Tax and Superannuation Laws Amendment (2015 Measures No. 2) Bill 2015

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Economics Section

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House: House of Representatives
Portfolio: Treasury
Commencement: The formal provisions of the Bill commence on the day it receives the Royal Assent. Schedules 1 and 3 commence on Royal Assent and Schedule 4 commences the day after Royal Assent. Schedule 2 commences on 1 July 2015.

Links: The links to the Bill, its Explanatory Memorandum and second reading speech can be found on the Bill’s home page, or through the Australian Parliament website.

When Bills have been passed and have received Royal Assent, they become Acts, which can be found at the ComLaw website.
### Schedule 3—Income tax look-through treatment for instalment warrants and similar arrangements

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**Purpose of the Bill**

This Bill has four Schedules and the purpose of each Schedule is briefly described below.

**Schedule 1** amends the *Income Tax Assessment Act 1997* and the *Income Tax (Transitional Provisions) Act 1997* to:
- provide roll-over relief for two or more taxpayers who enter into arrangements to realign their individual exploration interests with each other to achieve a common development strategy
- provide relief mechanisms for taxpayers entering into arrangements for the exchange of an interest in a mining, quarrying or prospecting right in return for an exploration benefit, which usually takes the form of receiving exploration services or having exploration services funded by another party – these are generally referred to as farm-in farm-out (FIFO) arrangements and
- address a technical issue that may have prevented some taxpayers claiming immediate deductions for expenditure for mining, quarrying or prospecting information.

**Schedule 2** amends the *Income Tax Assessment Act 1997* extend the statutory effective life of in-house software from four to five years.

**Schedule 3** amends the *Income Tax Assessment Act 1997*, the *Income Tax (Transitional Provisions) Act 1997* and the *Taxation Administration Act 1953* to provide for look-through treatment for instalment warrants, instalment receipts and similar arrangements. It also provides for the look-through treatment to apply to limited recourse borrowing arrangements entered into by regulated superannuation funds.

**Schedule 4** amends the *Income Tax Assessment Act 1997* and the *Income Tax (Transitional Provisions) Act 1997* to effect changes to the company loss recoupment rules by:
- modifying the continuity of ownership test for companies whose shares have unequal rights
- clarifying the operation of the same business test for consolidated groups and
- providing that, in applying the continuity of ownership test, certain entities such as a complying superannuation fund, a superannuation fund that is established in a foreign country, a complying approved deposit fund, a special company and a managed investment scheme may be treated as if they were a person.

**Committee consideration**

**Senate Standing Committee for the Scrutiny of Bills**

The Senate Standing Committee for the Scrutiny of Bills made no comment on the Bill.¹

**Financial implications**

The financial implications of the measures proposed in the Bill are generally small or unquantifiable.² The only exception to this is the measure proposed in **Schedule 2** to extend the statutory effective life of in-house software from four to five years, which is estimated to increase revenue by $420 million over the period 2014–15 to 2017–18.³

**Statement of Compatibility with Human Rights**

As required under Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* (Cth), the Government has assessed the Bill’s compatibility with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of that Act. The Government considers that the Bill is compatible.⁴

The Parliamentary Joint Committee on Human Rights considers that the Bill does not raise human rights concerns.⁵

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3. Ibid., p. 4.
4. The Statements of Compatibility with Human Rights for each Schedule of the Bill can be found at pages 32–33, 39, 61 and 104 of the Explanatory Memorandum to the Bill.
Policy position of non-government parties/independents

The Australian Labor Party (ALP) supported the measures proposed by the Bill when it was debated in the House of Representatives on 19 August 2015. This is not surprising, given that several of the measures were policies either announced or initiated by the ALP in Government:

- the legislation that gave rise to the changed tax concession provided to mining rights and information amended by Schedule 1 was enacted by the Tax and Superannuation Laws Amendment (2014 Measures No. 3) Act 2014, a policy announced by the ALP in Government as part of the 2013–14 Budget
- the changes proposed by Schedule 3 are similar to measures the Rudd Government announced in the 2010–11 Budget and
- the changes proposed by Schedule 4 are similar to proposals made by the Rudd Government and included in draft legislation in 2009. Legislation was, however, not introduced into Parliament.

