ABSTRACT

The tax loss landscape in Australia is gradually being transformed in recent years. This transformation is instigated on the premise of strengthening the "integrity" of the tax system by dealing with problems that includes loss duplication, loss trafficking, loss cascading and high compliance costs. The recent changes are said to produce a system that is more equitable, economically efficient or neutral (and perhaps even simpler). However, not only is the resultant tax loss landscape far from simple, even the goal of equity and efficiency cannot adequately justify the added complexity. It seems that a better explanation of the current tax loss landscape is the Government's desire to restrict the availability of tax losses in the system. The progressive introduction of the integrity measures and the intrinsic appeal of consolidation regime tend to disguise this motive of tax loss containment.

CONTENTS

INTRODUCTION

Changes made to tax loss rules in Australia in recent times are nothing short of startling. Most of these changes originated from the recommendations of the Review of Business Taxation.[1] The consolidation regime represents the latest instalment in this seemingly endless saga of changes.

Adopting a broad perspective, this paper charts the recent changes to the tax loss landscape in relation to domestic corporate groups. The intention here is to consider the general thrust and principle behind these rules in an effort to determine the (real) policy or motivation underlying these provisions and recent changes.[2]

This paper commences by outlining the policy and theory behind the design of tax loss rules. The history of the tax loss rules in Australia and the recent changes to these rules are then considered, followed by an exploration of the tax loss rules post consolidation.[3] This paper concludes by considering the current tax loss rules in light of the stated policies, and considers whether there is another, perhaps better, explanation for the way the rules work.

POLICY AND THEORY

Policy and theory are often put forth to justify the design of a taxation system, which includes the treatment of tax losses. It is thus useful to commence this paper by outlining a few relevant policies and theories.

Economic Framework

Three criteria form the foundation of modern taxation policy: equity, economic efficiency and simplicity.[4] The Review of Business Taxation has endorsed these

---

[1] The various reports released are entitled: A Strong Foundation ("ASF"), A Platform for Consultation ("APC"), and A Tax System Redesigned ("ATSR").

[2] The detailed mechanics of these loss rules will thus be delved into to the extend necessary in achieving this. Due to the extensive tax loss rules that exist in the Australian tax legislation, to attempt a comprehensive survey of the specific details of these rules would exceed the scope of this paper and would indeed require a book in itself. The tax loss provisions now cover more than 200 pages in the legislation!

[3] In this paper the rules governing the consolidation regime is based on the following Acts and bills as of the date of this paper: *New Business Tax System (Consolidation) Act 2002 (No. 1)* (referred herein as "the First Act"); *New Business Tax System (Consolidation, Value Shifting, Demergers, Etc) Act 2002* (referred to herein as "the Second Act"), and *New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002* (referred to as "the Third Bill"). The first two legislations have received Royal Assent and are operative from 1 July 2002. The Third Bill was introduced on 26 September 2002. This bill passed the House on 16 October 2002, and is currently in the Senate. Further Bills are scheduled to be released in the near future.

[4] These criteria originated from the four maxim outlined by Adam Smith – loosely summed up as equality, certainty, convenience and freedom from economic burden. Smith, A. (1776) "An Inquiry into the Nature and Causes of the Wealth of Nations, (Part 2, Chapter II, Book Five), 1952 ed, Chicago: William Benton.

criteria as the "national objectives" in the Charter of Business Taxation.[5] They thus should guide the design of business taxation system in Australia.

Equity

Equity is said to be "a basic criterion for community acceptance of the tax system".[6] The notion of equity has two favours: horizontal and vertical.[7] Horizontal equity states that people that have an equal ability to pay ought to bear equal burden of tax. To achieve this aim, the tax system must not only actually be fair, but it must be seen (ie. perceive) to be fair and non-discriminatory in its application to different taxpayers.[8] By comparison, vertical equity requires that taxpayers bear a tax liability in proportion to their respective abilities or wealth. Further, equity may also be evaluated in terms of 'administrative equity' and 'transitional equity' (as noted in the ASF document). The former refers to administrative procedures that do not inappropriately advantage some and disadvantage others, and the latter refers to overall fairness of transitional arrangements associated with changes to tax legislation.

In the context of business taxation, the ATSR considered that equity refers primarily to horizontal equity.[9] This means that entities carrying on business should be taxed in a similar manner. Vertical equity is relevant insofar that it relates to the taxation of distributions to individual owner(s) of the business. In relation to the treatment of tax losses, horizontal equity thus took on primary significance.

Efficiency

Efficiency itself is a very ambivalent or unclear concept.[10] In the common parlance, it captures the idea of certainty and non-arbitrary, and it overlaps somewhat with the notion of simplicity. Efficiency is best taken to mean the absence of distorting influences; and in this regard, it is synonymous to the notion of neutrality.[11] That is, the economic or investment decisions should not be affected by the existence or not of a particular tax. The Board of Review framed this notion in terms of optimising economic growth:[12]

---

[5] See ASF, Ch 6. ATSR, pp104 – 107.

[6] ATSR, at 105.

[7] See Waincymer, J. *Australian Income Tax Principles and Policy* (1993, 2nd ed), Butterworths, Sydney.

[8] Pedrick, WH. (1984) "Fair and Square for Taxation in Australia", Taxation in Australia, Vol 19, Sydney, TIA.

[9] ATSR, p 105.

[10] See Evans, C. 'The Australian Capital Gains Tax: Rationale, Review and Reform' (1998) 14 *Australian Tax Forum* 287 at pp 295-297.

[11] Evan, C., *op. cit.*

[12] ATSR, p105. See also ASF on p62; see also paragraphs 6.8 – 6.10.

> "…the business tax system should interfere to the least possible extent with, and indeed should promote, the best use of existing national resources, efficient allocation of risk, and long-term economic growth. Ideally, the business tax system should be neutral in its impacts and thus no be a consideration in business decision making. Poorly designed tax systems can inhibit economic growth by distorting business decisions."

Efficiency is important because the tax system is seen to be able to "significantly influence the efficiency with which Australia's natural resources, capital and labour are used".[13]

Simplicity

Simplicity is an attribute that is intuitively appealing, although it does not seem to fit in well with taxation law.[14] To lay people, and indeed to even many practitioners, taxation law is anything other than simple. Even the ASF documents acknowledged that the system is complex.[15] And the prospect of major improvement is grim. The ATSR concludes "[b]ecause of the inherent complexity in many business transactions, the business tax system will always contain complex provisions."[16]

Notwithstanding this, the Review still expressed the desire to achieve simplicity (to the extent possible). In this regard, two specific aims are set out:

- Have a tax system where the design is simple in that the economic substances is emphasised over the legal form;
- Have a tax system that justify any additional complexity that may be required from time to time on the basis that it yields improvement in equity or economic growth

Simplicity of a tax system could be proxy by cost – both administrative and compliance costs.[17] If the cost relative to revenue collected increase, the implication is that the system is increasing in complexity.

Treatment of Tax Losses in Theory

The existence of tax losses is inevitable with the periodic nature of income tax assessment as there are bound to be times when allowable deduction exceeds assessable income due to fluctuating economic performance of businesses.

---

[13] ATSR, at 13, footnote 2.

[14] Kenny, P. "A "Simplified Tax System" for Small Business" (2002) 6 The Tax Specialist 36 at 37.

[15] ASF, paragraph 6.15, p 64.

[16] ATSR, p106.

[17] See Kenny, P., *op. cit*.; Woellner, R., Barkoczy, S., Murphy, S. and Evans, C. *Australian Taxation Law* (2002), CCH; Sydney and Tran-Nam, B. "Assessing the Revenue and Simplification Impacts of Government Tax Reform" [1999] *Journal of Australian Taxation* 329.

In the absence of a mechanism to account and recoup tax losses incurred in prior years, these losses would be lost. Such an outcome would be contrary to the above economic policies. Investment in such an entity would be subject to the same quantum of tax as another entity without such losses. This would result in a lower return on investment, and hence, there would be a tax bias against such an investment.[18] This bias is compounded by the effect of the time cost of money. Thus, to satisfy the goal of neutrality, there needs to be a mechanism to enable the entity to utilise losses from prior years.

