2016-2017

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TREASURY LAWS AMENDMENT (2017 ENTERPRISE INCENTIVES NO. 1) BILL 2017

EXPLANATORY MEMORANDUM

(Circulated by authority of the
Minister for Revenue and Financial Services, the Hon Kelly O'Dwyer MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
CGT	Capital gains tax
ITAA 1997	*Income Tax Assessment Act 1997*
ITAA 1936	*Income Tax Assessment Act 1936*

General outline and financial impact

Access to losses

Schedule 1 to the Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Income Tax Assessment Act 1936* (ITAA 1936) to supplement the same business test with a more flexible similar business test. The similar business test improves access to losses for companies (and certain trusts) that have changed ownership and allows those companies and trusts to seek out opportunities to innovate and grow without losing access to losses.

Date of effect: The amendments apply to income years starting on or after 1 July 2015.

Proposal announced: The proposal was announced on 7 December 2015 as part of the Government's National Innovation and Science Agenda.

Financial impact: The amendments will have an unquantifiable financial impact.

Human rights implications: This Schedule does not raise any human rights issue. See *Statement of Compatibility with Human Rights* — paragraphs 1.59 to 1.62.

Compliance cost impact: The similar business test has an estimated compliance cost impact of $5.6 million per year. This cost has been fully offset within the portfolio.

Intangible asset depreciation

Schedule 2 of this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to provide taxpayers with the choice to self-assess the effective life of certain intangible depreciating assets they start to hold on or after 1 July 2016, rather than using the statutory effective life currently specified in the law.

Date of effect: The amendments apply to certain intangible depreciating assets that start to be held on or after 1 July 2016.

Proposal announced: The amendments are part of the Government's National Innovation and Science Agenda announced on 7 December 2015.

Financial impact: This measure has the following revenue implications:

2014-15	***2015-16***	***2016-17***	***2017-18***	***2018-19***
–	–	–	- $20.0 m	- $60.0 m

Human rights implications: This Schedule does not raise any human rights issue. See *Statement of Compatibility with Human Rights* — Chapter 2, paragraphs 2.32 to 2.36.

Compliance cost impact: Minimal.

Chapter 1
Access to losses

Outline of chapter

1.1 Schedule 1 to the Bill amends the ITAA 1997 and the ITAA 1936 to supplement the same business test with a more flexible similar business test. The similar business test improves access to losses for companies (and certain trusts) that have changed ownership and allows those companies and trusts to seek out opportunities to innovate and grow without losing access to losses.

Context of amendments

1.2 Where a taxpayer has more deductions for an income year than assessable income and net exempt income for the income year, the difference is a tax loss (see section 36-10 of the ITAA 1997).

1.3 A tax loss for an income year (the loss year) can be carried forward and deducted from assessable income in future income years if the company passes either:

- the continuity of ownership test (which is failed if the company has undergone a substantial change in ownership or control); or
- the same business test (which is failed unless the company carries on the same business and has not derived income from any new kinds of business or transactions).

The continuity of ownership test

1.4 A company fails the continuity of ownership test if it undergoes a substantial change in its ownership or control during the period starting at the beginning of the loss year and ending at the end of the year when the company wants to use the loss.

1.5 There is a modified continuity of ownership test for widely held companies and other eligible companies (see Division 166 of the ITAA 1997). The equivalent of the continuity of ownership test for trusts is known as the 50 per cent stake test and there is a simplified version for widely held unit trusts (see subsection 269-55(2) in Schedule 2F to the ITAA 1936).

The same business test

1.6 Generally, a company satisfies the same business test if it carries on the same business in the income year when it wants to use the loss (the 'same business test period') as it carried on immediately before the change of ownership or control that caused the company to fail the continuity of ownership test (the 'test time') (see subsection 165-13(2) of the ITAA 1997).

1.7 The 'same business test period' and the 'test time' vary depending on the purpose for which the same business test is applied.

1.8 Additionally, a company does not satisfy the same business test if either of the negative limbs of the same business test applies. The negative limbs apply if the company:

- derives assessable income from a business of a kind that it did not carry on before the test time (known as the new business test, see paragraph 165-210(2)(a) of the ITAA 1997); or

- derives assessable income from a transaction of a kind that it had not entered into in the course of its business operations before the test time (known as the new transaction test, see paragraph 165-210(2)(b) of the ITAA 1997).