At the time of writing, the views of other non-government parties and independent Members and Senators on the proposals included in the Bill have not been publicly expressed.

Schedule 1—Tax relief for certain mining arrangements

Background

Policy development

As part of the 2013–14 Budget delivered in May 2013, the Gillard Government announced that the tax concession of immediate deduction for the cost of assets first used for exploration would be better targeted by excluding mining rights and information from this concession.

In November 2013, in a joint media release following the change of government in September 2013, the Coalition Government announced that it would proceed with the measure.

In May 2014, as part of the 2014–15 Budget, the Government announced that it would clarify the treatment of realignments of interests between joint venture partners in the minerals and petroleum industry. This would address uncertainty for realignments which were potentially affected by the decision to limit the immediate deduction for mining rights first used for exploration.

The legislation to give effect to the 2013–14 Budget measure, the Tax and Superannuation Laws Amendment (2014 Measures No. 3) Act 2014 was introduced into the Parliament in late May 2014 and passed the Parliament in mid-June 2014. This legislation did not however incorporate the changes proposed in the 2014–15 Budget announcement, with the Parliamentary Secretary to the Treasurer noting when he introduced the Bill into the House of Representatives:

The immediate deduction will remain for the cost of rights acquired from a government issuing authority, the cost of geological, geophysical or similar information acquired from government authorities and the cost of data packages acquired from private providers.

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Draft legislation was released by the Treasury for consultation in January 2015 relating to the interest realignment and farm-in farm-out arrangements. At the time of writing, no submissions had been made available by the Treasury. However, the Australian Petroleum Production and Exploration Association had separately published its submission.

Key features of the 2014 changes on joint exploration activities

As noted previously, the *Tax and Superannuation Laws Amendment (2014 Measures No. 3) Act 2014* changed the tax treatment for mining, quarrying or prospecting rights and information first used for exploration or prospecting so that it was no longer immediately deductible unless certain activity tests were satisfied.

For acquisitions, after 14 May 2013, of mining rights and mining information first used for exploration, an immediate deduction is limited to three kinds of expenditure:

- the cost of mining rights and mining information acquired from an Australian government authority
- the cost of geological, geophysical or similar information acquired from specified providers and
- the cost of newly created mining information.

With the exception of these cases, the cost of acquiring a mining right and mining information first used for exploration will be deductible over 15 years or the effective life of the right or information, whichever is shorter.

A common feature of resource exploration activities is that they are often pursued by several different parties as a way of sharing risk as well as providing for a broader financing framework. The various structures used have tax implications for the parties involved.

An interest realignment arrangement occurs where the parties to a joint venture exchange interests in mining, quarrying or prospecting rights to pursue a single development project with a view to aligning the ownership of individual rights with the ownership of the overall joint venture.

Farm-out arrangements are arrangements entered into for the purpose of facilitating exploration for the discovery of minerals and petroleum resources. A typical arrangement provides for the owner of an interest in a mining tenement (the ‘farmer’) to transfer a percentage of that interest to another party (the ‘farmee’) if the farmee meets specified exploration commitments or contributes monetary payments. Often the commercial driver for such an arrangement from the farmer’s perspective is funding. That is, the farmer gives up future economic benefits, in the form of reserves, in exchange for a reduction in future funding obligations. For the farmee, it provides an opportunity to acquire an interest in a mining tenement.

The Explanatory Memorandum notes that the 2014 changes may have had the effect of impeding interest realignment arrangements that encourage joint development of resource discoveries and that the tax consequences for farmees could impede genuine exploration activity.

