

## Tax Brief

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### Accessing Corporate Losses

Treasury has released an Exposure Draft ('ED') of legislation to facilitate access to corporate losses for companies with multiple classes of shares on issue. This Tax Brief examines the strengths and weaknesses of the proposed regime and identifies some issues with the way it is designed to work.

#### 1. Background

Under current law, the ability of a company to utilise revenue losses, capital losses and bad debts is subject to meeting either the continuity of ownership test ('COT') or the same business test ('SBT'). It has long been appreciated that, on a technical reading of the provisions, various aspects of the operation of the COT could be a little problematic for companies with multiple classes of shares on issue – that is, shares with divergent rights to dividends, capital distributions or qualified voting rights. (Indeed, the explanatory material accompanying the ED is more forthright and appears to take it for granted that a company with differing share classes cannot satisfy the current COT.)

In the May 2008 Budget, the Assistant Treasurer announced that the Government would address two areas of uncertainty in the operation of the COT:

- the position of companies with multiple classes of shares on issue; and
- the meaning of 'voting power' where some shares have limited voting rights.

The Budget announcement also indicated that a change would be made to various rules operating at the intersection between the loss regime and the consolidation regime.

#### 2. Measuring continuity of ownership

The ED proposes two separate relieving measures that can be used to demonstrate continuity of ownership where the test in the current law has been failed. The measures can only be invoked where a company – or a corporate shareholder of a company – has shares on issue some of which do not have identical rights to dividends or capital distributions.

The first measure allows the continuity of ownership to be re-tested disregarding any shares on issue that are 'debt interests' for the purposes of the debt-equity tests in current law. This provision allows the effects of debt interests issued by the loss company and by another company holding shares in the loss company to be disregarded.

A blanket rule excluding all shares that are 'debt interests' from consideration is an interesting approach. There may well be shares on issue that satisfy the debt test but which also represent (all or most of) the economic ownership of a company. Yet it appears that selling such shares will now not trigger the loss denial rules. This result may be intended. It is consistent with the rules (discussed below) permitting 'secondary' classes of shares to be ignored and with the irrelevance of convertible notes to the COT under current law.

If continuity of ownership still cannot be demonstrated, the second measure allows the continuity of ownership to be re-tested disregarding certain shares ('**secondary shares**') that are currently on issue. The company must first identify its 'principal class of shares.' This is defined to mean the class of ordinary shares that represent the majority of voting power and value in the company. Continuity of ownership can then be re-tested concentrating on the ownership of the principal class of shares:

- if the company has only one class of secondary shares, those shares can be disregarded provided their value does not exceed 10% of the market value of all (non-debt interest) shares on issue; and
- if the company has more than one class of secondary shares, all those secondary shares can be disregarded provided the value of every secondary class is less than 10% of the market value of all (non-debt) shares on issue and the combined value of all secondary classes does not exceed 25% of the market value of all (non-debt) shares on issue.

A separate measure in the ED also offers some assistance where a company still fails the COT, even having excluded shares that are debt interests and secondary classes of shares. The ED proposes that the extent of the change of ownership will be measured using a simplified test. The simplified computation ignores the value of shares that are debt interests and any secondary shares that were disregarded and then measures the extent of the change of ownership by reference to the market value of shares or some other reasonable approach.

**Commencement.** This measure is back-dated to apply to tax losses and bad debts (and failure to meet other continuity of ownership tests) suffered in some prior income years. Consequently, companies which previously decided they were not entitled to deduct losses or bad debts under the law applying at the time will be able to re-consider their position applying the new tests, when the ED is eventually enacted. More precisely, the rules permit the company to re-examine losses suffered in income years commencing after 1 July 2002, and also losses of earlier years that were unrecouped as at 30 June 2002. As this is more than 4 years ago, the transitional provisions in the ED create a special exception to the tax statute of limitations to allow the Australian Taxation Office ('ATO') to issue an

amended assessment for the purpose of giving effect to this measure. Taxpayers will have 4 years after the commencement of the legislation to seek to have an appropriate amendment made.