1.9 The need to satisfy the same business test may discourage certain companies from innovating or adapting their businesses to changing economic circumstances. In particular, the two negative limbs in the same business test may discourage companies from entering into new kinds of transactions or new kinds of businesses.

The relevance of the same business test

1.10 The same business test is not only used for working out whether tax losses from previous income years can be used. The same business test is also used for establishing:

- whether a company can use a net capital loss from a previous year (which was incurred prior to a change of ownership or control) against current year capital gains (see Subdivision 165-CA of the ITAA 1997);
- whether certain companies can use losses to offset capital gains arising from capital gains tax (CGT) events that happen to CGT assets that it acquired prior to a change of ownership or control (see Subdivision 165-CC of the ITAA 1997);
- whether a company can deduct a debt written off as bad in an income year, where the debt was initially incurred prior to a change of ownership or control (see Subdivision 165-C of the ITAA 1997);
- whether special rules about how to calculate a company’s taxable income and tax loss, and net capital gains and losses, apply to a company for an income year during which the company has undergone a change of ownership or control (see Subdivisions 165-B and 165-CB of the ITAA 1997); and
- whether a company joining a consolidated group can transfer its losses to the head company of the consolidated group (see Subdivision 707-A of the ITAA 1997).

1.11 There is also a parallel same business test for listed widely held trusts (see Subdivision 269-F in Schedule 2F to the ITAA 1936). This parallel same business test is used for establishing:

- whether a trust can use tax losses incurred in a year prior to the change of ownership of the trust, or where there has been abnormal trading in the units of the trust (see Subdivision 266-D in Schedule 2F to the ITAA 1936);
- whether a trust can deduct a debt written off as bad, where the debt was incurred in a year prior to the change of ownership, or abnormal trading in the units of the trust (see Subdivision 266-D in Schedule 2F to the ITAA 1936); and
- whether special rules about how to calculate a trust’s net income and tax loss in an income year apply for an income

year during which there is a change of ownership or abnormal trading in the units of the trust (see Division 268 of Schedule 2F to the ITAA 1936).

Summary of new law

1.12 On 7 December 2015, the Government announced a package of measures designed to incentivise and reward innovation as part of its National Innovation and Science Agenda.

1.13 The amendments in Schedule 1 to the Bill implement one of the announced measures, which is to supplement the 'same business test' with a more flexible 'similar business test' for the purposes of working out whether a company's tax losses and net capital losses from previous income years can be used.

1.14 The similar business test also applies in working out whether a debt written off as bad can be deducted in an income year, and whether tax losses of listed widely held trusts can be used.

1.15 In working out whether a business carried on immediately before the test time (the former business) is similar to the business carried on in an income year during which the company wants to use the loss (the current business), it is necessary to consider the following factors, which are not exhaustive:

- the extent to which the assets (including goodwill) that are used in the current business to generate assessable income were also used in the company's former business to generate assessable income;
- the extent to which the activities and operations from which the current business generates assessable income were also the activities and operations from which the former business generated assessable income;
- the identity of the current business and the identity of the former business; and
- the extent to which any changes to the former business resulted from the development or commercialisation of assets, products, processes, services, or marketing or organisational methods, of the former business.

1.16 The similar business test encourages entrepreneurship by allowing companies to use losses in a wider range of circumstances and encourages companies to seek out new business opportunities and return to profitability.

Comparison of key features of new law and current law

New law	***Current law***
The same business test and access to prior losses	
The same business test is retained.	Where a company has undergone a change of ownership or control, it may access losses from years before the change if it passes the same business test. A company passes the same business test if its current business is the same as its former business.
The similar business test and access to prior losses	
When a company has undergone a change of ownership or control, the company may also access losses from years before the change if it passes the similar business test. A company passes the similar business test if its current business is similar to its former business.	No equivalent.
Relevance of the same and similar business tests for other purposes	
The same business test and the similar business test apply for other purposes (including in relation to listed widely held trusts).	The same business test applies for other purposes (including in relation to listed widely held trusts).
Use of company's tax losses or deductions to avoid income tax	
The integrity rules that prevent tax avoidance and income injection schemes continue to apply where the same business test is not satisfied (whether or not the similar business test is satisfied).	Integrity rules to prevent tax avoidance and income injection schemes apply where the same business test is not satisfied.

