduct revenue losses in respect of a CGT event that happened to CGT assets it owned at the time of the change, unless it satisfies the same business test.

The subdivision does not apply to companies with net asset value of less than \$5 million, and assets acquired for less than \$10000 may be excluded.<sup>35</sup> This provision gives relief to small businesses and is consistent with the CGT small business concessions threshold set out in s 152-10 ITAA 97.

The subdivision, which contains detailed provisions, is triggered by the failure of the company to satisfy one of the tests giving rise to a change in ownership set out in s 165-115C. A changeover time occurs when a person with more than 50% of the company's voting power, dividend entitlement or capital distribution rights has less than 50% after the test time. The calculation of 50% of these rights relies on s 165-150, s 165-155, s 165-160 – the continuity of ownership tests. Also, the subdivision now applies to trading stock.<sup>36</sup> The exclusion of trading stock losses when subdivision 165-CC was first introduced seems unreasonable as, in many businesses, stock values are reviewed and adjusted as part of normal business practice. Section 165-115E provides two different methods of calculating individual asset values on disposal. The subdivision is criticized for its complexity and the long tail that may apply to its application. Also, provisions appear not to accommodate gains rather than losses which are subsequently realized.<sup>37</sup>

The following example sets out some of the outcomes of the provision.<sup>38</sup> Person A purchases Company X, which is in trading difficulty, from Person B for a going concern value. Person A's plan is to change the business in such a way that it will fail the same business test. The result is the fire sale of obsolete stock. Company X will be denied a deduction because, under subdivision 165-CC, it will be treated as an unrealized loss at the changeover time. In fact, the stock may have been correctly valued at that time having regard to the business then undertaken. As Tony Baxter has pointed out, Person A may have been better off not to proceed with the transaction given its risky nature and let Company X go into liquidation.<sup>39</sup> This type

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35 Section 165-115 ITAA 97.

36 Section 165-115BA ITAA 97.

37 Above n 15, 190.

38 The example follows Tony Baxter, *ibid.*

39 *Ibid.*

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of situation also goes to the heart of the rationale for the retaining the same business test outlined above.

It may be that the Commissioner would accept the argument that there was no unrealized loss at the changeover time and accept the deduction for the written down stock. It seems unlikely that a rational business person would knowingly buy stock that he or she knew was over-valued and therefore contained an unrealized loss. In any event, if the stock was overvalued there would be a revenue gain to the tax authority because of the unrealized revenue gains.

#### **New Subdivision 165 CD ITAA 1997**

A major focus of the *Ralph Report* was to prevent the recognition of multiple losses which could arise by passing a single investment through a chain of companies. This is particularly relevant in a group situation. The legislation based on the Report's recommendations has been described by one commentator as 'some of the most horrifying legislation yet enacted in the company area requiring valuation of all company assets on a change in control and elaborate cost base adjustments'.<sup>40</sup>

Subdivision 165-CD of ITAA 97 was introduced in 2002. The purpose of the legislation is stated in s 165-115GA ITAA97:

This subdivision prevents multiple recognition of a company's losses when significant equity and debt interests that entities (not individuals) have in the company are realized.

The targeted behaviour is what the *Ralph Report* refers to as cascading.<sup>41</sup> The principal target of the *Ralph Report* is where losses are duplicated through a chain of companies within the same group to generate multiple losses. The subdivision will have less application in the future because of the new Consolidation Rules – Part 3-90 of ITAA 97 which allows groups of wholly owned entities to be treated as single entities for tax purposes. The existing grouping provisions of ITAA 97 were withdrawn as from 1 July 2003. The status of corporate losses under the new Consolidation Rules is discussed separately. Subdivision 165-CD also applies to losses which may be duplicated by disposal within a majority owned group, which will not come within the Consolidation Rules.

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40 Above n 9, 123.

41 Above n 2, 260.

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Prior to subdivision 165-CD, if a chain of companies went into liquidation, the capital losses on the inter-company shareholdings would 'cascade' through the chain. Subdivision 165-CD stops this cascading effect by reducing the cost base of the holding company's shares in the subsidiary company. The process by which the application of the subdivision is determined is set out in s 165-115H. *Step 1:* Determine whether there is an alteration time which occurs when there is an alteration event (ss 1165-115L, 165-115M, 165-115N, 165-115P, 165-115Q unless to be disregarded – ss 165-115K(2) and (4) ). The alteration events are basically the same as those of subdivision 165-CC and are defined in the same terms as the continuity of ownership rules in s 165-12. *Step 2:* Is the subject company a loss company with realized or unrealized losses? (ss 116-115R and 116-115W) *Step 3:* Determine whether there is an entity (not an individual) that had a relevant equity (s 165-115X) or debt interest (s 165-115Y) in the loss company immediately before the loss time. These latter sections are to be read in conjunction with s 165-115Z which defines a controlling interest in the same terms as subdivision 165-CC.

