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Abstract

This article examines the operation of the Same Business Test for carrying forward past tax losses and the uncertainty surrounding its interpretation.

Keywords

Company tax, carrying forward past tax losses, Continuity of Ownership test, Same Business test

DEVELOPMENTS IN THE SAME BUSINESS TEST: A MORE LIBERAL APPROACH POST-LILYVALE HOTEL?

ALEKSANDAR KUTLACA*

This article examines the operation of the Same Business Test for carrying forward past tax losses and the uncertainty surrounding its interpretation.

Companies do not have an unfettered right to carry forward past tax losses.¹ Instead, before a past tax loss may be offset against current income, companies must satisfy either the Continuity of Ownership Test ('COT')² or the Same Business Test ('SBT').³

Structure of the provisions

The Same Business Test provisions were rewritten in 1997, as part Tax Law Improvement Project (TLIP).⁴ Section 165-10⁵ states that a company cannot deduct a tax loss unless it satisfies the COT or the SBT.⁶

The SBT is imposed by s 165-13:

The company must satisfy the same business test for the income year (the same business test period). Apply the test to the business the company carried on immediately before the time (the test time) shown in the relevant item of the table.⁷

The table states that the test time is the '*latest time that it is practicable to show is in [a] period*' beginning at the start of the loss year and ending when the

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¹ *Income Tax Assessment Act 1997* div 36, s 165-10.

² *Ibid* s 165-12.

³ *Ibid* s 165-13.

⁴ See Chris Bevan, 'Love's labour's lost' (1997) 32 *Taxation in Australia* 91, 91.

⁵ *Income Tax Assessment Act 1997* (Cth).

⁶ Company is defined in s 995-1(1) of the *Income Tax Assessment Act 1997* to mean a body corporate or other unincorporated association or body corporate, excluding partnerships of non-entity joint ventures.

⁷ *Ibid* s 165-13(2).

company fails the COT.⁸ Consequently, the relevant test time is immediately prior to the failure of the COT. The SBT must be satisfied for the income year in which the company seeks to utilise the tax loss.⁹

The SBT itself is located in s 165-210.¹⁰ The focus of this article is the first subsection,¹¹ ('SBT(1)'), which imposes the broad requirement that the company carry on the same business:

(1) A company satisfies the same business test if throughout the same business test period it carries on the same business as it carried on immediately before the test time.

JUDICIAL INTERPRETATION

Same business test

Most judicial comment has surrounded the meaning of 'same business' (which is not defined in the Act), and the question of how similar the post-test business need be. As a necessary corollary, courts have discussed the question of characterising the pre-test time business.

⁸ Ibid s 165-15(2), item 1, column 3. The ATO calls the test time 'the change-over' and the income year the 'the period of recoupment' (*Taxation Ruling* TR 1999/9 [18], [20], [22]).

⁹ *Avondale Motors (Parts) Pty Ltd v FC T* (1971) 124 CLR 97. The Table in s 165-13 of the *Income Tax Assessment Act 1997* states that if a company comes into being during the loss year, the test time is as late as possible to show within a period spanning the start of the business until failure of the COT. This reinforces the conclusion that the SBT also applies to current-year losses. (Chris Bevan, 'Love's labour's lost' (1997) 32 *Taxation in Australia* 91, 96).

¹⁰ *Income Tax Assessment Act 1997*. The SBT is also employed in s 165-35, relating to calculating taxable income, and s 165-26 and s 165-132, relating to the deductibility of bad debts. The ATO considers the interpretation of the SBT relating to tax losses to also apply to the above three sections (*Taxation Ruling* TR 1999/9 [9]).