Further, the notion of equity also requires the recognition of prior year tax losses. If equity is considered over the time frame of an entity lifetime, then two entities that derived the same amount of income over its lifetime should ideally pay exactly the same amount of tax. Because tax is not paid as a single lump sum at the end of an entity's existence (as this would be impractical), tax losses that the entity incurred during its existence needs to be recognised to approximate this ideal equity position.[19]

To reflect these losses and to best achieve neutrality and equity, there theoretically needs to be unlimited carry forward and backward of tax losses. However, such unconstraint carry forward and backward of tax losses is not adopted for various practical reasons. For one thing, this is to avoid the creation of a "bottomless hole" for the Government.[20] The administrative complexity (or even impossibilities due to the extensive resources required) of such an approach provides another reason against it.

Constraint is also required due to the unique nature of company. Company may have a separate legal entity, but one characteristic is that its shares can be "owned" by shareholders. These shareholders can and do change from time to time. This change of ownership influences the application of the efficiency, neutrality and equity principle. Essentially, the problem is that losses could be duplicated and hence, encouraging loss trafficking.[21] This is because the seller of a company with tax losses would already have factored the value of the tax losses into the consideration for the sale of the company. At the same time, the company could, in the absence of constrain, continue to make use of losses in the company. Thus, the seller (being the original economic owner of the losses) of the company benefits from the losses and the company (and its new owner who have nothing to do with the losses) also benefits from the losses. Indeed, if tax losses are permitted to be carried forward after the sale of a company, successful companies would effectively be taxed to support the

[18] Stiglitz, J. *Economics of the Public Sector* (1988, 2nd ed), WW Norton & Co, New York.

[19] Refer to Lounghouse, G. "The "Same Business" test and Cleopatra's Ark" (1999) 28 ATRev 4 for further elaboration of this explanation of the necessity to provide for the recognition of tax losses on equity and neutrality grounds.

[20] Thuronyi, V. *Tax Law Design and Drafting: Volume 2* (1998), International Monetary Fund, Washington, DC, at p618- 619.

[21] Lounghouse, G., *op. cit.*

unsuccessful ones.[22] Further, investing in an entity for tax reason (ie. to access its tax losses) is economically inefficient.

It is because of such undesirable trafficking of losses that a limit is often placed upon the abilities of companies to carry forward tax losses.[23] The continuity of ownership test (COT) is designed for this very purpose. It denies the ability of profit making entity to acquire a loss making entity in order to use its tax losses, thereby preventing multiple benefits to be extracted from the same losses.

How does the same business test (SBT) fit in with this framework? Some argued that it does not, and that in fact it is unnecessary.[24] The same business test, even in the absence of consolidation, has been criticized by some as a rule that is opaque, inefficient and complex. It "can lead compliant taxpayers to engage in inefficient business practices at a cost to revenue for no efficiency or equity gain."[25] In theory, COT rules are perhaps sufficient to address the above undesirable loss trafficking problems. Reality is however far from simple. Additional policy reasons saw to the introduction of SBT as well as other modifications and additions to the core rules.

A BRIEF HISTORY: SHIFTING LANDSCAPE OF TAX LOSSES

The treatment of tax losses in Australia has been evolving throughout the decades. Tax losses (revenue and capital) in Australia are only available to offset assessable income if they satisfy certain criteria in the legislation. These criteria have grown increasingly onerous over the years, with the resultant tax loss rules in Australia becoming an "intricate web of technical rules."[26] This section provides an overview of these rules (in respect of corporate entities) and provides a sense of their recent evolution.

Originally the primary tax loss provisions are found within sections 80A to 80F of the *Income Tax Assessment Act 1936* ("ITAA36") – the former home of the COT and SBT. There were also sections 50A to 50N of ITAA36 that are designed to prevent a company from claiming deductions for "current year losses" where there are certain ownership changes during the year. During the Tax Law Improvement Project ("TLIP"), these carry-forward and current year loss rules have been rewritten in Part 3-5 of the *Income Tax Assessment Act 1997* ("ITAA97"). This is not the end of the evolution. Since then significant amendments and additions have been made.

---

[22] Lounghouse, G., *op. cit.*

[23] See Thuronyi, V., *op. cit.* at p619, 905; also Woellner, R., et al, *op. cit.* at paragraph 20-840, p1200.

[24] See Lounghouse, G., *op. cit.*

[25] Lounghouse, G., *op. cit.* at page 4. It is interesting to note that this author worked at the Australian Taxation Office; and whilst the article expressly states that the viewpoint expressed therein do not represent ATO policy, one could suspect that the ATO is at the very least sympathetic to this idea.

[26] Woellner, R., et al, *op. cit.* p1200.

Continuity of Ownership Test

In Australia, to prevent trafficking of tax losses through mere change in ownership of a company, the continuity of ownership test (COT) is adopted. This test sets a threshold of ownership change beyond which the prior year losses would not be available to offset against assessable income of the company. In very broad terms, the COT requires more than 50% of the voting, dividend and capital rights to be beneficially owned (directly or indirectly) by the same persons at all times during the ownership test period.[27] Following changes made in 1999, [28] the rule now requires the ownership to be tested from the start of the loss year until the end of the year in which a deduction is sought for the loss. Public companies have a different ownership testing time; they are only required to test for continuity of ownership at the start of the loss year, at the time of any abnormal trading in shares and at the end of each income year. Detailed rules specify when abnormal trading has occurred.

In addition, the same share needs to be held in the same way in order for the shares to be counted as continuous holdings.[29] Beneficial ownership by the same persons is not adequate. To guard against the possibility that control may change notwithstanding that the above 50% threshold has been satisfied, the legislation also contained a "control test" that requires there to be no change in control of the voting power of the company in order to obtain some taxation advantage.[30]

Same Business Test

The same business test functions as a concession to the COT. Historically, the tax loss provisions are guided by the policy notion that a company ought to be permitted to carry forward losses except to the extent that tax avoidance results.[31] The SBT was introduced in 1965 to provide an additional avenue to claim prior year losses in situation where the COT failed, and where the mergers or takeovers are motivated by "sound economic purpose" rather than tax reasons.[32] That is, if a company fails the COT or control test, it may still deduct prior year losses if it passes the SBT.[33] Note that the SBT only applies if there is a failure of COT.[34]

The basic requirement of the SBT is that the same business be carried on during the income year in which the loss is claimed and immediately before the change of

---

[27] Division 165.

[28] Some of these amendments are elaborated upon below at page 9.

[29] Sub-section 165-165(1).

[30] Section 165-15.

[31] Lounghouse, G., *op. cit.*

[32] Second Reading Speech to the *Income Tax Assessment Bill 1965* (Butterworth edition), p892. See also APC, paragraph 26.85, p561.

[33] Section 165-13.

[34] This requirement could present an issue in some situations. See below on page 14.

ownership that caused the COT and control test to fail. “Same Business” in this context means having the same identity, not merely similar. It is not necessary however, that the business continues to be identical in every respect. That is, organic growth through adoption of compatible new operations will be allowed as will abandonment of a portion of old operations. Nevertheless, losses will be denied if the company derived assessable income during the SBT period from business or transaction of a new kind that it did not carry on before the COT failure, or, if the company entered into a new business or new transaction before the COT failure in order to satisfy the SBT.

Trust Losses

The above COT and SBT rules deal with company losses. Losses that arise in trust are governed by distinct and analogous rules to prevent trafficking of losses in trust.[35] Different rules apply depending on whether a trust is a fixed, non-fixed or excepted trust. By way of a quick overview, a 50% stake test similar to the COT for companies applies in the case of fixed trusts and listed widely held trusts. This test focuses on more than 50% of distributions going to the same individuals during the relevant test period. That is, the same individual(s) must beneficially hold between them, directly or indirectly, fixed entitlement to more than 50% of the income and capital of the trust. Non-fixed trusts that have made a family trust election are generally not restricted by the trust loss rules. If the 50% stake test is failed, the SBT may only be available if the trust is a widely held trust. Further, non-fixed trusts need to consider the pattern of distribution test as well.