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19. Ibid.
Improvements to mining, quarrying or prospecting information

The amendments made by the Tax and Superannuation Laws Amendment (2014 Measures No. 3) Act 2014 provide that expenditure incurred in improving mining, quarrying or prospecting information is only entitled to an immediate deduction if the original information is acquired from specified sources. The Explanatory Memorandum notes that a secondary condition to claiming an immediate deduction for expenditure incurred in improving mining, quarrying or prospecting information may mean that taxpayers are not entitled to such a deduction for the expenditure incurred in improving mining information themselves.

Position of major interest groups

In its submission to Treasury on the draft legislation, the Australian Petroleum Production and Exploration Association (APPEA) did not express any view on the provisions overall. However, APPEA did make some suggested technical amendments to the draft legislation.

At the time of writing, no other major interest groups had publicly commented on the proposals included in Schedule 1 of the Bill.

Key issues and provisions

The reader is referred to pages 14 to 31 (paragraphs 1.29 to 1.99) of the Explanatory Memorandum to the Bill for a detailed explanation of the provisions, illustrated with examples.

Part 1—Interest realignment arrangements

Under current arrangements, interest realignment arrangements would trigger a capital gains tax liability or depreciating asset balancing adjustment. The changes proposed by Part 1 define the term ‘interest realignment arrangement’ and outline the relevant tax treatment depending on the circumstances that apply.

Item 1 of Schedule 1 inserts proposed sections 40–363 and 40–364 into the Income Tax Assessment Act 1997 to provide roll-over relief for interest realignments. Item 2 outlines the tax treatment of roll-over relief in certain instances, including assets that were held prior to the introduction of the capital gains tax regime (20 September 1985) and the introduction of the uniform capital allowance (UCA) arrangements from 1 July 2001.

Item 5 provides that amendments made by Part 1 apply to interest realignment arrangements entered into after 7.30 pm, by legal time in the Australian Capital Territory, on 14 May 2013.

Part 2—Farm-in farm-out arrangements

Item 10 amends the Income Tax Assessment Act 1997 to insert proposed Subdivision 40-K, which provides the substantive arrangements for the tax treatment of parts of interests in mining, quarrying or prospecting rights that are subject to farm-in farm-out arrangements. This includes defining the key terms ‘farm-in farm-out arrangement’ and ‘exploration benefit’.

Item 19 provides that the amendments made by Part 2 apply in relation to farm-in farm-out arrangements entered into after 7.30 pm, by legal time in the Australian Capital Territory, on 14 May 2013.

Part 3—Improvements to mining, quarrying or prospecting information

Item 20 repeals and replaces paragraph 40-80(1AB)(d) of the Income Tax Assessment Act 1997, to ensure that an immediate deduction will be available for expenditure incurred by a taxpayer to improve mining, quarrying or prospecting information.

Item 21 provides that amendments made by Part 3 generally apply to any mining, quarrying or prospecting information that an entity starts to hold after 7.30 pm Australian Eastern Standard Time on 14 May 2013.

24. Explanatory memorandum, ibid., p. 11.
Schedule 2—Increasing the statutory effective life of in-house software

Background

Existing arrangements

Under the *Income Tax Assessment Act 1997*, the effective life over which in-house software can be depreciated is specified to be a period of four years. The term ‘in-house software’ is defined in section 995–1 of the Act and covers computer software, or a right (for example, a licence) to use computer software that the taxpayer acquires or develops (or has another entity develop) that is mainly for the taxpayer’s use in performing the functions for which it was developed, and for which no amount is deductible outside the uniform capital allowance or the simplified depreciation rules for small business entities.

Policy development

In December 2014, the Government announced the proposal to extend the statutory effective life of in-house computer software from four years to five years as part of the 2014–15 Mid-Year Economic and Fiscal Outlook. The Government’s policy rationale for this change was summarised by the Minister introducing the Bill as being related to both the actual effective life of such assets and the overall budget situation, with the Minister noting in his second reading speech that:

> ... the effective life of software for tax purposes better reflects the typical useful life of software for businesses ...

