Amendments to the company loss rules

The Tax and Superannuation Laws Amendment (2015 Measures No. 2) Bill 2015 introduced into Parliament on 24 June 2015 contains some long-awaited and important changes to the company loss rules. This Tax Brief outlines how they will operate.

Unequal share structures

The key change proposed in the Bill amends how the current continuity of ownership test (COT) will operate for companies with multiple classes of shares. This measure was originally announced in the 2007-08 Federal Budget. An Exposure Draft of these measures was released in 2009 and, while the proposal survived the cull of unenacted measures in November and December 2013, it has still taken 6 years for that Exposure Draft to be finalised and introduced into Parliament.

In general terms, the COT rules insist that, if a company wishes to deduct various kinds of losses, it must demonstrate that the same ultimate owners held at least 50% of certain rights in the company from the start of the loss year to the end of the year in which the loss is to be used. Meeting this test requires tracing through intermediate shareholdings held by other companies, trusts and other entities. The required level of continuity must be demonstrated separately for dividend rights, capital rights and for voting rights in the company. Variations on this formulation exist for widely held companies, if the losses in question are unrealised losses, and in certain integrity rules in Division 175.

It has long been acknowledged that there are difficulties applying the COT to companies with unequal share structures – that is, if share classes carry different dividend, capital or voting rights or if shares carry discretionary rights. 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.

The amendments will apply with retrospective effect from 1 July 2002.

Dividend and capital rights

If some of a company’s shares carry different (or discretionary) dividend or capital rights, and as a result the company is unable to determine whether it has maintained sufficient continuity of dividend or capital rights, the company will be able to test continuity of ownership using one of three other methods. (Different rules will apply for testing continuity of dividend and capital rights, as opposed to voting rights.)

The substitute methods must be applied sequentially – ie, method 2 can only be applied if the company cannot determine whether it maintained continuity after applying method 1 and so on. The three methods are:
1. if the company is unable to demonstrate continuity of dividend and capital rights, it can re-test disregarding the effect of any shares on issue that are debt interests under the debt-equity tests;

2. if the company is still unable to demonstrate continuity of dividend and capital rights, it can re-test disregarding the impact of any ‘secondary share class’ on issue. For the purposes of this test, a class of shares is a ‘secondary share class’ only if it represents 10% or less of the market value of all of the company’s shares on issue (excluding debt interests). This test is only available if the value of all secondary share classes is 25% or less of the market value of all the company’s shares (excluding debt interests); and

3. finally, if the company is still unable to demonstrate continuity of dividend and capital rights, it can re-test using either the market value of the shares (other than ‘secondary share class’ and debt interests) as the basis for determining ownership, and if it is not reasonably practicable to work out the market value of the remaining shares, or if the total market value of the remaining shares is nil, then on a reasonable basis having regard to certain listed factors.

These alternative options are only available if the company is unable to determine continuity under the current rules. To put this another way, once it has been demonstrated that a company has failed to maintain sufficient continuity under the ordinary rules, it cannot seek to apply these options to resurrect the entitlement to use its losses.

In relation to method 2, the Explanatory Memorandum states that any secondary share class which was on issue during the test period but was redeemed before the relevant test time cannot be disregarded. It seems that the reason for this requirement that the secondary share classes remain on issue at the relevant test time is because the market value tests will be applied based on market value at the test time. As a result, any company that has difficulties applying the test because of the existence of a secondary share class which was redeemed before the end of the relevant test period will need to apply method 3.

Companies applying method 3 are only required to test the continuity of dividend or capital rights (as applicable) at specified times (including just before and just after the issue or redemption of any shares of a remaining class, or the variation of dividend or capital rights or any remaining shares), rather than continuously as is generally required for non-widely held companies.

**Voting rights**

Different rules apply for testing continuity of voting rights. If a company’s shares do not all carry the same voting rights or if the company’s shares do not carry all of the voting rights in the company (whether because of the terms of the shares, a shareholders’ agreement or for any other reason), the company will be able to choose to calculate its voting rights based solely on the maximum number of votes that could be cast on a poll for:

- election of a director; or

- an amendment to the company’s constitution, other than an amendment altering voting power or the rights attaching to any of the company’s shares.