Quarantine and Other Ordering Rules

Whilst losses can typically be deducted in the order in which they are incurred,[36] there are certain quarantining and ordering rules that need to be adhered to. Certain types of losses are quarantined in that they can only be offset against income of the same type. They include net capital losses, film and foreign losses.[37] Foreign losses are further restricted in that they are quarantined against foreign income types; i.e. income, other passive income, offshore banking income and other foreign assessable income. Prior year losses must first be offset against any ‘net exempt income’ in the relevant income year.[38]

[35] These rules are contained within Schedule 2F of ITAA36.

[36] Section 36-15(5).

[37] Section 79D and section 160AFD of ITAA36.

[38] Section 36-15(3).

Transfer of Losses

The loss transfer provision is the precursor to the consolidation regime in existence now. The loss transfer measure is a partial consolidation approach that addresses certain artificial and unproductive practices undertaken by businesses in the absence of such loss transfer rules. Creative techniques, like the use of intercompany charges or transfer of income producing (or loss producing) assets, were used to deal with this deficiency by indirectly shifting the losses around the group, and hence using it to offset (indirectly) income of the group. The danger of such actions, of course, was the constant prospect of the ATO striking the transaction down whether under the general anti-avoidance provision or applying section 80DA to deny the losses carried forward. Such planning to ensure wholly owned corporate group do not pay tax are also time consuming and commercially disruptive.

The answer to these problems is said to rest with consolidation. The Asprey Committee considered the prospect of adopting consolidation in the mid-1970s, and made the following comment:[39]

> "Whilst the Committee accepts in principle that a company and at least its wholly owned subsidiary should be treated as one entity for income tax assessment purposes it does not favour the adoption of group assessment procedures. It recommends that group relief procedures modelled on those currently in force in the United Kingdom should be available in Australia, though subject to conditions which would be more restrictive than under the United Kingdom law."

At that point in time, a full consolidation model is not favoured by the Committee; rather, group relief measures that are modelled upon the rules then in force in the United Kingdom are endorsed. No legislation emerged until the Campbell Committee made the following recommendation concerning tax losses in a corporate group:[40]

> "(a) A loss suffered by one company should be permitted to be offset against the taxation income of another company in the same group.
>
> (b) This option should be made available either by a consolidated tax return or by permitting a transfer of tax losses within a group.
>
> The Committee further recommends that the options be available to company group satisfying 100% common ownership requirement. However, consideration could be given at a future date to some relaxation of this requirement."

---

[39] Commonwealth Tax Review Committee *Asprey Report*, AGPS, Canberra, 1975.

[40] Final report (September 1981) of the Campbell Committee into the Australian financial system. Although the Campbell committee was not explicitly asked to inquire the taxation system, it has found that it was necessary to examine aspects of the taxation system as part of the review.

Section 80G of ITAA36 was borne in 1984.[41] This section allows companies that are members of the same wholly owned group to transfer losses to each other. The companies must satisfy the group membership requirements at all times from the start of the loss year to the end of the income year. The amount of the loss that can be transferred between wholly-owned companies is limited to the assessable income of the transferee company in the year of transfer. With the introduction of capital gains (CGT) tax in 1985, section 160ZP was also inserted to enable the transfer of capital losses from one group company to another.

Under the TLIP rewrite, section 80G became Division 170-A of the ITAA97. Likewise, Division 170-B replaced section 160ZP in relation to the transfer of capital losses. This rewrite process went well without any fundamental problems.[42] Division 170 transfers will not be available after 30 June 2002, although a transitional rule that takes into account this relief is available in prescribed circumstances.[43]

Amendments and More Amendments

In recent times, perhaps as a result of the Review of Business Taxation, there is an increasing desire to combat the evil of loss duplication, loss cascading and value shifting. The fundamental source of these mischief is the presence of CGT. This introduced the problem of dual cost bases, which makes possible duplication of loss (and gain). In the face of these mischief, Division 170 is perceived to be inadequate from a revenue risk management perspective. (The division is not perfect to the taxpayers either.) Such concerns have saw to the introduction, at an alarming rate, of a series of new (and highly complex) provisions in the tax legislation. A broad survey of these new measures is as follow: -

Tightening of Continuity of Ownership Test. The continuity of ownership test in Division 165 has been "strengthen" making it more difficult to satisfy then ever.[44] The satisfaction of the test now requires continuous ownership throughout the "ownership test period", that is from the loss year to the end of the income year.[45] In addition, under the "same share test", exactly the same share must be held by the same person in order for the share/ interest to be counted. Perhaps recognising the harshness of these provisions, so called "saving" measures were also added that are supposed to provide some relief in terms of satisfying the COT in situation where there are likely

---

[41] Section 80G was inserted into the ITAA36 by the *Income Tax Assessment Act (No. 4) 1984* and applies to losses incurred in the year ended 30 June 1985 and subsequent years.

[42] Baxter, T. "Tax Reform - A Seasoned View" (2000) 71 Charter 28.

[43] Ie. the value donor rule. See page 14. Although subdivisions 170-A and 170-B will continue to apply to a transfer of tax losses or net capital losses in situation where one of the companies is an Australian branch of a foreign bank. These latter exception is added by the Third Bill.

[44] These amendments were made under the *New Business Tax System (Integrity and Other Measures) Act 1999* and became operative as of 21 September 1999.

[45] Section 165-112(1).

to be no (or limited) tax mischief. The saving rule broadly states that if less than 50% of the underlying company loss contributed to the loss in the interest held and disposed, then the same share test will not apply. However, ironically, the saving measures are themselves next to impossible to apply in practice.[46]

Loss Duplication Due to Unrealised Losses. Sub-division 165-CC[47] has been inserted into the ITAA97 in 1999 to target situation where there are changes in ownership and there are unrealised losses in the company. These provisions require the taxpayer to apply a complex array of tracking rules regarding assets owned by the taxpayer whenever there is a change in ownership or control.

Inter-Entity Loss Multiplication. This is followed closely by the addition of subdivision 165-CD, which primarily aims to eliminate the inter-entity loss multiplication problem caused by the existence of a dual cost base in a company. Such loss multiplication is said to undermine the "integrity" of the tax system by turning a single economic loss sustained by a company into multiple tax benefits for taxpayer holding an interesting in the company.

These provisions are exceeding complex,[48] arguably unfair in operation and methodologically incomplete.[49] The broad definition adopted means that even a highly profitable company can be a "loss company" for the purpose of this sub-division. Even "trading stock loss" is within the ambit of the provisions. The application can be very vague as, for instance, adjustment under these provisions is whatever is "appropriate" having regard to certain listed factors.[50] Many commentators have pointed out that the adjustments are one-sided: cost base reduction inevitably exceeds cost base increases.[51] All these only add to the compliance burden on taxpayers, as well as yielding potentially inappropriate tax outcomes.

Duplication of Capital Losses. At the same time, subdivision 170-C was inserted.[52] This subdivision operates retrospectively from 22 February 1999 (with some rules to apply from 13 April 2000). The main objective of these provisions is to prevent

[46] Baxter, T. "Tax Loss Provisions: Lost in a Maze" (2000) 35 TIA 186.

[47] These subdivisions were first introduced under the *New Business Tax System (Integrity and Other Measures) Act 1999*, but were extensively amended by the *New Business Tax System (Miscellaneous) Act (No. 2) 2000*. Even though Royal Assent was only received on 30 June 2000, these provisions applied retrospectively from 11 November 1999.

[48] For a good paper describing these provisions, see Ferrier, M. (2002) "Aspect of the operation of the loss integrity measures", an Unpublished paper.

[49] See Baxter, T., *op. cit.* at p190, 195.