¹¹ Subsection (2)(a), the 'new business test' (NBT), prohibits a company from deriving income from a business of a kind it did not previously carry on. Subsection (2)(b), the 'new transactions test' (NTT), prohibits a company from deriving income from transactions it had not entered into before the test time. These sections are not examined here. Subsections (3) and (4) are anti-avoidance measures that, in essence, state that a company does not satisfy the SBT if the NBT or NTT are only met with the purpose of satisfying the SBT, or, if the company incurs expenditure in carrying on a new business or entering into new transactions within the same business test period. In the absence of any reported decisions (Winnie Ma, 'The Continuity of Business Tests for carrying forward losses' (1999) 8 *Revenue LJ* 141, 157), no comment will be provided on these sections.

Same business

The 'leading'¹² case in this area is the judgment of Gibbs J, sitting as a single judge of the High Court, in *Avondale Motors (Parts) v FCT*.¹³ Gibbs J strictly interpreted¹⁴ 'same business' to mean 'identical business',¹⁵ rather than a 'similar'¹⁶ business.

In his view, the section was 'imposed to prevent persons from profiting'¹⁷ by purchasing loss-making companies and offsetting other income. Further, as a 'general rule', where the ownership of a loss-making company changes, even if a 'similar' business is carried on post-acquisition, there 'would have been no business reason for the purchase of the [company], but only the wish to obtain the right to claim another's losses as a deduction from one's own income',¹⁸ and consequently, a strict interpretation follows.

In this case, the company originally sold motor parts. After the ownership change,¹⁹ the company also sold motor parts, but at another location, under a different name and management and using different stock. Consequently, the taxpayer failed the SBT.

Gibbs J, however, conceded that a company may 'expand or contract its activities' or 'close an old shop and open a new one' without breaching the test.²⁰

The English Tax Court commented on this matter in *Rolls-Royce Motors Ltd v Bamford*²¹ stating 'there is all the difference in the world between organic growth ... and a sudden and dramatic change'. This case concerned a company with six divisions, four of which were sold together. The Court held the sold divisions, trading as a separate company, were not the same business.

¹² Ibid [30].

¹³ (1971) 124 CLR 97.

¹⁴ Interpreting SBT(1) before the 1997 TLIP rewrite.

¹⁵ *Avondale Motors (Parts) v FC T* (1971) 124 CLR 97, 105.

¹⁶ Ibid.

¹⁷ Ibid.

¹⁸ Ibid.

¹⁹ And a subsequent period of dormancy.

²⁰ Ibid 104.

²¹ (1976) 51 TC 319.

(2010) 20 REVENUE LJ

Australian courts endorsed this approach in *Felder Downs (WA) v FCT*²² where the Court said 'if a business evolves it does not necessarily follow that the essential character of the business is not changed'.²³ In this case, the company, before the ownership change, carried on the business of growing cereals and clover, whereas after the change, it reared cattle who fed on the cereals and clover.²⁴ While the business had 'evolved', its essential character had changed.

The *Rolls-Royce* approach, that the cessation or sale of a significant portion of the business will cause the business to fail SBT(1), was confirmed in Australia in *Case Y45*.²⁵ A company that sold agricultural machinery and conducted an agricultural consulting business pre-ownership change ceased selling machinery after the changeover and was deemed to breach SBT(1).

Whether the same business is actually being carried on after the test time is a question of fact and degree.²⁶ The relevant factors appear to include:²⁷

- products sold/manufactured
- manufacturing process²⁸
- market for goods/services²⁹
- method of selling³⁰
- methods and sources of finance, working capital
- goodwill, trading name, trademarks, patents
- location

²² (1979) 45 FLR 242.

²³ Ibid 247.

²⁴ Ibid.

²⁵ *AAT Case 7,272* (1991) 22 ATR 3395.

²⁶ *Avondale Motors (Parts) Pty Ltd v FCT* (1971) 124 CLR 97, 104, *Hammond Investments Pty Ltd v FCT* 77 ATC 4311, 4315.

²⁷ Winnie Ma, 'The Continuity of Business Tests for carrying forward losses' (1999) 8 *Revenue LJ* 141, 149; *Taxation Ruling* TR 1999/9 [61].

