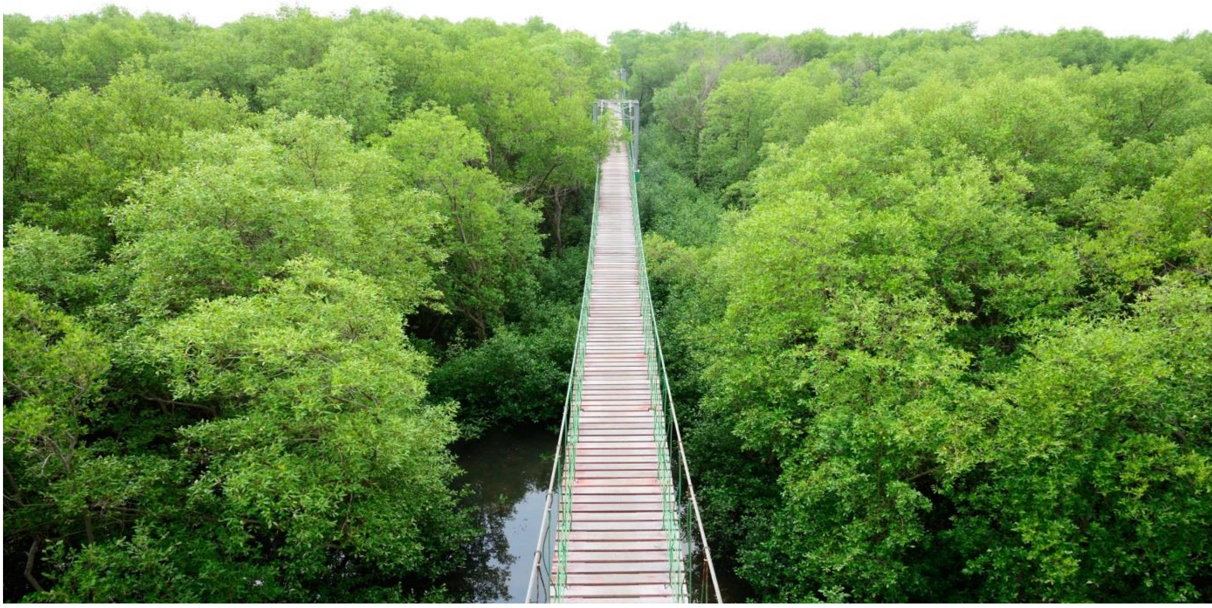
April 2016
2017/04 - Australia

Tax insights
New "similar business test" for loss recoupment



Snapshot

On 6 April 2016, the Government released exposure draft (ED) legislation to introduce a "similar business test" for companies (and listed widely held trusts) to access prior year tax losses. This is further to the 7 December 2015 Government announcement of a package of measures designed to encourage and reward innovation as part of the National Innovation and Science Agenda.

Presently, prior year tax losses can be recouped if the continuity of ownership test is passed, or failing that, the same business test is satisfied. The ED supplements the same business test with a more flexible "similar business test", as an alternative to the same business test.

The amendments are intended to apply with respect to losses incurred in income years starting on or after 1 July 2015.

The measure should apply to all companies and listed widely held trusts.

Submissions on the ED are due by 22 April 2016.

In addition, the Government has also proposed a relaxation of the existing same business test to address the no new business / no new transactions tests. This has not been included in the ED.

Introduction

As part of the “Ideas Boom” within the National Innovation and Science Agenda (NISA) announcement, the Government proposed various measures to encourage and reward innovation. The NISA announcement proposed the following changes in respect of carry forward tax losses:

- The current same business test will be relaxed to allow companies to access prior year losses when they have entered into new transactions or new business activities. This will encourage entrepreneurship by allowing loss-making companies to seek out new opportunities to return to profitability; and
- A new and more flexible similar business test will be introduced, under which companies will be able to access losses where their business, while not the same, uses similar assets and generates income from similar sources.

The ED addresses only the second of these proposals by introducing the similar business test. At this stage, the various tests in the existing same business test have not been relaxed. No change is proposed to the continuity of ownership test.

Currently, companies that have received new equity investment (such that they fail the continuity of ownership test) may be discouraged from innovating or from adapting to changes in economic circumstances by the need to satisfy the same business test to utilise prior year losses. The Government indicates that the measures “will encourage entrepreneurship by allowing loss making companies to ‘pivot’ and seek out new opportunities to return to profitability”.