[50] See illustration in De Zilva, A. "Transfer of Company Losses Within Wholly Owned Groups" (2001) 36 TIA 238.

[51] Baxter, T. (2000), *op. cit.* at 29; and De Zilva, A. *op. cit.*

[52] By the *New Business Tax System (Integrity and Other Measures) Act 1999* and significantly amended by the *New Business Tax System (Miscellaneous) Act (No. 2) 2000.*

duplication of capital losses within wholly owned group as a result of transfer between group members. These provisions may become superfluous after the consolidation regime; although it would continue to have operation for groups that do not choose to, or is not eligible to, consolidate.

Capital Losses in Linked Group. Subdivision 170-D was also added to the legislation by the above mentioned legislations. These provisions address transactions between members of so called "linked group" or "connected entity". Effectively, these provisions deem disposal of asset at a loss to so called "linked" company, or "connected" trust, to be a tax avoidance transaction such that any deduction or capital losses would be denied until the assets leave the linked group or the linked group ceases to exist.[53] This provision "is difficult to justify in terms of anti-avoidance…[as] companies do not habitually sell assets to partly owned entities in order to crystallise capital losses for tax purposes…"[54]

LANDSCAPE POST- CONSOLIDATION

With the introduction of the consolidation regime the treatment of tax losses in Australia is once again modified. The old rules still exist (except a few that will be phased out)[55], but superimposed on these rules are a series of new rules regarding losses. These rules deal with two main aspects: (i) bringing losses into a consolidated group, and (ii) using those losses within the consolidated group. The mechanics of these rules are summarised below before turning to consider the purpose of these rules in light of the overall policy framework.

Transferring Tax Losses to Consolidated Group

Rules governing the transfer of losses to a consolidated group are contained in subdivision 707-A. These rules determined whether losses[56] of the joining entity can be brought into the consolidated group, or, whether they are cancelled.[57]

The general principle is that a loss may only be transferred to the consolidated group if the loss could otherwise have been used outside the group by the entity seeking to transfer it. The stated policy aim behind the transfer rules is thus to minimize, if not

[53] Of course, there are further extensive rules that governed what comprises a linked group, and rules that deal with deem linking, de-linking and re-linking.

[54] Baxter, T. (2000), *op. cit.* p194.

[55] This includes, for example, Sub-division 170-D, which deals with the transfer of tax losses between members of wholly owned group. This rule is currently scheduled to be abolished from 1 July 2004. See also footnote 43.

[56] Losses in this regard cover: revenue tax losses (including film losses), net capital losses, and foreign losses. Refer to sections 707-115(1) and 707-1(4).

[57] Losses that do not satisfy the transfer tests are permanently cancelled and will never be used by any entity. Section 707-105(2). Also, a head company can also choose to cancel (irrevocable) the transfer of a loss (s707-145 and s707-150).

eliminate, any potential to accelerate loss utilization through consolidation. However, it seems that the practical operation of the rules – through a modified continuity of ownership and same business tests[58] – is achieving more than this.

The existence of such transfer tests has inserted additional complexity to the tax regime. In applying these modified COT and SBT rules the taxpayers are required to make a series of "assumptions" so that the existing rules can work properly, as well as to apply these rules to different time frame (ie. test time) than under the existing rules. All these rules have added to the complexity and confusion. For instance, a new concept of the "trial year"[59] is introduced as a result; and to complicate the situation, the SBT testing time varies depending on whether the losses is pre or post 30 June 1999. This concept of "trial year" is designed to fortify the integrity of the test by ensuring that there is a minimum of 12 months to apply the same business test.

This preoccupation with the integrity of the tax system is littered throughout the new measures, adding further to the complexity. For instance, whilst a transferred loss is generally taken to have been made by the head company for the income year in which the transfer occurs;[60] however, where a debt of the head company is forgiven (in accordance with Subdivision 245-B in Schedule 2C to the ITAA 1936) in the income year in which the loss transfer occurs, subsections 245-105(5) and (6) apply as if the head company made the transferred loss for an earlier year.[61] This ensures the loss can be reduced by the net forgiven amount of the debt as only prior year losses can be reduced under the debt forgiveness rules.

Consistent with the single entity principle and the inherited history rule, a transferred loss is taken to have been made by the head company to which it is transferred.[62] The head company may either use the loss in working out its taxable income or transfer it to another group of which it becomes a member in the future. The transferred loss is no longer taken to have been made by the joining entity, and hence, the joining entity may never use the loss even if the joining entity leaves the group. A newly added section 707-410 makes it very clear that notwithstanding the so called "exit history rule", the losses remained with the head company and cannot be taken away by the

---

[58] These tests are collectively referred to as "transfer test" or "gateway test".

[59] The 'trial year' is the period commencing the later of: (s707-120(2))

- 12 months before joining time;
- the time the joining entity came into existence;
- the time the joining entity last ceased to be a subsidiary member of a consolidated group if the joining entity had been a member of a consolidated group before joining time but not a member just before joining time

And end just after joining time.

[60] Subsection 707-140(1).

[61] Subsection 707-140(3).

[62] Subsections 707-105(1) & 110(1), 707-140(1).

leaving entity.[63] This effectively creates a "lock-in" effect that restricts the mobility of tax losses within the system.

Utilisation of Losses

The transfer tests noted above are but the first hurdle. The fact that losses can be transferred into the consolidated group need not mean that they can in fact be used (at least not freely).[64] The legislators have imposed a limit on the rate at which these losses can be used by the group. The general principle is that transferred losses are to be used at a rate that approximate the rate that it would otherwise be used up had the loss entity remain outside the consolidated group.[65]

The principle sounds simple, but its mechanics is less than user-friendly.[66] Transferred losses can only be offset against a fraction of the head company's income and gains.[67] The usage restriction is achieved through a device called the "available fraction" (AF).[68] Available fraction is a proxy for the income generating capacity of the transferor relative to the income generating capacity of the joined group. It is determined on the assumption that the market value reflects the capacity to generate income or gain in the future.[69] To work out the maximum amount of losses recoupable by the head company in respect of each sort of losses within the different bundles, the AF is multiplied against the relevant category of taxable income of the head company (ie. the consolidated income of the group). The AF would also need to be recalculated or adjusted where certain adjustment event occurs.[70] It is interesting to note that this adjustment is one-sided and do not apply to head company capital reductions or when loss entities leave the group (even thought the sale proceed may not equal the market value originally adopted.)

Anyhow, the process is complex.[71] The compliance and resources involved in practice to apply these rules cannot be underestimated. Indeed, valuation exercise involved as part of the AF computation adds to the complexity and compliance costs. Further, all

---

[63] This section was specifically inserted by *New Business Tax System (Consolidation and Other Measures) Act (No. 1) 2002* to make this point very clear.

[64] The existing loss recoupment requirements (ie. those in Divisions 165, 166) must also be satisfied. Further, the application of these requirements to a consolidated group is not without difficulties. See below.

[65] Section 707-305.

[66] The very detailed rules are contained within Sub-division 707-C of ITAA97.

[67] Section 707-310.

[68] This was referred to as the "entity loss factor" under the first exposure draft, and as the "loss factor" in the second exposure draft.

[69] Refer to formula in section 707-320.

[70] The relevant events are contained within subsection 707-320(2).

[71] Although, with credit to the co-design process, the mechanics provided in the legislation is already much more workable and comprehensible that those originally proposed under the draft consolidation bills.

these computation only determine the AF which merely function to set the tax loss limit. This amount may not be the amount that could be applied against the assessable income. For that it is necessary to consider the amount of transferred losses (for the particular category) that is available, and to consider whether the existing loss recoupment rules have been satisfied. The new rule only adds to the complexities and costs of applying the tax loss measures. Whilst it may provide better "integrity" to the Government, but it imposes a high compliance burden on the taxpayers.