The Explanatory Memorandum indicates that a right for a shareholder to appoint a director will give a shareholder voting rights even if the director is appointed without a poll. However, it is unclear how the proposed legislation achieves that outcome given the specific reference to ‘the maximum number of votes that could be cast on a poll’.

Shares which are disregarded in determining dividend or capital rights are not disregarded for testing continuity of voting rights.
Choice requirement

The Bill requires a company to choose to apply the alternate methods for determining dividend, capital or voting rights outlined above. Although the Bill states that a company’s tax return will be sufficient evidence of the choice, it is unclear how the choice requirement will apply where the changes are being applied retrospectively (the rules are backdated to 2002), or in respect of amended assessments.

For example, a company that claimed a deduction for a carried forward loss in the year ended 30 June 2012 could not have chosen to apply the methods set out above to determine whether it satisfied the COT before it lodged its tax return for that year. Therefore the company’s income tax return for that year cannot be evidence of the company having made the requisite choice. If the ATO formed a view that the company did not satisfy the COT for the year ended 30 June 2012, what, if anything, would the company be required to do to enable it to rely on the alternative methods?

Same business test and tax consolidation

The same business test currently insists that a company must, in the current year, continue to carry on the business that it carried on at an earlier point of time, and that it will not be carrying on ‘the same business’ if it earns income from a ‘transaction of a kind’ or a ‘business of a kind’ that it did not undertake before that time.

For consolidated groups, the law then rather cryptically provides that the tax consolidation ‘entry history rule’ does not apply for the purposes of the ‘same business test’ – which seems to imply that the ‘business’ being tested is just the head entity’s business, not a business which includes anything done by any of the subsidiary members. This was the intention of the rule when it was inserted: to prevent the head entity of the group from being affected by the subsidiary member’s business history.

However, there has been a concern that on a technical reading of the section, the entry history rule would still apply for the purposes of the ‘transaction of a kind’ and ‘business of a kind’ tests. In practice the ATO has taken the view that the entry history rule does not apply for the purposes of these tests.

The Bill will amend the legislation to reflect that understanding, again with effect from 1 July 2002.

COT tracing rules

The Bill will also amend the rules about when a company can stop tracing through intermediate entities to find the ultimate owners.

Non-widely held companies will no longer have to trace through complying superannuation funds, foreign pension funds, complying approved deposit funds, first home saver account trusts, special companies or managed investment schemes to individual beneficiaries when determining continuity of ownership. (A similar concession already applies in respect of widely held companies.) This amendment will apply for the purposes of the COT, the unrealised loss rules and the company loss and integrity rules in Division 175.

This amendment applies with effect from the 2011-12 income year.
For further information, please contact

Sydney

Tim Kyle
tim.tim.kyle@greenwoods.com.au
phone +61 2 9225 5934

Cameron Blackwood
cameron.blackwood@greenwoods.com.au
phone +61 2 9225 5950

Melbourne

Narelle McBride
narelle.mcbride@greenwoods.com.au
phone +61 3 9288 1715

Perth

Nick Heggart
nick.heggart@greenwoods.com.au
phone +61 8 9211 7593

G&HSF document ID 510615251_1.docx

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

Liability limited by a scheme approved under Professional Standards Legislation

Greenwoods & Herbert Smith Freehills Pty Limited (ABN 60 003 146 852)

www.greenwoods.com.au

Sydney

ANZ Tower, 161 Castlereagh Street, Sydney NSW 2000 Australia
Ph +61 2 9225 5955, Fax +61 2 9221 6516

Melbourne

101 Collins Street, Melbourne VIC 3000, Australia
Ph +61 3 9288 1881 Fax +61 3 9288 1828

Perth

QV.1 Building, 250 St Georges Terrace, Perth WA 6000, Australia
Ph +61 8 9211 7770 Fax +61 8 9211 7755