Similar business test

The ED introduces a new continuity of business test with two alternatives tests. The continuity of business test can either be satisfied via:

- The existing same business test, or alternatively
- By the new similar business test.

Consistent with the existing framework, the continuity of business test must be applied in the year of recoupment and tested against the business carried on immediately before the “test time”, typically being when the continuity of ownership test was failed.

The similar business test introduces the concept of the former business (carried on immediately before the test time) and the current business carried on throughout the year in which it is sought to recoup the losses.

In determining whether the current business is similar to the former business, any relevant matter can be taken into account, but in particular, the following must be taken into account:

- The extent to which the assets (including goodwill) that are used in its current business to generate assessable income were also used in the company’s former business to generate assessable income;
- The extent to which the sources from which the current business generates assessable income were also the sources from which the former business generated assessable income; and
- Whether any changes to the former business are changes that would reasonably be expected to have been made to a similarly placed business.

The question of whether the similar business test is passed will remain a question of fact, involving a weighing up of all relevant factors. Whilst the test is clearly wider than the existing same business test and is to be welcomed, it will continue to involve much subjectivity and debate. Taxpayers may consider seeking a ruling.

In respect of the second point and the reference to “source”, this is not referring to the geographic question of source i.e. is income derived from sources in Australia. Rather, the explanatory memorandum refers to sources of the company’s assessable income in a commercial or operational sense: “The sources of the company’s assessable income are the specific activities or operations from which it generates assessable income. For example, if a company ran an Italian restaurant, and then opened up a takeaway fish and chips shop, the takeaway fish and chips shop would amount to a new source of assessable income”.

Some examples

The EM also contains a number of examples under which the similar business test is passed or failed. Some key takeaways from the examples:

- The analysis asks whether the "identity" of the business has been changed, and tests the extent to which the business has changed versus the similarities.
- In one of the examples, it is considered that the company begins to generate income from new sources, whilst at the same time, the central part of the company's income generating activities relate to the original sources and activities. Notwithstanding the new sources of income, on balance, the company can still satisfy the similar business test.
- Example 3 involves a company that brews and sells bottled ice tea changing to a company that buys bottled ice tea from another producer and distributes the product, under a different brand name and to a subset of the previous customer base. This example fails the similar business test although it is noted that the company would likely pass the test if it sold the new product under its original brand name and to the same customer base.
- Example 4 involves a company changing from selling homewares to selling stationery and art supplies, whilst retaining the brand name and logo of the original business. Notwithstanding the use of the same premises, brand name and logo, there has been a change in the identity and sources of income such that the similar business test is failed.

Who does the measure apply to?

The measure amends the existing Division 165 which applies to companies generally. Whilst aspects of the NISA package target particular companies (such as early stage innovation companies or ESICs), the similar business test is not so limited, and applies to all companies.

In addition to the carry forward of tax losses by companies, the similar business test is also relevant for other purposes including capital losses and bad debt deductions.

The measure will also be applied to supplement the same business test rules in Schedule 2F of the Income Tax Assessment Act 1936 in respect of listed widely held trusts.

Consequential amendments

Many provisions throughout the Act refer to the same business test. A series of consequential amendments will be made throughout the legislation to remove references to same business test / same business test period, and replace it with business continuity test / business continuity test period. As noted, the business continuity test will include both the same business test and the similar business test.

One of the consequential amendments relates to Division 707 in the consolidation provisions, which deals with tax losses when a company joins a tax consolidated group: a modified same business test is to be applied. This will be amended to refer to the modified business continuity test. A specific provision will also be inserted to prevent the similar business test from being applied to losses that were originally incurred for income years beginning before 1 July 2015. Without this provision, a loss actually incurred in an income year beginning before 1 July 2015 could be transferred to a head company in an income year beginning on or after 1 July 2015 and could be a loss eligible to be recouped by the head company using the new similar business test where the continuity of business test is relevant.

When does the measure apply?

The amendments are intended to apply with respect to losses incurred in income years starting on or after 1 July 2015.

Submissions

Submissions on the ED are being sought by Treasury before 22 April 2016.

Contacts

For more information, please contact

David Watkins
Partner
+61 (2) 9322 7251
dwatkins@deloitte.com.au

John Rawson
Partner
+61 (8) 8407 7158
jorawson@deloitte.com.au

David Ocello
Partner
+61 (8) 9365 7041
docello@deloitte.com.au

For further information, visit our website at www.deloitte.com