Transitional Rules: Concessions or Nightmares

As is common with new legislation, transitional measures are rampant. Two concessions are provided in respect of the rate of usage of tax losses where the group consolidate before 1 July 2004.[72]

The first is easy to understand. It provides that COT losses incurred before 21 September 1999 can be recouped within three years. This could be more favourable than the rate of utilisation under the AF method. But it seems somewhat ironic that to determine whether this concession produces a more favourable outcome, it is first necessary to compare it with the various alternative scenarios! An added complication is the 21 September 1999 date. Why? This is the time when this concession was announced; it is designed to protect the "integrity" of the system by blocking transactions undertaken to benefits from the transitional rules.

The second concession – the so called value and loss donor rules – may be a concession, but with respect, is more of a nightmare (at least to those unfortunate enough to have to work through the permutation of the various scenario). This concession is designed to recognise the fact that the AF methodology ignores the ability of the entity in question to transfer losses to other entities within the same group under the pre-consolidation regime. This concession achieves this by allowing members of a consolidated group to transfer values and losses amongst each other so as to change the modified market value, and hence, increase the AF. Again, simple to state, but exceedingly complex to do in practice!

Anomalies

Despite the added complexities, the tax loss measures still contain anomalies and deficiencies. The recent changes may provide better integrity, existing anomalies persist. For instance, a known anomaly with the current rules in Division 165 and 166 of the ITAA97 is that unless a company can identify precisely the date on which they have failed the COT, they would not be able to apply the SBT and hence there could be losses that they would not be able to use notwithstanding that the SBT would have

[72] These concessions are contained within a separate Act, the *Income Tax (Transitional Provisions) Act 1997.*

passed had it been possible to apply the test! The COT and SBT are consequently unworkable in relation to a consolidated group.[73] Further, the operation of COT in relation to publicly held company or widely held group is also defective as tracing to ultimate natural person is next to impossible in such cases.[74]

Fortunately, the Government is expected to release a number of options in the near future to address these concerns.[75]

Same Business Test

There are considerable uncertainties concerning the application of the same business test within a consolidated group. This uncertainty stemmed from the drafting of the legislation, and the manner in which the provision is interpreted and applied by the Courts and ATO. This is a practical and ongoing issue. The problem is that it has never been easy (even in the absence of consolidation) to define what the business is in reality and whether any given changes to the business is significant enough to turn it into a different business. In theory, there are three approaches that the Courts could adopt:[76]

1. confine the language to the point where the privilege becomes difficult to use;
2. apply a broad notion of business;
3. case-by-case approach where each case turn on its own facts (ie. in essence a non-test.)

Currently, the same business test is narrowly applied by the Courts. This is seen in the leading case of *Avondale Motors (Parts) Pty Limited*[77]. In relation to the then section 80E, Gibbs J commented:[78]

> "…the words 'same as' import identity and not merely similarity and this is so even though the legislature might have expressed the same meaning by a different form of words. It seems to me natural to read the section as referring to the same business in the sense of the identical business… mere similarity of kind is not enough."

[73] PWC, "Tax consolidation third instalment. But wait, there's more", Article prepared by PWC Australian Tax Services, 26 September 2002

[74] A point recently referred to in a ICAA Submission, para 2.2.6, 23 October 2002.

[75] Assistant Treasurer Press Release C59/02, 16 May 2002, have indicated that measure will be introduce to change the requirement that the COT be failed first before applying the SBT. This proposal has currently not been legislated.

[76] Lounghouse, G., *op. cit.*

[77] (1971) 124 CLR 97.

[78] (1971) 124 CLR 97 at 105- 106.

Curiously, prior to the release of *Taxation Ruling 95/31*, which followed the same narrow approach, the Commissioner appears to have adopted a broader view than would be the case under *Avondale Motors*.[79]

This narrow approach could cause great difficulties for a consolidated group. The difficulties arise on two interrelated level. The first difficulty concerns the identification of the business of the consolidated group. With the consolidated group treated as a single entity for tax purposes pursuant to the single entity rule,[80] how should the business be defined? For a group of companies that are all in the same industry, for example, wine making, the answer is easy.

The question became next to impossible to answer for a group of companies with multiple business lines. Suppose DiversifyCo is the parent company of a diverse resident group. DiversifyCo has a long history of acquisition and divestments in different industries and currently has many subsidiary companies which carry on activities in a range of sectors and at different stages of the production process. It has interests in subsidiaries that produces and distributes wine, produces chemical additives for food processing, a transport company and a finance company. What is the business?

This leads directly to the second difficulties: what degree of changes to the "business" is required to fail the SBT? In the example above, would the disposal of the wine making line means that the group no longer has the same business? For such a diverse group, does it have to be operating in the wine and food additives businesses in order to carry on the same business, or, is it sufficient that it is a group that is and has been dynamic and looks to be in whichever activity gives an acceptable return to stakeholders at that time? The current application of the same business test tends to point towards the former. Under such a narrow view, the simple act of reorganising or rationalising the business could cause the test to fail.

There is currently little guidance on this issue. The ATO is silent as to how it intends to apply the same business test in relation to a consolidated group. Despite that such issues are widely known it is perplexing that they are not properly addressed in the final legislation (although there are further measures to come). So far the issue is merely acknowledged:[81]

> "Generally, the tests are more easily satisfied by individual entities because their business and transactions are relatively stable over a period of time. However, entity group tend to be more diversified in nature with

[79] Gates, S. "'Same Business Test' - Carry Forward of Loss Deduction" (1995) 6 JBFLP 121, and Kirkwood, J. "Tax Issues Arising on Floats" in NSW Intensive Seminar, Taxation Institute of Australia, 28 October 1993.

[80] Section 701-1.

[81] APC, paragraph 26.84, p560- 561.

> a greater likelihood of undertaking new businesses or transactions that could cause them to fail the test."

It is understood that this issue is on Treasury's agenda and is being actively considered. It is hoped that some sensible rule will emerge. What is needed is legislation that isolates the same business test to the legal entity, or the same business test conditions need to be amended.[82] In this regard the Board of Review has previously noted in the APC that the SBT should not be relaxed to the stage that it became effectively a "similar business test" as this would "go well beyond the policy rationale for the SBT" and could extend the current limited exception to most acquisitions of loss entities outside consolidated groups.

New Deficiency

Whilst the intra-group dividend trap issue disappear under consolidation (due to the fact that intra-group transactions are ignored for tax purposes), external entity dividends could present an issue. The problem is that the dividend would work to reduce losses otherwise available in the group first, and hence resulting in wastage of tax losses![83]

Some Light in the Darkness

Amongst the complexities and anomalies, there are a few pleasant surprises (which some may refer to as opportunities) in the tax loss landscape.

1. Access to Trapped Losses

The consolidation transfer rules provide access to losses that may otherwise be trapped in a subsidiary in situation where the losses cannot be transferred under Division 170. This is best illustrated by way of an example. Suppose LossCo incurred a tax loss of $1,000 during the 1998 income year. LossCo became a wholly owned subsidiary of HoldCo on 1 July 2000. A consolidated group comprising of the HoldCo and LossCo was formed on 1 July 2002.

Under pre-consolidation loss transfer rules, both the loss company and the income company must be related for the period from the start of the loss year until the end of the year in which the losses are to be recouped under Sub-Division 170-A. Consequently, because LossCo and HoldCo were not members of the same wholly

[82] ICAA Submission on 23 October 2002, para 2.2.1.

[83] The Government recognised this issue and has proposed to introduce measure to prevent wastage of current year loss. See Assistant Treasurer Press Release C59/02, 16 May 2002. There are currently no legislation on this aspect as yet.

owned group during both the loss and income year, LossCo would not be able to transfer the losses to HoldCo under Division 170.[84]

By comparison, under consolidation LossCo would be able to transfer the losses to HoldCo (ie. the head company) as a SBT loss assuming that the same business test is satisfied. This means losses that used to be trapped within LossCo can now be used to offset income in HoldCo. With the consolidation rules, once losses have entered the consolidated group (whether as a COT or SBT losses), the losses are available for use against any income (of the same class) of the group, even if those income are from a newly acquired business or company. This makes it possible to offset existing losses against income generated from newly acquired businesses. For example, if HoldCo, in the example above, acquire NewCo on 1 January 2003, the consolidated income of the group that is attributable to NewCo's income can be reduced by the transferred losses available (subject to available faction limit). However, this outcome may not hold if rules analogous to the income injection test under the trust loss provision is introduced to company group.