Detailed explanation of new law

The similar business test

1.17 The amendments in Schedule 1 to the Bill supplement the existing same business test with a new and more flexible similar business test. The tests are collectively known as the 'business continuity test'.

1.18 A company satisfies the similar business test if its current business is a similar business to its former business. The similar business test also applies to listed widely held trusts.

1.19 Generally, a company satisfies the similar business test if the business it carries on throughout the income year when it wants to use a loss (the 'business continuity test period') is similar to the business it carried on at the time immediately before the change of ownership or control that caused the company to fail the continuity of ownership test (the 'test time'). ***[Schedule 1, items 8 and 21, subsection 165-211(1) of the ITAA 1997, subsection 269-105(1) in Schedule 2F to the ITAA 1936]***

1.20 As with the same business test, the focus of the similar business test is on the identity of the business. It is not sufficient for the current business to be of a similar 'kind' or 'type' to the former business. For example, it is not enough to say that the former business was in the hospitality industry and the current business is in the hospitality industry. Instead, the test looks at all of the commercial operations and activities of the former business and compares them with all the commercial operations and activities of the current business to work out if the businesses are similar.

1.21 In working out whether the current business is similar to the former business, regard must be had to the following four factors, which are not exhaustive:

- the extent to which the assets (including goodwill) used in the current business to generate assessable income were also used in the company's former business to generate assessable income;
- the extent to which the activities and operations from which the current business generates assessable income were also the activities and operations from which the former business generated assessable income;
- the identity of the current business and the identity of the former business; and

- the extent to which any changes to the former business resulted from the development or commercialisation of assets, products, processes, services, or marketing or organisational methods, of the former business.

[Schedule 1, items 8 and 21, subsection 165-211(2) of the ITAA 1997, subsection 269-105(3) in Schedule 2F to the ITAA 1936]

1.22 As with the same business test, whether the current business is similar to the former business is a question of fact. For the similar business test, regard must be had to each of the four factors. The factors should be considered in light of the overarching question of whether the current business is a similar business to the former business. In some circumstances, a factor may suggest that the similar business test is satisfied, while another factor may suggest that the similar business test is not satisfied. This requires the factors to be compared. The relative importance of each of the factors depends on the facts and circumstances of each particular case.

1.23 The four factors allow for differences between the current and former businesses that result from attempts to grow or rehabilitate the business. However, they also mean that there should be a clear similarity in the business identity of the operations of the former business and the current business. If a business changes its essential character or identity, or if there is a sudden or dramatic change in the business brought about by either the commencement, the acquisition or the cessation of activities, then the business would fail the similar business test.

Factor one: same assets used to generate income

1.24 The first factor to be considered is the extent to which the assets (including goodwill) that are used in the current business to generate assessable income throughout the business continuity test period were also used in the former business to generate assessable income. The term ‘assets’ includes physical and intangible assets. Intangible assets include goodwill, trade names, trademarks, patents, royalty arrangements, and other intellectual property rights of the company. ***[Schedule 1, items 8 and 21, paragraph 165-211(2)(a) of the ITAA 1997, paragraph 269-105(3)(a) in Schedule 2F to the ITAA 1936]***

1.25 Goodwill will often be important when considering this factor. Goodwill is the product of combining and using the tangible, intangible and human assets of a business for such purposes and in such ways that custom is drawn to the business. The attraction of custom is central to the legal concept of goodwill. Goodwill is a quality or attribute that derives from, among other things, using or applying other assets of a business. It may derive from a site, personality, service, price or habit that obtains custom (see paragraph 12 of Taxation Ruling TR 1999/16).