²⁸ Eg, outsourcing or self-producing.

²⁹ Eg, number, type, location etc of customers, retail/wholesale. For example, in *Seaman v Tuckets* (1963) 41 TC 422 when a company that formerly manufactured confectionary, and had bought sugar and cellophane on its own account, ceased production and bought those items for resale to its new parent company, it breached the English equivalent of SBT(1).

³⁰ Eg, retail/wholesale, outright/consignment, sale/lease.

- number of employees
- management and directors
- keeping of accounts.

TR 1999/9 provides an overview of other relevant cases, but concludes by relying on the strict approach of Gibbs J in *Avondale Motors*, requiring an 'identical business' to be carried on after the test time. Essentially, the ATO's interpretation allows minimal changes in the above mentioned factors, namely, those arising from 'mere expansion[s] or contraction[s] of the [relevant] business'.³¹

Recent decisions

The above cases, those relied upon by the ATO, are largely from the 1970s. This is understandable; since this period there were only three decisions concerning SBT(1) from senior Australian courts. The first decision, *Deputy Commissioner of Taxation v Australasian Feed*³² in 1999, merely confirmed that SBT(1) is a question of fact.

The second, in 2008, *Coal Developments (German Creek) v Commissioner of Taxation*,³³ concerned a company that sold their interest in a joint venture, but continued collecting unsold debts. While prepared to concede 'a business can pass through a life cycle, perhaps, [with] an establishment phase, a period of operation or income production, and ending with cessation',³⁴ the Court held that the legislation does not permit the test to be applied with 'elasticity', and ultimately followed the strict *Avondale* approach holding that SBT(1) was not satisfied.

The most recent pronouncement came in 2009, from the Federal Court of Appeal in *Lilyvale Hotel v FCT*.³⁵ Here, the taxpayer owned a hotel. They employed a management company to operate the hotel. The management company's responsibilities included employing staff, establishing prices, renting rooms and other space in the hotel (functions, stores), purchasing

³¹ *Taxation Ruling* TR 1999/9 [39].

³² [2000] FCA 1351, [46].

³³ [2008] FCAFC 27.

³⁴ *Ibid* 12.

³⁵ [2009] FCAFC 21.

(2010) 20 REVENUE LJ

inventories and supplies, advertising and keeping the books of account.³⁶ The management contract was terminated; after which the owners operated the hotel in the same style, under the same name, with the same staff and marketed in the same manner.³⁷

The ATO contended that the owner was not carrying on the same business after the hotel sale and termination of the management contract, and thus failed SBT(1).

The Court disagreed, and held the business carried on after the test time was, in fact, the same business for three reasons. First, the Court adopted a broad categorisation of the business before the test time, as discussed later. Second, the Court held that the actions of an agent could be attributed to the agent's master in satisfying SBT(1).³⁸ The Court held that 'we are unable to comprehend why [the activities of the agent] should be excluded from consideration of the [taxpayer's] business before the [test time]. On the contrary, they must be taken into account.'³⁹ Further noting that 'a person does not cease to carry out an activity because he or she [does so] through an agent'.⁴⁰ On this interpretation, the operation of the hotel by the management company before the test time was imputed to the owner, so that after the test time there was no change in the business. The Court held it was incorrect to have regard to 'the management of the business' when considering SBT(1).⁴¹ In the view of the ATO, this is as far as the decision extends.⁴²

The third reason, which has attracted attention,⁴³ is the apparent weakening of *Avondale*, in that the Court did not require the business before the test time

³⁶ Ibid [18].

³⁷ Ibid [28].

³⁸ Ibid [43].

³⁹ Ibid.

⁴⁰ Ibid [56].

⁴¹ *Lilyvale Hotel Pty Ltd v Commissioner of Taxation* [2009] FCAFC 21 [46].

