Attachment Q

REINFORCING TAX SYSTEM INTEGRITY — PREVENTING LOSS DUPLICATION AND VALUE SHIFTING

The integrity of the entity tax system and the revenue base will be protected by removing current defects and anomalies in the treatment of entity losses and value shifting.

Key features

The loss duplication and value shifting integrity measures will address the following areas:

- loss duplication on transfer of revenue losses;
- artificial debt forgiveness;
- defects in the continuity of ownership test;
- duplication of unrealised losses;
- disposal of loss assets within majority owned groups; and
- excess deduction rules for mining operations.

The measures addressing the first two issues will be temporary, applying only until a consolidation regime for wholly owned company groups is introduced as part of the unified entity regime. Further details on the measures are provided in the appendix to this attachment.

Commencement

The measures relating to loss duplication on transfer of revenue losses and artificial debt forgiveness will have application from 22 February 1999, as foreshadowed in the Treasurer's Press Release No.10 of 22 February and the accompanying letter from Mr Ralph to the Treasurer. The repeal of excess deduction rules for mining operations will apply in part from 11.45 am AEST 21 September 1999 and in part from the 1999-2000 income year. The remaining measures will apply from 11.45 am AEST 21 September 1999.

Current arrangements

Losses on the sale of membership interests in an entity are duplicated when the entity is also allowed the losses. Also, artificial losses are created by shifting value out of assets while the assets' tax values remain unchanged. Mining operations benefit from being able to carry forward losses separate from the general loss carry-forward provisions.

Why change is needed

Defects and inconsistencies in the current rules relating to loss duplication and value shifting need to be addressed to protect the revenue base and integrity of the business tax system. These defects are further explained in the appendix to this attachment.

Preventing Loss Duplication and Value Shifting — Further Details

Loss duplication arises because losses on assets are reflected in the value of ownership interests in an entity that holds those assets. Losses on the sale of membership interests are duplicated when the entity is also allowed the losses. In entity chains, there can be multiple layers of duplication.

Currently, the continuity of ownership test reduces the scope for substantial duplication of a company's realised losses by subjecting the losses to the same business test where there has been a change in the majority underlying ownership of the company.

Value shifting occurs where value is shifted out of an asset while the asset's tax value remains unchanged. The subsequent sale of the asset could result in an artificial loss, not corresponding to an economic loss suffered by the taxpayer.

The following measures are directed at improving the integrity of the tax system. They prevent substantial loss duplication and artificial losses arising from value shifting.

Interim measures applying prior to unified entity regime

The measures are as proposed by *A Tax System Redesigned*, Recommendation 6.18 (relating to revenue loss transfers) and Recommendation 6.19 (relating to artificial losses from debt forgiveness).

Loss duplication on transfer of revenue losses

When a company in a chain incurs a revenue loss, that loss may be reflected in the market values of shares held by companies above it in the chain. When the loss is transferred, to be deducted by another company in the group, the measure reduces the cost bases for the shares up the chain to prevent the loss from being duplicated as capital losses on the sale of those shares.

The measure will apply where revenue losses are transferred between members of a wholly owned company group in the period from 22 February 1999 until the commencement of the unified entity regime on 1 July 2001.

Artificial losses from debt forgiveness

If a valuable debt is owed between commonly owned companies and the creditor company forgives the debt, this may enable holders of interests in the creditor company to claim an artificial loss. The measure denies tax recognition of such artificial losses.

The measure will apply to forgiveness of debts between commonly owned companies where forgiveness occurred during the period from 22 February 1999 until the commencement of the unified entity regime on 1 July 2001.

Remove defects in the continuity of ownership test

This measure is as proposed by *A Tax System Redesigned*, Recommendation 6.9(a).

Under the existing tax law, a company is able to deduct a loss if majority ownership in the company is maintained. The existing continuity of majority ownership test applying to companies' losses will be modified so that broadly, the test is only satisfied if:

(a) there is no substantial change in the composition of ownership within a group of continuing owners; and

(b) majority ownership is maintained throughout the period from the loss year to the end of the claim year.