### 3. Voting power

The ED also contains a modified definition of 'voting power' which can be invoked where a company has shares on issue some of which do not have identical voting rights.

Where this is the case, the ED provides that the 'voting power' is determined by examining the number of votes that could be cast on a poll:

- for the election of a director, if the election of directors is determined by casting votes that are based on the holding of shares. This will be the operative rule for listed companies; or
- for the adoption or amendment of the company's constitution, in all other cases. This alternative would come into play, for example, for single member proprietary companies, companies limited by guarantee, incorporated associations or mutual companies.

This may seem a simple solution, although there will be circumstances where the identity of the shareholders entitled to vote on a resolution will require some consideration. For example, the holders of preference shares will not ordinarily be eligible to vote on such resolutions, but they can acquire voting rights under corporate law in certain cases, often if dividends on the preference shares have not been paid. Nor is the meaning of the term 'votes attached to shares' always going to be self-evident – for example, in small companies the voting rights might exist only while a particular person holds a share – in such a case, is the result of the ballot determined by the rights attached to the share or by the identity of the voter? In the same vein, in some companies, the holders of each class of shares may simply be entitled to appoint a specified number or proportion of Directors, without recourse to a vote. Again, how such matters are to be dealt with is not obvious.

**Commencement.** Again the measure is back-dated. This measure applies to losses and bad debts occurring in years after 1 July 2007, and also losses and debts of earlier years unrecouped as at 30 June 2007.

### 4. Consolidation and SBT

The consolidation provisions contain highly elaborate provisions dealing with tax losses. They provide detailed prescriptions about testing the availability of existing tax losses at the time of consolidation, transferring the losses to the head entity of the group and the rate at which they can be utilised thereafter inside the group.

The consolidation provisions are supplemented by another rule in the loss provisions which says, in effect, that after consolidation, the business of the group is to be determined without needing to consider the businesses that

the subsidiary members carried on prior to joining the group. This rule is apparently intended to defeat the entry history rule – that a subsidiary member brings with it into the group the accumulated history of all the events that happened to it before it joined the group.

This issue has been around for several years and was addressed in a discussion paper issued by the ATO in 2004. In a Tax Ruling issued in 2007, the ATO had confirmed the position that,

[the loss rule] and the entry history rule ... operate in such a way that the activities of an entity during any period when that entity was not a member of a consolidated group are ignored when determining ... the 'business' of the head company of a consolidated group ...

For whatever reason, the current drafting and the ATO Ruling have been considered inadequate and the loss provision is replaced in the current draft. The new version is apparently considered to express the intended outcome more clearly and is perhaps best understood as a measure to buttress the position already taken in the Ruling.

The new drafting does not, however, solve all of the difficulties that the juxtaposition of these two rules create. For example, if the entire entry history of a subsidiary member is to be ignored for the SBT rule – including the business that it carried on – then why is it not the case that all of the income that the subsidiary's activities generate inside the group should not be regarded as income from new transactions or from carrying on a new business so far as the head entity is concerned? There are clearly deep imponderables here.

**Commencement.** The replaced version is to be retrospectively inserted into the tax legislation. It has effect from 1 July 2002, the date upon which the consolidation provisions commenced.

## 5. Next steps

The Exposure Draft was released for consultation purposes. A formal Bill to give effect to these proposals is likely later this year.

For further information, please contact

**Sydney**

Richard Hendriks  
[richard.hendriks@gf.com.au](mailto:richard.hendriks@gf.com.au)  
phone 61 2 9225 5971

**Melbourne**

Ken Spence  
[ken.spence@gf.com.au](mailto:ken.spence@gf.com.au)  
phone 61 3 9288 1451

Hayden Scott  
[hayden.scott@gf.com.au](mailto:hayden.scott@gf.com.au)  
phone 61 3 9288 1545

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

Greenwoods & Freehills Pty Limited  
ABN 60 003 146 852  
Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia  
Facsimile (02) 9221 6516 Telephone (02) 9225 5955  
Liability limited by a scheme approved under Professional Standards Legislation  
510042248