Factor two: assessable income generated from the same activities and operations

1.26 The second factor is the extent to which the activities and operations from which the current business generates assessable income throughout the business continuity period were also the activities and operations from which the former business generated 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 activity or operation that produced the company's assessable income. ***[Schedule 1, items 8 and 21, paragraph 165-211(2)(b) of the ITAA 1997, paragraph 269-105(3)(b) in Schedule 2F to the ITAA 1936]***

Factor three: the identity of the business

1.27 The third factor is the identity of the current business and the identity of the former business. ***[Schedule 1, items 8 and 21, paragraph 165-211(2)(c) of the ITAA 1997, paragraph 269-105(3)(c) in Schedule 2F to the ITAA 1936]***

1.28 This factor requires a comparison between the identity of the former business and the current business. The comparison will show which characteristics of the former business have been retained and which characteristics have changed or disappeared. In addition, the comparison will show which characteristics of the current business are derived from those of the previous business and which characteristics are new additions.

1.29 This factor requires a broad-ranging enquiry into the identity of the businesses and is not limited to matters of mere branding and public recognition. It requires an examination of the cumulative effect of all changes that are reflected in the identity of the current business compared to the identity of the former business.

1.30 The relative importance of particular business characteristics (for example products and services offered, type of activities performed and identity of suppliers and consumers) will depend on the nature of the previous business and current business in each case. In particular, a comparison between the core functions of the current business and those of the former business is of most significance.

Factor four: development of former business

1.31 The fourth factor is the extent to which any changes to the former business result from the development or commercialisation of assets, products, processes, services or marketing or organisational methods of the former business. ***[Schedule 1, items 8 and 21, paragraph 165-211(2)(d) of the ITAA 1997, paragraph 269-105(3)(d) in Schedule 2F to the ITAA 1936]***

1.32 This factor considers the degree of connection and continuity between the former business and the current business. It is not sufficient that the change is a reasonable business decision in that it makes commercial sense, or is a good business opportunity. Rather, there must be something in the activities or operations of the former business that make the change a natural organic development of the former business.

Impact of new income and transactions

1.33 Unlike the same business test, the similar business test does not incorporate the former test's negative limbs (see paragraphs 1.8 and 1.9). This change allows a company to derive assessable income from new business activities and to enter into new transactions without automatically failing the business continuity test. Such changes, however, are nevertheless relevant when considering whether the similar business test is satisfied.

Changes to the business made in contemplation of a change in ownership or control

1.34 The similar business test includes an integrity provision to counteract changes to the business that are made prior to and in contemplation of a change in ownership or control for the purpose of being able to satisfy the similar business test. This is based on the equivalent provision in the same business test (subsection 165-210(3) of the ITAA 1997), which prevents contrived arrangements from satisfying that test. ***[Schedule 1, items 8 and 21, subsection 165-211(3) of the ITAA 1997 and subsection 269-105(4) in Schedule 2F to the ITAA 1936]***

Examples of the operation of similar business test

1.35 The following examples demonstrate the operation of the similar business test.

Example 1.1: Similar business test passed

Furnish Art Pty Ltd is a start-up online retail company that sells various household furniture items from established brands. In its first year, Furnish Art made a tax loss.

Through conducting this business, Furnish Art discovered that there was a market for affordable, high quality mattresses.

While it continues selling furniture from established brands, Furnish Art decided to expand the mattress component of its business. To acquire funds necessary to make this change, Furnish Art gained a new equity investor, causing it to fail the continuity of ownership test.

Furnish Art researched and developed its own mattresses (and applied to register its patents, trademarks and designs with IP Australia) and it outsourced the manufacturing of the mattresses to a local factory.

Furnish Art commenced selling its new mattresses through its website and under its established 'Furnish Art' brand name, alongside the other furniture products. Approximately 15 per cent of Furnish Art's sales are from its specialised mattresses.

Furnish Art then became profitable and sought to recoup the tax losses incurred prior to the ownership change.

Furnish Art would satisfy the similar business test.

With regard to the first factor, the current business is generating income from the same assets as the former business in so far as it continues to generate income from its brand name, website and goodwill. However, it is also generating income from new assets, namely, the various intellectual property rights connected to the range of new mattresses.

With regard to the second factor, the current business is generating income from the same activities and operations to the extent that it is generated from the online reselling of furniture items from established brands. However, income is also being generated from the sale of the specialised mattresses that Furnish Art has developed.