> The new treatment will start for expenditure made on or after 1 July 2015 and will result in a saving of $420 million over the four years to 2017-18. That is not far from half a billion dollar—money which can be redirected to fund other priorities.

The proposed increase follows on from a one and a half year increase (from 2.5 years to four years) to the statutory effective life that was announced in the 2008–09 Budget and subsequently legislated by the *Tax Laws Amendment (Budget Measures) Act 2008*. The rationale for the change in the 2008–09 Budget was ‘the Government’s commitment to responsible economic management’.

The Coalition, then in opposition, was critical of the measure, noting during parliamentary debate:

> This measure contained within the Bill is another tax hit on business, and small business in particular. Software is bought for operational, not tax, reasons. That is something that the government just does not seem to grasp. Software is a pretty fundamental thing that businesses need to conduct their operations. The measure in this Bill defers deductions. The measure is estimated to raise about $1.3 billion over the forward estimates.

Position of major interest groups

At the time of writing, no major interest groups had publicly commented on the proposals included in Schedule 2 of the Bill.

Key issues and provisions

**Item 1** of Schedule 2 replaces the reference to ‘4 years’ for the specified effective life of in-house software in Table item 8 in existing subsection 40–95(7) of the *Income Tax Assessment Act 1997* with ‘5 years’.

**Item 2** replaces the existing table in section 40–455 which provides for a specific percentage depreciation over a four year period for capital expenditure allocated to a software development pool (nil in year 1, 40 per cent in year 2, 40 per cent in year 3 and 20 per cent in year 4), with an alternative table that provides for deductions

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over a five-year period (nil in year 1, 30 per cent in year 2, 30 per cent in year 3, 30 per cent in year 4 and 10 per cent in year 5).

Item 3 provides that the amendments made by item 1 apply to in-house software if its start time occurs on or after 1 July 2015 and those made by item 2 apply to expenditure incurred in an income year starting on or after 1 July 2015.

Schedule 3—Income tax look-through treatment for instalment warrants and similar arrangements

Background

What is an instalment warrant?

A 2010 government discussion paper on the tax treatment of instalment warrants defined the product in the following way:

Instalment warrants are a form of derivative or financial product that entails borrowing to invest in an asset, such as a share or real property (the underlying asset). In its simplest form, the investor makes an upfront payment, which typically includes prepaid interest and borrowing fees. The underlying asset is held on trust during the life of the loan to provide limited security for the lender. The investor is required to pay one or more future instalments.

If the investor pays all the future instalments, the trustee transfers the underlying asset to the investor. Alternatively, the investor may direct the trustee to sell the underlying asset and transfer the proceeds to the investor (less any fees).

If the investor defaults on the outstanding instalments, the trustee sells the underlying asset to fund the outstanding instalments and any other costs. 34

A similar arrangement is named an ‘instalment receipt’. The Explanatory Memorandum notes that the key difference between this arrangement and a warrant is that no borrowing is involved, rather there is the provision of credit to acquire an asset that is held on trust until the purchase price of that asset is fully paid by the investor. 35 Other secured financing arrangements can be structured to operate in the same way as instalment warrants and receipts. 36

The Bill uses the term ‘instalment trust’. Briefly, this term refers to the trust established by the instalment warrant or receipt or similar arrangement which holds the assets in question. Item 5 of Schedule 3 further defines this term (see further comment below).

Who uses such arrangements?

While any investor may make use of instalment warrants and similar arrangements, Self-Managed Superannuation Funds (SMSFs) have been conspicuous in their use of these products. Generally, superannuation funds may not borrow to purchase investments. 37 However, SMSFs are allowed to do so where they employ Limited Recourse Borrowing Arrangements (LRBA). 38 Such arrangements limit the lender’s rights to recover any debt to the specific assets purchased under that arrangement. Consequently, only the specific asset purchased using this arrangement may be recovered in the event of a default, and not the entire assets of the SMSF engaging in the arrangement.