The principal operative provision of subdivision 165-CD is s 165-115ZA, which applies to an entity that has a relevant equity or debt interest in a loss company immediately before an alteration time for the loss company. Reductions in cost bases must be applied to a range of assets as determined by s 165-115ZA(3) - (5).

The definition of a 'loss company' is critical to the application of the subdivision. This is set out in s 165-115R (3).

The company is a loss company at the alteration time if: (a) at the beginning of the income year it had an undeducted tax loss or undeducted tax losses for an earlier income year or income years; or (b) at the beginning of the income year it had unapplied net capital loss or unapplied net capital losses for an earlier income year or income years; or (c) it has a tax loss for the income year, calculated as if the income year were a period for the purposes of subdivision 165-B [Working out the taxable income and tax loss for the income year of the change]; or (d) it has a net capital loss for the income year, calculated as if the income year were a period for the purposes of subdivision 165-CB [Working out the net capital gain and the net capital loss for the income year of the change]; or (e) it has an adjusted unrealized loss at the alteration time.

The emphasis here is on unrealized losses because realized losses are already reflected in the company's tax and management accounts.

A controlling interest in a loss company which is greater than 50% can be acquired by associates who between them constitute a controlling stake. Thus joint venture

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stakeholders could be vulnerable to the application of subdivision 165 CD. Also, a loss company under s 165-115R can be profitable companies if it has, for example, carry forward tax losses. Conversely, every situation in which an operating loss occurs which is followed by an alteration event will give rise to an adjustment. The provisions are very broad in their application.<sup>42</sup>

Essentially, subdivision 165-CD is an anti-tax avoidance provision. The compliance requirements are significant if the operation of the subdivision is triggered by an alteration event. These are ameliorated in a similar manner to subdivision 165-CC. Unrealized assets acquired for less than \$10,000 do not have to be calculated. An entity together with certain related entities do not have to count unrealized losses at an alteration time, if the entities have a net asset value of less than \$5 million under the test in s 152-15 for small business CGT relief.<sup>43</sup>

A criticism of subdivision 165-CD is that it does not necessarily reflect corporate reality. Its underlying assumption is that unrealized capital losses may be valuable, but this will not always be so. A company which has a controlling interest in another entity which it sells may incur a real loss, but under the provisions of the subdivision a tax deduction or capital loss could be denied to it under the subdivision.<sup>44</sup>

#### **Tax losses and the new consolidation rules**

The new Consolidation Rules were a key element of the *Ralph Report*. It saw its proposals '...as a major benefit to large Australian business groups':

It will allow transactions between wholly owned companies to take place without any tax consequences. This will result in large savings in tax compliance costs and will allow decisions about such transactions to be made entirely on commercial grounds. In particular it will allow company groups to restructure without incurring significant taxation consequences.<sup>45</sup>

The *Report* recognised that there would be significant transitional costs.<sup>46</sup> The new Consolidation Rules were effective from 1 July 2002 and are contained in Part 3-90 of ITAA 97.

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42 Above n 15, 194.

43 Section 165-115GC(4) ITAA 97.

44 Above n 15, 196.

45 Above n 2, 32.

46 Ibid 17.

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Entry into the new consolidation taxation scheme is not compulsory. However, the existing grouping provisions (Division 170 ITAA 97) for wholly owned groups ceased on 30 June 2003. From this date, groups no longer had access to loss transfers between companies that are part of the same wholly owned group.<sup>47</sup> The scheme is effectively compulsory for wholly owned groups with loss companies. However there are tangible benefits - losses are pooled and remain with the head company if a member leaves the group. Losses utilized by the head company can be either losses generated by the group or existing losses of an entity before it joins a group. Group losses must be utilized before transferred losses. The availability of either group or transferred losses continues to be determined by the continuity of ownership and same business tests.<sup>48</sup> These rules are modified for determining whether the company has maintained the same ownership in the case of transferred losses. Given the recentness of the legislation, this article will concentrate on the transfer of losses to the corporate group.