⁴² Grahame Hager, *Decision Impact Statement - Lilyvale Hotel Pty Ltd v C of T* (2009) ATO <<http://law.ato.gov.au/atolaw/view.htm?Docid=LIT/ICD/NSD1193/2008/00001&PiT=99991231235958>>. Consequently, the decision has not been appealed.

⁴³ Kevin Shields and Zoran Vukojevic, 'Lilyvale v FCT - same business test for prior year losses broadened' (2009) 61 *Keeping Good Companies* 238; Charles Armitage, Chris Peadon and Adam Ahmed, 'Lilyvale - same business test - decision reversed' (2009) Allens Arthur Robison <http://www.aar.com.au/pubs/tax/cutax_mar09.htm#Lilyv>.

to be *identical* to the business carried upon after. The Court began by looking at the purpose of the section. In contradistinction to Gibbs J in *Avondale*, who characterised the social mischief the first iteration of SBT(1) aimed to cure as the trading of tax losses, the Court in *Lilyvale* examined the Treasurer's Second Reading Speech to *Income Tax Assessment Bill 1965* which introduced the original SBT(1). It found that SBT(1) was introduced subsequent to the introduction of the COT, as a measure to alleviate the 'harsh consequences'⁴⁴ that may flow from the application of that test. The Court noted in the Treasurer's speech that SBT(1) was not intended to filter transactions where there was not a transfer of 'profitable business from one company to another so that income which would otherwise be taxed is derived free of tax'.⁴⁵

This strongly indicates, firstly, that in the absence of an intention to traffic a tax loss, at least in the original provisions, SBT(1) may not be intended to apply. Secondly, and more importantly, it demonstrated that the basis of Gibbs J's judgment in *Avondale* was based on an incorrect foundation, and calls into question the validity of the conclusions reached.

While taking care to factually distinguish *Avondale*,⁴⁶ the Court indicated that a more liberal interpretation of SBT(1) was favoured. Even with the imputation of the management company's actions onto the taxpayer, the taxpayer did not carry on the *identical* business before and after the test time.⁴⁷ The pre-test activities of the taxpayer were (a) owning property, (b) employing an agent to manage the entire business, (c) managing a hotel

⁴⁴ *Lilyvale Hotel Pty Ltd v Commissioner of Taxation* [2009] FCAFC 21 [6].

⁴⁵ *Ibid* (emphasis added).

⁴⁶ *Ibid* [50]-[52].

⁴⁷ The agent's actions were deemed to be the actions of the parent but, nonetheless, the nature of the business changed from an owner, who contracted out management, to a company undertaking all relevant decisions itself. This applies *even though* the managerial decisions of the agent can be imputed to the owner; who the decisions were made by, and the level of control exercised by the parent, both altered after the test time. While the operation of the hotel did not, on the facts, appear to change significantly, the *manner* in which the hotel was operated, and consequently, the business conducted by the taxpayer, changed considerably. Further, while pre-test, accounts were kept by the agent, post-test, the books were kept by the parent. These factors are enough to breach the strict SBT(1). That the hotel would not appear to have changed to customers does not disguise the fact that the 'back room' machinations to effect that appearance had themselves changed. The manner in which the hotel was operated altered, even with the attribution of the agent's acts to the principal.

(attributed by the Court to the taxpayer). After the test time, the second activity ceased. This change would have breached SBT(1) under the strict interpretation espoused in *Avondale*.⁴⁸

It must be noted, though, that *Lilyvale* is not a decision of the High Court, whereas *Avondale* is. It is submitted, however, in light of *Lilyvale*, that more deviation is allowed in the above list of factors than formerly permitted. The ATO's view may be less tenable, and indeed, the validity of TR 1999/9 view is now regarded as 'uncertain'.⁴⁹

Pre-test business characterisation

Clearly, to determine if the business after the test time is the 'same', it must be compared against the business before the test time. The question of how to characterise that business has received judicial attention.