The changes are directed at removing the following defects in the existing test:

- the existing test fails to register a change in majority ownership when this occurs through a change in the composition of ownership within a group of continuing owners.
  - For example, the existing test does not recognise a change in ownership of a company when, in a company that is 99 per cent owned by person A and 1 per cent owned by person B, A sells more than half of his shares, or even almost all of his shares, to B; and
- the existing test allows majority ownership to be reinstated despite a disposal of a majority of the shares in the intervening period between the loss year and the claim year.
  - This results in loss duplication, as the loss would have been reflected in the price the owners received on disposal of their shares.

The changes will apply to tax losses claimed by companies from 11.45 am AEST 21 September 1999.

Prevent duplication of unrealised losses

This measure is as proposed by *A Tax System Redesigned*, Recommendation 6.10.

When a company experiences a change in majority ownership, the existing law prevents the company from deducting a realised loss (subject to the flaws that are to be corrected by the preceding measure) unless the company satisfies the same business test. Selling a company that has unrealised losses, so that, in a formal sense, the losses can be realised when the company is under the new ownership can circumvent this rule. The measure will prevent this subversion of the policy underlying the existing law by denying deductibility of unrealised losses following a change in majority ownership unless the company satisfies the same business test.

Where there has been a change in the majority ownership of a company, losses subsequently realised by the company on assets held at the time of ownership change will be disallowed unless the same business test is satisfied in the claim year. Losses on such assets will be disallowed only to the extent of the company’s net unrealised loss at the time of ownership change. Broadly, a company’s net unrealised loss at a particular time is the net loss that the company would have realised if it had disposed of all of its assets for their market value at the time.

The measure will apply to a company’s unrealised losses where there is a change in the majority ownership of the company from 11.45 am AEST 21 September 1999.

Disposal of loss assets within majority-owned groups

This measure is proposed by *A Tax System Redesigned*, Recommendation 6.11(b). The commencement date has been brought forward because of the likelihood of this artificial loss creation opportunity being exploited before the commencement of the unified entity regime, which has been deferred to 1 July 2001.

The measure will effectively defer tax system recognition of a revenue or capital loss where an asset that has declined in value is sold by one company to another in the same majority-owned group. The measure prevents a loss from being realised before the asset is actually disposed of by the group.

Currently, the law provides for compulsory roll-over of loss assets transferred within wholly-owned company groups so that a capital loss that would have been available to the transferor would be denied to the transferor but allowed to the transferee when the asset is disposed of outside the group. This measure will extend the compulsory roll-over provisions to transfers between wholly-owned companies where a *revenue* loss would (apart from this measure) be available on transfer.

As losses are transferable only between companies that are part of a wholly owned group, different rules are required to deal with loss assets transferred within majority-owned groups between companies that are not wholly owned. In these circumstances, a revenue deduction or a capital loss that would (apart from this measure) be available on transfer will be available to the transferor only when the asset is actually disposed of outside the majority-owned group. A majority-owned group is one that is majority-owned directly or indirectly by the same individual or entity (including a trust), and their associates.

The measure will apply to the transfer of loss assets occurring from 11.45 am AEST 21 September 1999.

Repeal of excess deduction rules for mining operations

This measure is as proposed by *A Tax System Redesigned*, Recommendation 8.17.

The current excess deduction rules provide a means of carrying forward losses separate from the general provisions for company and trust losses. They were enacted when there was a seven year limit on the carry forward of non-primary production losses, and recognised the fact that the mining sector might not be able to use early year losses fully within seven years. However, the seven year limit was removed in 1990, and as a consequence of that and other recommendations of the Review of Business Taxation, separate rules are no longer necessary.

There are two elements to the measure.

The first is that excess deductions carried forward from the previous income year that are available to a taxpayer at 11.45 am AEST 21 September 1999 will be treated as allowable deductions at that time, rather than at the end of the income year as is currently the case.

The second is that deductions for exploration and prospecting expenditure and allowable capital expenditure, including deductions allowable under the first measure, will be deductible without limit. If they exceed the available income, the excess will contribute to a tax loss for the year. That measure applies to assessments for the 1999-2000 income year and later income years.