The continuity of ownership test requires the joining entity to maintain a majority of the same ownership for the period between incurring the loss until just after the joining time. The same business test requires the joining entity to carry on the same business for at least 12 months prior to the joining time.<sup>49</sup>

A key element of the testing process is the concept of the 'trial year'. This is defined in ITAA 97 s 707-120(2) as starting at the latest of (i) 12 months before the joining time, (ii) the time the joining entity came into existence, or (iii) the time of the gap between a joining entity ceasing to be a member of a consolidated entity and just before the joining time and ending just after the joining time.

### **Continuity of ownership test**

The continuity of ownership test applies the requirements of s 165-12 ITAA 97 to the joining entity, to ensure that these are satisfied during the trial year. The general continuity requirements apply so that continuity of ownership must be maintained from the commencement of the loss year as well as the commencement of the trial period.

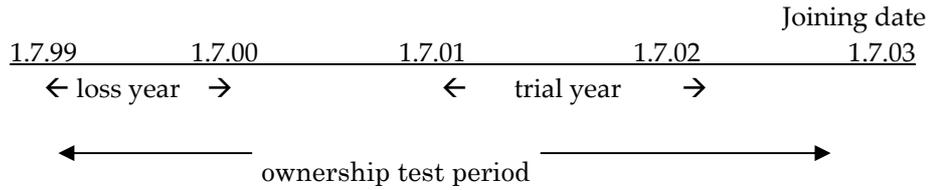
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47 Above n 8, B1-17.

48 Ibid B2-3 2.

49 Section 707-125(2) ITAA 97.

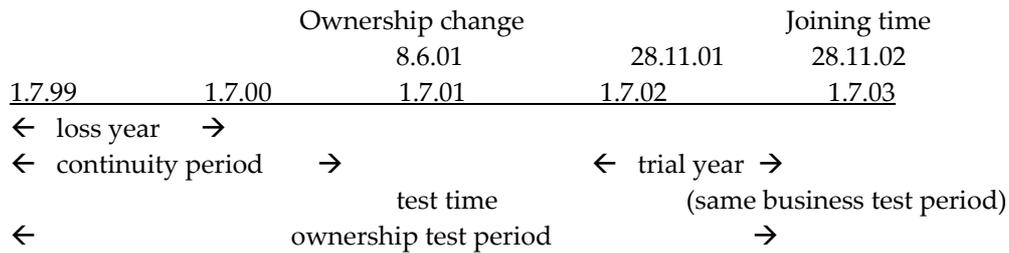
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The control test is failed if a person starts to control the entity’s voting power during the trial period for the purposes of gaining a benefit from the application of the tax legislation.

**Same business test**

This is addressed in s 707-125 which operates if the joining entity made the loss for an income year starting after 30 June 1999 and ss 165-13(3), 165-15(2), 165-15(3), 166-5(4) or 166-5(5) applies. If s 707-125 applies, the joining entities business must be tested at the following points: (i) just before the end of the income year in which the loss was made; (ii) the income year in which the joining entity first fails the ownership test; and (iii) the trial year. If the loss was made by the joining entity for an income year starting before 1 July 1999, the test is applied just before the first failure of the ownership test and at the trial year.



In this context the same business test effectively acts as a gateway test. Its aims to ensure that the testing periods are of sufficient length for the same business test to be applied. This addresses the situation where a new subsidiary is acquired and the change of ownership and consolidation occur at the same time.<sup>50</sup>

<sup>50</sup> J Gonsalves, ‘The Impact of Losses’ (2001) 35 (8) *Taxation in Australia* 453, 454.

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The loss of a joining entity becomes the loss of the head company, and the head company is treated as having made the loss in the income year of the transfer.<sup>51</sup> Before utilizing a loss, the head company must apply the general loss recoupment provisions. The head company must pass the continuity of ownership and same business tests. Subdivision 707-205 provides for a modified test period for the same ownership of a transferring loss entity. Section 707-205(2) provides that the ownership test period as defined by ss 165-12(1) and 166-5(1) starts at the time of the transfer. This means the losses are untainted by events which occurred in the head company prior to the transfer. Section 707-210 is complex and assumes that the utilisation of losses transferred from a company depends on the company that made the losses earlier.