The number of SMSFs has continued to increase. In the June 2010 quarter there were 787,510 SMSFs. This figure had increased to 999,927 by March 2015. 39 Between June 2013 and March 2015 the percentage of total SMSF
assets made up of LRBA arrangements has fallen from 1.8 to 1.6 per cent. However the dollar value has increased from $8.8 to $9.5 billion.40

What is a look-through treatment?
As noted above, the assets purchased via an instalment warrant, or similar arrangements, are held in trust. The trust should gain the benefits of holding that asset. However, long standing tax practice has been to assess the investor purchasing the asset as receiving the benefits and incurring the losses from holding that asset.42 The trust is ignored for tax purposes. Thus the trust is ‘looked through’ when an investor’s tax affairs are assessed.

What problem is being dealt with by the proposed amendments?
The ATO has advised that existing tax law does not support the ‘look through’ treatment of an investor purchasing an asset via an instalment warrant or similar arrangement.42 The proposed amendments alter taxation law so that the look through treatment of instalment warrants is grounded in that law.

Position of major interest groups
Generally the proposed changes have received support from the tax and investment community, but some concerns were expressed in submissions on the exposure draft of the proposed changes. The Tax Institute supported the proposed changes but sought to broaden its scope.43 There has been limited comment on the proposed changes. One legal group, commenting on the exposure draft of this legislation, noted that:

The proposed legislation is a step forward; however it fails to deal with the treatment for GST purposes, which is a major area of concern in a number of limited recourse borrowing arrangement (LRBA) transactions. Unless this is appropriately dealt with in the final legislation, extreme care must be taken to ensure that GST is dealt with properly in an LRBA. In particular, our concern is that [ATO ruling] GSTR 2008/34 is not wide enough to apply to all LRBA.45

Another legal group supports the proposed changes but also suggests additional changes to the draft legislation.46 Industry reaction appears to strongly support the proposed amendments.47

Key issues and provisions
Item 1 of Schedule 3 inserts proposed Division 235 into the Income Tax Assessment Act 1997 to provide a legislative basis for ‘look through’ treatment of instalment warrants and similar arrangements. The main provisions are in proposed Subdivision 235-I. They are:

• proposed section 235-815 applies this proposed subdivision to entities that have beneficial interests in an instalment trust (see below) as well as the trustee of that instalment trust
• proposed section 235-820 establishes the look through treatments of instalment trusts
  – the concerns noted above about clarifying the treatment of instalment warrant and similar arrangements for Goods and Services Tax (GST) purposes appears to be covered by proposed subsection 235-820(5) of the Income Tax Assessment Act 1997 (see item 1 of Schedule 3), which clarifies that any GST consequences arising from such transactions apply to the investor, not the interposed trust

42. Ibid.
43. The Tax Institute, Submission to Treasury, Look-through treatment for instalment warrants and instalment receipts—Exposure draft, 16 February 2015, accessed 4 September 2015.
44. This ruling deals with the GST treatment of real property transactions by ‘bare’ trusts: Australian Taxation Office (ATO), Goods and Services Tax Ruling, GSTR 2008/3, Goods and services tax: dealings in real property by bare trusts, ATO website, accessed 4 September 2015.
• **proposed section 235-825** defines the term ‘instalment trust’, amongst other definitions, for the purposes of this proposed subdivision (see below) and

• **proposed sections 235-830, 235-835 and 235-840** further define which trusts are instalment trusts for the purposes of this proposed subdivision (see below).

**Item 5** inserts three proposed definitions into existing subsection 995-1 of the *Income Tax Assessment Act 1997*. These new definitions are:

• ‘instalment trust’ – which has the meaning given by **proposed section 235-825**

• ‘instalment trust asset’ – has the meaning given by **proposed section 235-825** and

• ‘regulated superannuation fund’ – which is proposed to have the same meaning as in the *Superannuation Industry (Supervision) Act 1993* (*SIS Act*).