It appears settled that it is relevant to look at the entire business, rather than its individual activities; the business is more than the composite of its individual element.⁵⁰ *Lilyvale*, as mentioned previously, appears to have ushered in a broader and more generous characterisation. The Court held the taxpayer 'correctly described the business which it carried on as that of 'owning and operating ... [a] hotel to derive revenue from its guests and profits from its operation' (emphasis added), the manner in which the hotel was managed had 'no bearing upon the identification of the business'.⁵¹ This approach indicates a broad classification of the pre-test business, which includes the purpose of the business but ignores the manner in which this purpose is achieved. This expansion represents the more liberal view of SBT(1) espoused in *Lilyvale*.

When the pre-test business is to be characterised remains unclear. The legislation provides that it is to be 'immediately'⁵² before the change in ownership. This leads to obvious difficulties if applied strictly, most notably for seasonal businesses. In TR 1999/9, the ATO does not require the business

⁴⁸ See, eg, *Rolls-Royce Motors Ltd v Bamford* (1976) 51 TC 319.

⁴⁹ Kevin Shields and Zoran Vukojevic, '*Lilyvale v FCT* - same business test for prior year losses broadened' (2009) 61 *Keeping Good Companies* 238, 238.

⁵⁰ *J G Ingram & Sons Ltd v Callaghan* (1968) 45 TC 151, *Rolls-Royce Motors Ltd v Bamford* (1976) 51 TC 319.

⁵¹ *Lilyvale Hotel Pty Ltd v Commissioner of Taxation* [2009] FCAFC 21 [46].

⁵² *Income Tax Assessment Act 1997* s 165-210(1).

activities to be continuing at the precise time immediately prior to the change in ownership, but rather, that they have not been permanently discontinued.⁵³ While there appears to be no judicial support for or against the ATO's position, it appears logical. How far back a taxpayer is permitted to look to characterise their business, however, remains uncertain.

COMMENTS

SBT(1) suffers from two main 'problems':⁵⁴ its potential harsh consequences⁵⁵ and uncertainty.⁵⁶

Severity

Under the *Avondale* approach, a strict test of what constituted the same business was enforced. This meant that any changes other than small organic growth or decline led to the business failing SBT(1), with the consequence that the company would not be able to offset future income against past losses.

The strict interpretation can be justified if the purpose of the statute is to prevent the trafficking of tax losses, as was supposed in *Avondale*.⁵⁷ This approach does not stand scrutiny on two fronts. Firstly, consider the following two examples.

1. A franchised business has taxable income. Another identical franchise makes tax losses. The first business buys the second, with the express purpose of offsetting taxable income. As they are franchises,⁵⁸ the business before and after the acquisition would meet the strict SBT(1). Even though losses have been trafficked, the strict SBT(1) is satisfied.

⁵³ *Taxation Ruling* TR 1999/9 [35]-[37].

⁵⁴ Chris Bevan, 'Love's labour's lost' (1997) 32 *Taxation in Australia* 91, 91.

⁵⁵ Winnie Ma, 'The Continuity of Business Tests for carrying forward losses' (1999) 8 *Revenue LJ* 141, 160.

⁵⁶ Andrew Strange, 'Topical Issues in Corporate Tax Losses' (2003) 13 *Revenue LJ* 99.

⁵⁷ This conclusion is unsurprising, given the taxpayer's concession in *Avondale* that the sole purpose was to take advantage of tax losses (see Winnie Ma, above n 55, 163). This strict approach, even in light of the generous purpose, was also held to apply in *Case Y45 22 ATR* 3395.

⁵⁸ And presumed to be identical.

(2010) 20 REVENUE LJ

2. Shareholders buy a loss-making business, hoping to convert it into a profitable undertaking. The purpose of the acquisition was to turn assets for profit, not to offset taxable income. The new owners change some elements of the company to make it profitable. Even though losses have not been trafficked, the strict SBT(1) is not satisfied.