A key element of the treatment of losses under the Consolidation Rules is that, in determining the losses utilized in an income year, group losses must be utilized before transferred losses. The mechanism for calculating the amount of transferred losses in an income year is set out in subdivision 707-C. The first step is to calculate a bundle of losses which comes into existence at the initial transfer time (s 707-315(1)) and which comprises every loss that is transferred at that time from the real loss maker (s 707-315(2)). The next step is to calculate an available fraction of the losses for the utilization of each bundle of losses using the following formula:

**Modified market value of the loss entity**

Adjusted market value of the consolidated group

Section 707-325(1) sets out the modified market value calculation . Its purpose is to prevent a loss making entity from inflating its losses before joining a consolidated group to obtain a higher available fraction. The adjusted market value of the consolidated group at the joining time is the market value, ignoring losses and assuming its franking account balance is nil. The available fraction must be adjusted on the occurrence of certain events. For example, if a new loss member joins the group, there is an injection of capital, arms length transaction increasing market value, transfer of a bundle where the head company of an existing group is acquired by another group.

Additional to this standard approach is a concessional method of calculating the utilization of transferable losses during the transition period of 1 July 2002 to 30 June 2004. The concessional method utilizes losses over three years. The decision to adopt

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51 Above n 8, C3-1 5.

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the concessional method or the available fraction method would need to be calculated on a case-by-case basis. However, if the choice is made to adopt the concessional method, it is irrevocable and must be made for all eligible losses in a particular bundle.<sup>52</sup> The available fraction may be increased when a head company chooses to consolidate during the transitional period and the loss entity joins at the time the consolidated group comes into existence.<sup>53</sup>

The above is a brief overview of the significant issues arising in respect of the use of carry-forward tax losses for companies entering the new consolidation regime. The relevant section of the Consolidation Reference Manual runs to 119 pages, the vast majority of which is taken up with worked examples which may arise from the application of Part 3-90, particularly in relation to loss entities joining a consolidated group and the application of the available fraction method. No doubt the single enterprise approach that the new Consolidation Rules embodies will result in lower compliance costs for large groups in particular. The transitional phase will be complex and expensive. For small groups with tax loss subsidiaries, joining the scheme may be disadvantageous if the modified loss carry-forward tests preclude or defer the use of losses because of the available fraction methodology.

The *Ralph Report* was concerned that the amount of the same business test losses in the tax system would result in revenue loss, if they were immediately available under the consolidation regime.<sup>54</sup> The *Report* proposed a cap and phased utilization of such losses. The tax legislation addresses the problem by applying a modified same business threshold test to preserve the losses on entry to a consolidated group, as well as the deferral of the utilization of transferred losses by subordination to existing head company losses and the application of the available fraction method. The introduction of the new Consolidation Rules apparently makes it possible for large and complex groups to fail the same business test, if they subsequently join an existing consolidated group.

### Conclusion

This article considers the recent legislative developments on corporations' ability to utilize carry-forward tax losses. The *Ralph Report* with its ambition to achieve a unified entity taxation accounting system has been a driving force in the legislative

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52 There is a worked example of the application of both methods in the *Consolidation Reference Manual*, above n 8, C3-1 9.

53 *Ibid.*

54 Above n 2, 525.

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changes. There is now a significant divergence from the single legal entity doctrine of the corporations law to the way companies are treated for taxation purposes. Nowhere is this more the case than in the treatment of carry-forward tax losses.

The principal legislative planks in this process are the continuity of ownership and same business tests in Division 165 of ITAA 97. Their explicit objective is to preserve the tax revenue base by limiting the utilization of what would otherwise be available tax losses through the application of a qualifying regime which displaces the separate legal entity doctrine. This could be seen as an acknowledgement of the ineffective tax avoidance provisions of the legislation. This was no doubt exacerbated by the strict construction interpretative approach adopted by the Barwick High Court in the 1970s and 1980s which encouraged the development of a significant tax avoidance industry. The provisions subsequently introduced rely on the elements of Division 165 in establishing the qualifying tests for the preservation of carry-forward tax losses.

The other important factor which has added to the complexity of the rules relating to tax losses has been the introduction of the capital gains tax regime. This has greatly added to a number of possible tax loss incidents which need to be addressed by the legislation. A large part of this legislation is by way of anti-avoidance measures.

A general theme of the *Ralph Report* is a striving for intellectual integrity within the conceptual framework of the entity regime approach. Given the strong input of the bureaucracy into the reporting process, there is a concern that this approach has resulted in unnecessary complexity at the expense of the practical requirements of business taxpayers and their advisors. The approach of the ATO officer outlined above in respect of the same business test is not particularly encouraging. Nor does the treatment of loss multiplication contained in subdivisions 165-CC and 165-CD ITAA 97 provide reciprocity as far as the treatment of the multiplication of gains is concerned.

In dealing with carry-forward losses, business taxpayers are faced with a very complex legislation which has been exacerbated by the new Consolidation Rules. This makes it difficult in many cases to fully foresee the consequences of business decisions in this area.