Under this scenario, the value donor concession would however not be available because of the inability to meet the existing loss transfer tests. The implication is that the market value of HoldCo cannot be added to the market value of LossCo for the purpose of determining the loss factor for the SBT losses.

2. Refreshing SBT Losses

The consolidation rules operate in such a way that SBT losses are refreshed.[85] There are two aspects to this. First, losses that used to require the satisfaction of the same business test no longer do as SBT losses transferred to the group are taken to have been made by the head company at time of transfer.[86] The recoupment of transferred losses depends on the operation of the existing loss recoupment provisions in Division 165 or Division 166, meaning that the head company must either satisfy the continuity of ownership test, or if that fails, the same business test. Consequently, the head company is not required to compare its business as a head company with the business it carried on as a single entity prior to Consolidation.[87] The EM stated thus:[88]

> "SBT losses are not subject to further business testing in the hands of the head company unless the head company fails the COT or seeks to transfer the loss again."

[84] Refer to section 170-30.

[85] This seemingly generous concession is driven by the inherent difficulty in terms of devising rules to ensure that the same business test could apply to losses incurred before consolidation.

[86] Subsection 707-140(1) of ITAA97.

[87] Section 707-400.

[88] Paragraph 6.105 of the first Act.

Second, the continuity of ownership is tested from the time of consolidation (ie. time of transfer) to the end of the income year in which the losses are to be used. This conclusion arises because under section 165-12, the relevant "ownership test period" is "the period from the start of the loss year to the end of the income year." Due to the operation of sub-section 707-140(1) as noted above, transfer losses are taken to have been incurred on the date of consolidation. Thus, the starting date for the purpose of the loss utilisation test is from the date of consolidation.

This effectively "refreshes" the losses; changes to the ownership in the head company or the original loss entity before the date of consolidation are ignored. The implication is that the SBT losses transferred into the consolidated group is safe and can be applied against future income of the group unless there is changes to more than 50% of the ownership of the head company by reference to the ownership of the company on the date of consolidation.

This concession means that losses transferred as SBT losses are treated differently to those transferred as COT losses. The latter must still pass the "inherited history COT" (or if that failed, the SBT) before those losses can be recouped by the head company.[89] That is, the head company would need to apply the test to the original loss maker from the start of the loss year to the joining time, and then to the head company from the joining time until the end of the recoupment year.

3. Access to Trust Losses

The new rules provide some scope of transferring trust losses (revenue and capital) to a corporate group. Previously, losses in trust are trapped within a trust. Under the consolidation rules, a trust can transfer its losses to the head company provided the transfer test is satisfied.

However, the practical usefulness of this ability to transfer trust losses is limited in a number of ways. For a start, very limited number of trust is eligible to be a subsidiary member of a consolidated group. The operation of the membership requirements contained within Division 703 of the Act are such that practically only fixed unit trust, and perhaps hybrid trust, can be an eligible entity.[90] Next, even if this hurdle is satisfied, the losses would still be subject to the available fraction limit. Further, attempt to acquire a trust (with tax losses), or otherwise make such a trust wholly owned by the head company, would not provide access to the losses in the trust where the acquisition or transactions result in the failure of the 50% stake test. Unlike the

[89] This is due to the operation of the inherited history rule in section 701-5. The treatment of SBT losses is an exception to this rule.

[90] To be eligible all of the beneficiary or discretionary objects of the trust must be members of a consolidatable group. A pure discretionary that typically have individual discretionary objects, or charity as discretionary object, would not be eligible. See also paper by Munro, K. "Trust Planning", Seminar Paper, Taxation Institute of Australia, 6 June 2002.

case of the company in a similar situation, the same business test is not available as a transfer test.

Comparison with Tax Policy Framework

The problems sought to be addressed by the amendments noted in the previous section arise largely because of the different tax treatment between a group of subsidiaries and divisions within a single company. Consolidation in this sense is thus seen as the cure: by treating all the entities as one, it eliminates the source of the problem. The APC considered that the removal of the formal requirements for loss transfer would reduce complexity and lower compliance costs.[91] Further, by preventing loss cascading and loss duplication, consolidation is said to promote equity.[92]

At this stage of the evolution of the tax system, it is not clear that the objectives set out by the Review of Business Taxation have been met. If the aim is to reform business taxation so as "to ensure maximum simplicity, certainty, stability and voluntary compliance as well as lowest system operating costs",[93] then it would seem to have fallen far short of its goal.

Whatever definition of simplicity is adopted, the tax loss rules are not simple. An exceptionally voluminous quantities of legislations have been released within a very tight time frame to target concerns such as deductibility of carried forward losses, inter-entity losses, unrealised losses and transfer of tax losses. This was followed closely by the consolidation regime with its own multifaceted variations to the tax loss rules. The result is an assortment of new complex rules, with various starting dates; and on top of which there are the transitional rules, which spelt out a world of its own. This is not simple. As one writer said:[94]

> "The pace and extent of reform of the rules for claiming the tax losses of an entity to prevent the "duplication" of tax losses has added to a significant layer of complexity to legislation already requiring caution and diligence in its application."

Even in the absence of consolidation, the provisions are so bloated and complex that it is barely comprehensible, let alone capable of being applied with any degree of certainty. Indeed, it is probably correct that "other than a restricted group of officers

---

[91] APC, paragraphs 25.7 and 25.9.

[92] APC, paragraph 25.17. Also refer to Recommendation 15.1 in ATSR and paragraph 2.3 of the EM to the *New Business Tax System (Consolidation) Act (No. 1) 2002*.

[93] ASF, p62.

[94] Carpenter, S. 'Changing the Concept of Ownership" (2000) 4 The Tax Specialist 106.

within the ATO it is doubtful that there is any understanding of the actual operations of these provisions."[95]

Trade off between the various policy objectives are inevitable. Although simplicity is perhaps not achievable in an inherently complex economic system, but as the Board of Review have said, additional complexity should be justified by improvement in equity or economic growth (ie. the other two aspect of the national objectives).[96] It is submitted that the satisfaction of these goals are doubtful, and may not provide an adequate explanation of the real purpose behind the new rules. The introduction of amendments to address a limited number of mischief seem hardly justifiable. The measures are often heavy-handed and broad (and often without safeguard of requiring a tax avoidance purpose). They could potentially catch many innocent, or perhaps even perfectly legitimate, commercial transactions. Further, attempt to structure transaction to avoid falling into these provisions may result in irrational economic behaviour.[97] It is difficult to see how these rules can lead to better economic growth.

So are there any other policies or rationale that may explain why the treatment of tax losses (especially in a consolidated group) is the way it is today?

THE REAL PURPOSE

Integrity (aka Anti-Avoidance)

On one view, it seems that anti-avoidance, or "integrity",[98] is the driver behind the recent spate of changes to the tax loss rules, including those under consolidation, in Australia.

The amendments introducing the same shares test, the loss duplication and multiplication provisions are said to strengthen the integrity of the tax loss measures. Such activities are undertaken to avoid tax, and consequently undermined the revenue. It is thus reasonable that the measures are driven by the desire to control tax avoidance behaviours. Although it seems that the ATO would disagree as seen from the following statement issued by the ATO in relation to the September/November 1999 "loss integrity" measures:[99]

---

[95] Williams, D. "A Background to the New Consolidation Regime - How did we end up here?" in Taxation Institute of Australia (2001), 15 February 2001.

[96] See ATSR, p105.

[97] Baxter, T., *op. cit.*

[98] The term "integrity" seems to have been used as an euphemism for the word "anti-avoidance" in recent years.