  – Section 19 of the *SIS Act* defines a regulated superannuation fund. Briefly, such a fund must have a trustee. The trustee must be a constitutional corporation, except if the fund is a pension fund. The trustee must also have given the Australian Prudential Regulation Authority a notice stating that the *SIS Act* applies to the trust in question.48

The main definition is that of an ‘instalment trust’. **Proposed section 235-825** specifies that a trust is an instalment trust if:

• it is covered by **proposed section 235-830** and satisfies the requirements in **proposed section 235-835** or

• the trust is covered by **proposed section 235-840**.

**Proposed section 235-830** provides that an arrangement is an instalment trust where:

• the security for the borrowing/credit is provided by the assets acquired by the trust

• the investor has a beneficial interest in the underlying investment as the sole beneficiary of the trust

• the credit was provided to acquire the asset or assets held by the instalment trust

• the investor is entitled to the benefit of all income from the underlying investments and

• the investor is entitled to acquire legal ownership of the underlying investment once the borrowing/credit arrangements have been discharged.

However, proposed section 235-830 does not apply to situations where the investor is a regulated superannuation fund that has entered into an arrangement that includes a borrowing (**proposed subsection 235-830(2)**).

**Proposed section 235-835** requires that the underlying investment of an instalment trust be:

• a share, a unit in a unit trust or a stapled security or a direct or indirect interest in an entity that holds an interest in a share, a unit in a unit trust or a stapled security and

• such shares, units or stapled securities are listed on an approved stock exchange and meet specified requirements for being ‘widely held’.

Under section 67 of the *Superannuation Industry (Supervision) Act 1993* regulated superannuation funds are not allowed to borrow to purchase investment assets, and may only borrow to meet specified short term needs. This explains the exclusion of regulated superannuation funds from the **proposed section 235-830**.

An exception to the prohibition on borrowing in certain situations is provided in subsection 67A(1) of the *Superannuation Industry (Supervision) Act 1993*, amongst which is where a borrowing in undertaken to acquire a single asset, and the borrowing liability is limited to that asset, and not all the assets of that superannuation fund. **Proposed section 235-840** defines an arrangement to be an instalment trust where the trustee of a

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regulated superannuation fund undertakes a borrowing that is covered by either subsection 67A(1) or former subsection 67(4A), of that Act.\(^4\)g

**Item 6 of Schedule 3** inserts proposed subsection 235-810 into the *Income Tax (Transitional Provisions) Act 1997*, which applies the provisions of proposed Subdivision 235-1 of the *Income Tax Assessment Act 1997* to assets acquired from the 2007–08 income year or later years.\(^5\)0

**Concluding comments**

The proposed amendments make long awaited changes to the *Income Tax Assessment Act 1997*. They are uncontroversial and effectively provide a legal basis for long standing Tax Office practice when assessing these transactions.

**Schedule 4—Multiple classes of shares**

**Background**

The proposed amendments in **Schedule 4** mainly concern the ‘Continuity of Ownership’ test (COT). The purpose of this test is determine whether a company may claim prior year losses as a deduction against income for tax purposes in circumstances where there have been changes in that company’s shareholdings due to mergers, acquisitions, divestments or other corporate restructuring events.

**The continuity of ownership test**

To utilise prior years’ losses, under the COT (Divisions 165 and 166 of the *Income Tax Assessment Act 1997*), a company’s shares carrying more than fifty per cent of all dividend, voting and capital rights must essentially be beneficially owned by the same persons at all times during the ownership test period. The ownership test period broadly starts at the beginning of the loss year and ends at the end of the year of recoupment. Furthermore, the majority underlying ownership test must be satisfied in relation to the same shares. Certain concessional COT tests are available to widely held and/or listed companies.\(^5\)1

**Rationale for the COT**

The COT has existed in legislation since the Second World War, as the following quote notes:

> In 1944, the continuity of ownership test (COT) was established for private companies to address ‘loss trafficking’, that is, purchasing companies in order to gain a tax advantage from the carry forward losses. Loss trafficking was described by the Treasurer at the time as the practice ‘of buying up shares in practically defunct companies and then operating those companies for purposes other than those for which they were originally registered’.\(^5\)2

In April 2012 the Business Tax Working Group issued a Final Report on Tax Losses. That report noted:

> There is no single, coherent policy that governs the tax treatment of carry forward losses. Our current system attempts to negotiate various competing policy considerations, not least of which is the impact the treatment of losses has on government revenues.