If the purpose of SBT(1) is to prevent the trafficking of tax losses, it is hopelessly inept at achieving it. The above examples demonstrate the potential harsh consequences of the strict SBT(1): it can be satisfied where the goal is to trade in tax losses, and can be failed where purely economic reasons effected a change in ownership.⁵⁹

If, as was advanced in *Lilyvale*, the purpose of SBT(1) was to alleviate the 'harsh consequences'⁶⁰ of the COT, it follows that SBT(1) should be applied in a liberal and generous manner.⁶¹ Regard should also be had to the Explanatory Memorandum to the 1964 Bill,⁶² which, consistent with the Treasurer's comments referenced in *Lilyvale*, advocates a purposive approach.

Under this approach, SBT(1) is not intended to operate stringently to deny companies the ability to utilise past tax losses; this is the role of the COT. Instead, the SBT is to assist companies who have failed the COT to, nonetheless, carry forward losses. With this in mind, both of the examples above would likely satisfy SBT(1), and the harshness of *Avondale* interpretation is avoided.

Uncertainty

The 1997 rewrite has 'not resolved all the problems arising'⁶³ under the old provisions, and judicial pronouncements on SBT(1) have been 'inadequate'.⁶⁴

⁵⁹ The irony is that under the strict SBT(1), if a loss-making business is sold, the new owner is faced with an unenviable choice: alter the business in an attempt to make it profitable, and consequently lose what may be one of the business's largest assets (the tax loss), or, keep the business unchanged to take advantage of the past loss, with a detrimental effect on profitability. A tax loss may not, of course, correspond with an accounting loss.

⁶⁰ *Lilyvale Hotel Pty Ltd v Commissioner of Taxation* [2009] FCAFC 21 [6].

⁶¹ Prior to *Lilyvale*, the AAT had expressed the view that, even if the purpose of SBT(1) was to assist taxpayers in carrying forward tax losses, the provisions were nonetheless to be interpreted strictly (*Case Y45 22 ATR 3395, 3400*).

⁶² Which introduced the SBT.

⁶³ Winnie Ma, above n 55, 142.

⁶⁴ *Ibid.*

The provisions themselves are complex, and conflicting case law fails to resolve the uncertainty. *Lilyvale* was endorsed, in an industrial relations context, by the Federal Court of Appeal in 2009.⁶⁵ Whether this approach is broadly adopted, however, remains to be seen. The ATO argued the case advanced nothing new, despite the case clearly holding (at a minimum) that the purpose of SBT(1) was different from that espoused in TR 2009/9.⁶⁶

CONCLUSION

The need for legislative reform, or clear judicial pronouncement from superior authority, is evident. The uncertainty relating to the SBT⁶⁷ leads to inefficiencies, inequities, and increased compliance costs. This analysis has only examined the first of five sections within the SBT; the other four pose just as many interpretation questions.⁶⁸

The *Henry Tax Review* noted there may be 'merit in reviewing the [SBT] to give greater weight to simplicity and certainty objectives'.⁶⁹ While *Lilyvale* goes some way to providing clarity and promoting fairness in the SBT, the magnitude of its impact remains to be seen.

⁶⁵ *National Union of Workers v Coles CDC Eastern Creek Pty Ltd* (2009) 178 FCR 12.

⁶⁶ Contrast *Lilyvale Hotel Pty Ltd v Commissioner of Taxation* [2009] FCAFC 21, [6] with *Taxation Ruling* TR 1999/9 [31].

⁶⁷ In determining how much change is allowed, how to characterise the business before the test time, what role agency plays, how the section interacts with the NTT and NBT, what the purpose of the section is, and what role that plays in interpretation.

⁶⁸ See, for example, Winnie Ma, above n 63.

⁶⁹ *Australia's future tax system - Report to the Treasurer*, Commonwealth (2009), 176.