[99] Australian Taxation Office, Workshop Discussion Paper: The 'loss integrity' measures: topical issues and frequently asked questions, Corporate Tax Association workshop, 24 November 2000, paragraphs 1.10 and 1.11, p. 4.

> "The measures address structural flaws in the tax law and thereby add to its integrity. In the context of losses, "integrity" means that a loss is recognised only once by the tax system except where there is a clear policy to allow a loss that may be a duplicate (for example where a company loss is available to individuals on the disposal of equity in a company and also to the company on satisfaction of the same business test).
>
> Integrity measures are not *anti-avoidance* measure; "integrity" is not a substitute term for 'anti-avoidance'. The measures are not directed at particular tax avoidance activity or schemes. Nor do they require for their application any purpose of tax avoidance, whether objective or subjective. They are not intended to prevent or hamper legitimate business transactions. What the measures *are* about is ensuring that the structure of the tax law is right so that the *tax outcomes* of transactions are also right."

This view has been criticised by a learned author as being contrary to the reality of the situation – notably that the continuity of ownership test (which lays the foundation of these subsequent measures) is itself anti-avoidance in nature and the reference by the ATO that these provisions are not contingent on a purpose test is contrary to the fact that there is a purpose requirement in Subdivisions 165-CC and 165-CD.[100]

Even the tax losses measures within the consolidation regime are arguably driven more by tax avoidance concerns than by the desire to provide more economically efficient, equitable or simple tax system that facilitates the competitiveness of Australian business enterprises. Despite the emphasis on achieving the latter goals, problems with loss cascading and loss duplication have also repeatedly been cited as amongst the dominant drivers behind the consolidation regime.[101] The aim is to eliminate the fundamental cause of these unwarranted outcomes: the existence of dual cost bases in the form of equity interests and underlying assets. As one author has stated:[102]

> "The ultimate irony is that what was originally discussed by the Asprey Committee in the context of tax reform to provide additional equity to the then system of taxation, now comes forward as an anti-avoidance and revenue raising measure (although the general principles and the recommendation for consolidation perceived by the Ralph Committee as

[100] Ferrier, M. "Aspects of the operation of the loss integrity measures", an unpublished paper, 13 March 2002. The anti-avoidance background of the continuity of ownership test is outlined above on page 3.

[101] Refer APC, paragraphs 25.3- 25.5. Also ATSR, p517.

[102] William, D., *op. cit.*

> providing "major advantages to entity group" this is not the reason for its introduction)."

Loss Containment

Whether the rules are referred to as anti-avoidance or integrity measures, one outcome is clear: the tax environment is being slowly transformed such that the abilities to claim tax losses by corporate group is becoming a rarity due to the significant restrictions imposed, both as part of the consolidation regime and as part of the changes made shortly before consolidation. Although pocket of "opportunities" exist (which could yield beneficial outcome if the situations are right), these are in the minority. The policy rationale of equity, efficiency and simplicity may often have been cited as the basis for reform of the tax system; yet, it is submitted that the real drivers of reform are not even remotely close to such economically rational objectives.

The tax system of Australia "display the properties of elasticity, complexity and invisibilibility" that is the hallmark of politically self-interest behaviours.[103] That is, in order to dissociate the link between taxing people, which is inherently unpopular, and their decisions, politicians will tend to prefer a tax system that is complex and invisible such that they could effectively tax people without their knowledge.[104] Politicians do not want to be seen as the one responsible for delivering a tax increase. The consolidation regime and in particular, the treatment of tax losses both before and after the consolidation regime commenced, underscores this point. As shown in the above discussion, the rules governing tax losses are exceedingly complex. Pre-consolidation, the tax loss rules are already complex; consolidation, not only did it not simplify the rules, introduces an additional thick layers of, at times, mind-boggling rules and exceptions.

A better explanation of the motive behind the recent reforms and amendments is the desire to restrict or contain the availability of losses in the system. This objective is "not about getting a fairer, simpler system of taxation, it is about the government seeking to manipulate the revenue."[105] This is not surprising given that there are estimated some $40 to $50 Billions of unused tax losses in Australia. Obviously, this represents a potential major leakage from government revenue, one that is hard to control and difficult to predict from year to year. To address this, an easy solution is

[103] See Blount, S. "The Art of Taxation" (2001) 16 Australian Tax Forum 345. The author noted that an economically rational tax system have the characteristics of simplicity, transparency and fairness; whereas, politically rational tax system are complex and opaque and are only "fair" to the extent that the fairness translate to electoral majority.

[104] Blount, S., *op. cit.*

[105] Baxter, T., *op. cit.*

to legislate to reduce the amount of losses available or otherwise seek to control its usage![106]

All the recent amendments are doing precisely this; they are progressively eroding the taxpayer's ability to claim tax losses. Take the "same share" test for instance. This is a test that is relevant to a number of tax loss measures: in the application of the continuity of ownership test in determining whether prior year and current year losses (revenue or capital) could be claimed;[107] determination of whether a "changeover time" has occurred in relation to unrealised losses;[108] and determination of whether an "alteration time" has occurred in relation to the inter-entity loss measures.[109] In broad terms, this test requires the same owner to own exactly the same share throughout the relevant ownership period.[110] The applications of the same share test are harsh and represents a severe restriction on the ability of subsidiary companies of public company group to demonstrate that the test have been satisfied,[111] and hence effectively wiping out the losses that could otherwise be used by the company group. Moreover, even though the same share test does not apply to listed public companies, the test does apply to the shares that such a listed company owned in a private company.

Although there are "saving provisions" in Division 165 and 166 of ITAA97 that seek to lessen the impact of such rules in certain situations,[112] the complexity and uncertainties these rules introduced are themselves a source of concern. These "saving provisions" essentially require the company to demonstrate somehow that there has been no substantial duplication of tax losses within the company group.[113] These provisions are vague and are open to interpretation.

Even the rule pre-consolidation is leaning towards restricting tax losses. A particular requirement under the loss transfer provisions is interesting and supports the point that a hidden agenda of the government and the ATO is to curtail the ability to claim prior year losses. The transfer provision requires that losses be transferred pursuant to a written agreement that must satisfied certain requirements, one of which is that the amount of tax losses being transferred must be specified. This requirement often presents practical problems: sometimes the quantum of losses or income made by the

[106] Baxter, T., *op. cit.*

[107] Refer to section 165-12 of the ITAA97.

[108] Refer to section 165-115C of the ITAA97.

[109] Refer to section 165-115L of the ITAA97.

[110] Subsection 165-165(1) of ITAA97.

[111] Carpenter, S., *op. cit.*

[112] For example, refer to subsections 165-12(7), 166-170(8), 165-37(4), 165-115C(4), 165-123(7) of the ITAA97..

[113] Carpenter, S., *op. cit.* The test is framed in terms that requires the company to have information from which it would be "reasonable" to draw certain conclusion. But what is reasonable? The standard is unclear.

income company may not be known with certainty. The amount may change; for example, the taxable income may need to be revised upward if the company discovered amount that should have been include and put in an amended tax return. The use of an agreement that "self-adjust" seem to be the practical answer, but the ATO in *Taxation Ruling TR 98/12* regard such "formula document" as unacceptable. This was subsequently confirmed by the Courts in *Harts Australia*[114]. The focus on the form, rather than the substance, is unfortunate.[115] This restriction on the ability to transfer tax losses to group company effectively renders the already limited form of group consolidation even more limiting than it is.