> A key justification for loss integrity rules is that they remove incentives for ‘tax driven’ activities involving entities with losses. The challenge is how to frame these rules to discourage tax driven practices without impacting adversely on legitimate commercial activities.\(^5\)3

For example, the report noted that the COT (along with other rules) was implemented to:

> ... target specific behaviour that could lead to loss duplication, whereby multiple [tax] losses stem from one economic loss.\(^5\)4

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49. Subsection 67(4A) of the *Superannuation Industry (Supervision) Act 1993* (version as at 1 July 2010) was removed by item 7 of Schedule 1 of the *Superannuation Industry (Supervision) Amendment Act 2010* (No. 100 of 2010), both accessed 4 September 2015. The provisions of the repealed subsection are similar to the current provisions of existing subsection 67A(1) of the *Superannuation Industry (Supervision) Act 1993*.


51. Explanatory Memorandum, op. cit., p. 64.


53. Ibid., p. 36.
The problems that the COT (and its companion Same Business Test) is meant to address are illustrated by the following example:

Anne injects equity of $100 in Company A (assume she is the only shareholder). During income year 1, the company makes a (revenue) loss of $100. Assume the company has poor prospects of earning future revenue against which it might use its loss. However, the loss potentially has a theoretical tax value of $30 to someone who could immediately use the loss against other income.

At the start of income year 2, Boris purchases Anne’s shareholding for $20. Boris is willing to pay $20 for the shares because he is confident he can use the tax loss against other income in year 2. Anne will have made a capital loss on her shares of $80. Assuming she has other capital gains for the year, Anne will have realised some of the tax value of the revenue loss incurred by the company plus the value of the capital loss on her equity in Company A. Boris shields $100 of income from his other business in year 2 by using the carried-forward loss and terminates the business activities of company A.55

Are there difficulties in the COT’s operation?

In 2012 a senior tax practitioner noted difficulties in applying the COT in practice, in particular with regard to tracing the ownership of shares in certain situations:

…the COT can often be problematic to apply due to the requirement to trace through ownership, particularly in cases where ownership is held indirectly through a number of entities (including fixed and non-fixed trusts and partnerships).

For example, for the purposes of applying the COT, if interests in the loss company are held by non-fixed trusts (such as discretionary trusts), it can be difficult to trace through to the ultimate beneficial owner. Or, in the case where a company has a small number of shareholders, any slight changes to shareholdings may result in a failure of the COT. Further, companies often face difficulties when applying the same shares/same owners test over a prolonged period of time.

Other difficulties which company’s [sic] may face include scenarios whereby the company has multiple classes of shares on issue or special distribution arrangements regarding its dividends, or where company shares do not all carry the same voting rights... .

In addition, for the purposes of applying the COT, it may, in practice, be time-consuming, costly and difficult to trace beneficial ownership to individual shareholders and to monitor this tracing on an ongoing basis.56

The proposed amendments seek to address these problems.

The Same Business Test

If a company does not pass the COT in order to utilise prior years’ losses, it may apply the ‘Same Business Test’ (SBT) to achieve the same end. Briefly:

A company satisfies the SBT if it carries on the same business in the claim year as it carried on immediately before it failed the COT. The SBT is intended to ensure continuity of the whole of the business activities carried on by the taxpayer just before it failed the COT and the whole of the business activities carried on by the taxpayer during the period of recoupment.57

The proposed amendments contain changes in the application of the SBT in relation to consolidated groups or multiple entry consolidated groups (MEC).

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54. Ibid., p. 37.
55. Ibid., p. 38.
Position of major interest groups

One accounting group has noted:

As a result of the changes proposed in the Bill, companies with unequal share structures may now be able to claim they satisfy the COT test with a little more confidence. 58

Key issues and provisions

Item 1 of Schedule 4 inserts proposed Division 167 into the Income Tax Assessment Act 1997. This new division contains the bulk of the modifications to the COT. Briefly, if an entity cannot work out whether it satisfies the COT for the purposes of claiming a prior year’s losses for tax purposes, in circumstances of unequal capital structure (that is, where the company’s shares have unequal rights to dividends, capital distributions or voting power) it can:

• disregard any debt interests in its capital structure (proposed section 167-15); if the situation is not resolved it can then

• disregard secondary share classes (as well as the debt interests) (proposed section 167-20); if the situation is still not resolved it can then

• treat the remaining shares as having fixed rights to dividends and capital distributions (proposed section 167-25), while also disregarding any debt interests and secondary share classes in the company’s capital structure.

While these proposed changes will greatly ease the administrative task of determining whether a company can utilise the prior year’s losses it may also lead to some losses being used that are not within the policy’s intent. Unfortunately, there is no way of determining whether this will occur in advance.

Item 53 of Schedule 4 inserts proposed section 167-1 into the Income Tax (Transitional Provision) Act 1997. The effect of this new section is to apply the provisions of proposed Division 167 of the Income Tax Assessment Act 1997 to any relevant act which occurred from 1 July 2002.

The Explanatory Memorandum notes that normally, under section 170 of the Income Tax Assessment Act 1936, a company’s income tax assessment can only be amended within four years of the date of assessment. 59 The Memorandum also states that the operation of section 170 of the Income Tax Assessment Act 1936 will be altered to give effect to this decision. This is achieved by clause 4 of the Bill, which will allow amendment of past assessments provided that the amendment occurs within four years of the commencement of Schedule 4 to the Bill.

Even by the standards of tax legislation, where retrospective application of provisions is not unusual, this degree of retrospectivity is unusual to say the least. The Explanatory Memorandum is less clear on why this particular date was chosen. 60 This early application date opens up the possibility of a large number of tax losses that were previously un-utilised, being claimed, and possibly leading to significant revenue impacts.

Item 54 in Part 2 of Schedule 4 repeals existing section 165-212E of the Income Tax Assessment Act 1997 and substitutes proposed section 165-212E. The revised section states that ‘the entry history rule’ in section 701-5 of the Income Tax Assessment Act 1997 does not operate for the purposes of the SBT in section 165-210. The existing text appears to cover much the same ground where it states:

For the purposes of the same business test, if an entity (the joining entity) becomes a subsidiary member of a consolidated group or a MEC group, section 701-5 (the entry history rule) does not operate to take the business of the head company of the group to include the business of the joining entity before it became a member of the group. 61

59. Explanatory Memorandum, op. cit., p. 103.
60. Ibid., pp. 101–102.
What appears to be new is that the proposed text is to apply from 1 July 2002, according to item 55 of Schedule 4. Existing section 165-212E of the Income Tax Assessment Act 1997 applied from 14 December 2005. The Explanatory Memorandum notes that this item is beneficial to taxpayers. No doubt it will make achieving compliance with the SBT easier for consolidated groups, but it may also result in additional deductions from previous years’ company taxable income to arise. While the retrospective application of the proposed new section is not as startling at that of items 1 and 53 above, it may still lead to some additional revenue leakage.

**Concluding comments**

The application of some of the changes in Schedule 4 from 1 July 2002 may give rise to additional workloads for the Australian Tax Office in revising company income tax assessments. Additional administrative resources may be required to meet this possible increased workload.

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62. Section 165-212E of the Income Tax Assessment Act 1997 was inserted by item 76 of Schedule 1 to the Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Act 2005. This item applied from the date of Royal Assent, which was 14 December 2005.