The recently introduced consolidation regime also function to erode the tax losses within the system. Significant restrictions are placed on the amount of losses that can enter a consolidated group and restrictions are also placed on the rate of loss utilisation. Such restriction may be explained on the basis of promoting equity in that a consolidated group should not be given an advantage as against companies that have not been consolidated. It also guards against trafficking, and hence, contributes towards neutrality. Yet, the restrictions imposed are more explicable by the desire to restrict the amount of losses in the system. The underlying theme is one of containment – to place a limit on the amount of losses that can enter into a consolidated group and to limit the rate those losses could be used. So important is this goal of loss containment that the legislator is willing to depart from the framework behind the consolidation regime; instead of adhering to the single entity rule and the inherited history rule, the tax loss rules depart from it.[116]

There is no logical or policy reason for such restrictions, other than this containment motive. This point is underscored by a quick comparison of the Australian rules to the New Zealand consolidation provisions. New Zealand introduced an elective consolidation regime that operates from 1 April 1993. Unlike the Australian approach, the New Zealand system enables losses to be transferred outside the consolidated group. It is possible for a company to transfer losses to a consolidated group or to receive a transfer of losses from a consolidated group. Further, pre-consolidation losses are kept separate in the group member that incurred them, but can be subsequently transferred to the consolidated group for use by it. This seems nice and simple compared to the extremely complicated loss transfer and recoupment rules under the Australian system. The difference is arguably attributable to the fact that the New Zealand legislation was not originally introduced as a tax avoidance (integrity) measure, whereas the Australian system is.

---

[114] *Harts Australia Pty Limited v Commissioner of Taxation* [2001] FCA 1188.

[115] Richards, R. "Grouping of Company Losses" (2000) 70 Australian CPA 62.

[116] Ie. The introduction of the restriction is contrary to those principles. The EM to the First Act acknowledged this; paragraph 6.7 therein states that to the extend that the transfer test and loss utilisation rules are inconsistent with those principle, the principles are overridden.

In Australia, the seed for the loss containment idea can be found in the original consultation document. The options put forth in the APC mostly involve restrictions on the usage of tax losses (some more so than other).[117] Some proposals effectively denied the ability to bring carry forward losses into a consolidated group. The loss containment motive is evidenced most clearly by the following statement in the ATSR:[118]

> "[d]ue to the very large amount of SBT losses in the tax system, it is not possible to allow all SBT losses into a consolidated group. The cost to revenue would be too large."

Under the ATSR, losses that satisfy the COT could only be brought into the consolidated group immediately to the extent that the losses relate to the group's interest in the entity at the time the losses were incurred. The balance is to be brought in over a period of five years.[119] And SBT losses can only enter a consolidated group subject to even more onerous limits.[120]

The concept of the "available fraction" in the final legislation has departed (in a favourable way) from the original recommendation as it was recognised that the original recommendation would be inequitable in some situations.[121] However, this is at the cost of losing the flexibility to exclude subsidiary entities from the consolidated group.[122] This serves to further limit the ability of corporate groups to retain tax losses. Furthermore, the quick cut-off dates for the transitional concessional measures tend to put pressure on taxpayers to consolidate early, and hence, further accelerating the erosion of losses in the system.

CONCLUSION

Setting economic efficiency, equity, and simplicity as the "national objective" in business tax law design sounds impressive; however, the reality is that these policy objectives have little impact on the tax legislation. In fact, "[r]ather than maximising simplicity and efficiency subject to some normatively derived equity constraint, contemporary taxes are extraordinarily complex, expensive to administer and often appear to violate the most basic principles of equity."[123] In the realm of tax losses, this is clearly the case.

---

[117] Refer to Ch 26.

[118] ATSR, p525.

[119] Recommendation 15.3 (a) in ATSR.

[120] The limits are: total SBT losses must not exceed the less of $10 Million or 5% of equity in the entity; and SBT losses to be brought in over five years. See Recommendation 15.3 (b) in ATSR.

[121] Paragraph 8.4 of the EM to the First Act.

[122] Recommendation 15.3(c) allows the consolidated group to choose to exclude entity from the group in certain cases.

[123] Blount, S., *op. cit.* at page 346.

The recent shift in the tax loss landscape is more explicable by the desire to erode the availability of tax losses in the system. That this is a motive behind the changes is no secret; except that it is not something that have been emphasised much by the Government. This goal tends to be hidden by the noble crusade against tax avoidance, which is itself dressed up as “integrity” measures. The “national objectives” provide a further layer of disguise. The effect is that the availability of tax losses in the system is gradually, but surely, eroding. It is perhaps curious that despite the noise and the protest against the so called Option 2 and the Entity Tax Regime, there are little fuss about the changes introduced by the government in relation to tax losses. Yet, the consequences could be as serious. The only difference is that the effect is less apparent and takes longer to detect.

BIBLIOGRAPHY

Baxter, T. 'Tax Reform - A Seasoned View' (2000) 71 Charter 28.

Baxter, T. 'Tax Loss Provisions: Lost in a Maze' (2000) 35 TIA 186.

Blount, S. 'The Art of Taxation' (2001) 16 Australian Tax Forum 345.

Carpenter, S. 'Changing the Concept of Ownership' (2000) 4 The Tax Specialist 106.

Commonwealth Tax Review Committee *Asprey Report*, AGPS, Canberra, 1975.

De Zilva, A. 'Transfer of Company Losses Within Wholly Owned Groups' (2001) 36 TIA 238.

Evans, C. 'The Australian Capital Gains Tax: Rationale, Review and Reform' (1998) 14 Australian Tax Forum 287.

Ferrier, M. 'Aspect of the operation of the loss integrity measures' an Unpublished paper, 2002.

Gates, S. '‘Same Business Test’ - Carry Forward of Loss Deduction' (1995) 6 JBFLP 121.

Gonsalves, J. 'The Impact of Losses' (2001) 35 TIA 453.

Institute of Chartered Accountant of Australia, Submission regarding New Business Tax System (Consolidation, Value Shifting, Demergers and Other Measures) Bill 2002, 23 October 2002, <http://www.icaa.org.au/tech/index.cfm?menu=163&id=A105244242>

Kenny, P. 'A “Simplified Tax System” for Small Business' (2002) 6 The Tax Specialist 36.

Kirkwood, J. 'Tax Issues Arising on Floats' in NSW Intensive Seminar, Taxation Institute of Australia, 28 October 1993.

Lounghouse, G. 'The “Same Business” test and Cleopatra’s Ark' (1999) 28 ATRev 4.

Munro, K. “Trust Planning”, Seminar Paper, Taxation Institute of Australia, 6 June 2002.

Ralph, J. Review of Business Taxation, Final Report, *A Tax System Redesigned* (1999), AGPS, Canberra.

Ralph, J. Review of Business Taxation, Second Discussion Paper, *A Platform for Consultation* (1999), AGPS, Canberra.

Ralph, J. Review of Business Taxation, First Discussion Paper, *A Strong Foundation* (1998), AGPS, Canberra.

Raphael, D. 'The New Corporate Tax Loss Provisions of 2000: Division 165 of the Income Tax Assessment Act 1997' (2001) 30 ATRev 61.

Richards, R. 'Grouping of Company Losses' (2000) 70 Australian CPA 62.

Rosenblum, R. 'Loss Transfers' (1996) 25 ATRev 160.

Spences, K. 'Consolidations and Losses' (1999) 34 TIA 244.

Stiglitz, J. *Economics of the Public Sector* (1988, 2nd ed), W Norton & Co, New York.

Thuronyi, V. *Tax Law Design and Drafting: Volume 2* (1998), International Monetary Fund, Washington, DC..

Trajer, K. 'Consolidations: Losses' in Conference Paper (2002), Taxation Institute of Australia, 12 March 2002.

Tran-Nam, B. 'Assessing the Revenue and Simplification Impacts of Government Tax Reform' [1999] Journal of Australian Taxation 329.

Waincymer, J. *Australian Income Tax Principles and Policy* (1993, 2nd ed), Butterworths, Sydney.

Williams, D. 'A Background to the New Consolidation Regime - How did we end up here?' in Taxation Institute of Australia (2001), 15 February 2001.

Woellner, R., Barkoczy, S., Murphy, S. and Evans, C. *Australian Taxation Law* (2002), CCH, Sydney.

TAX LOSSES: AN EXAMINATION OF THE LANDSCAPE PRE AND POST CONSOLIDATION

Raymond Yu

19 November 2002