With regard to the third factor, there is a change in Furnish Art's business from reselling established products to both reselling established products and selling mattresses it has developed itself.

However, the change is one that supplements the former business's identity as a subsidiary or ancillary business activity, rather than replacing the former business. This indicates that the current identity of the Furnish Art business is sufficiently similar to the identity of the former business.

With regard to the fourth factor, the change to the business is one that reflects the ongoing development of the former business's assets and processes. The current business makes use of many of the assets, processes and methods of the former business, including the business website, marketing strategies and organisational methods.

The above analysis of the factors leads to the conclusion that the former business and the current business are sufficiently similar to satisfy the test. The identity of the Furnish Art business has been maintained, and although the business has changed and derived income from new assets, these new assets and activities do not outweigh the similarities between the former and current business and the current business's reliance on the development of the former business's assets.

This conclusion would likely be different if Furnish Art ceased to sell other furniture products and instead became exclusively an online retailer of mattresses which it developed itself.

Example 1.2: Similar business test passed

RePoly Pty Ltd has developed a way to turn algae into biodegradable plastic. To do this, it incurred large initial expenditure on research and development and manufacturing technology. It also applied to register its patents with IP Australia. In each of the first three years of operation, RePoly made a tax loss.

To ensure its viability, RePoly brings in an early stage investor who contributes additional equity capital. This results in a majority change in ownership, causing RePoly to fail the continuity of ownership test.

After this change, RePoly seeks to expand its business in an effort to reach profitability. It discovers that the algae treatments that it uses to make the plastics can also be used to make a teeth-whitening product. Sales to overseas dentists of the teeth-whitening product become a small part of RePoly's business. RePoly reaches profitability in its fourth year of operation and seeks to deduct its past tax losses against current year assessable income.

RePoly would satisfy the similar business test.

Although RePoly is generating assessable income from different activities and operations to the extent that it is generating income from selling teeth-whitening products, the sale of plastic (the company's former business) still continues to be a central part of the business's income-generating activities.

With regard to the first factor, it is significant that RePoly generates its income from the same key asset (the intellectual property relating to the unique algae treatments) with respect to both the biodegradable plastic and teeth-whitening products. On the other hand, the existing goodwill in relation to its reputation for selling biodegradable plastic products would have limited utility in relation to the sale of the teeth-whitening products.

With regard to the second factor, RePoly continues to generate assessable income from its specialised manufacturing technology.

With regard to the third and fourth factors, the identity of the business does change to a certain extent as the company exploits additional commercial applications for its technology. Importantly, however, the business identity remains predominantly associated with the exploitation of algae technology. The changes in the business identity are slight and reflect the evolution of the business and the development of its core business assets and processes. The organic growth of the business is significant when considering whether the current business is similar to the former business.

Overall, the continued centrality of the unique algae treatment to the business, combined with the fact that the biodegradable plastic business continues to be the most substantial part of the business, is enough to cause the similar business test to be satisfied. In this case, this is enough to outweigh the fact that the sale to dentists of a teeth-whitening product is a new income-generating activity for the business.

This conclusion would likely be different if RePoly ceased to sell biodegradable plastic products and instead focused exclusively on the manufacture and sale of teeth-whitening products.

Example 1.3: Similar business test failed

Peach & Ice Co brewed and sold iced tea. It brewed and bottled the iced tea in its fully-equipped manufacturing plant. It marketed the iced tea under its Peach & Ice Co brand name, selling its product to supermarkets, caterers and takeaway shops.

High production costs meant that Peach & Ice Co incurred large tax losses. The shareholder with majority ownership of Peach & Ice Co sold its shares to a new investor, causing Peach & Ice Co to fail the continuity of ownership test.

After the ownership change, Peach & Ice Co decided to cease production of iced tea and sell its manufacturing plant and equipment.

Following the sale, Peach & Ice Co adopted a new business model. Under the new model, the company purchases bottled iced tea from another producer that it distributes and resells. The iced tea no longer carries Peach & Ice Co's brand name. The business sells iced tea to a more limited subset of its previous customers, selling mainly to caterers and takeaway shops (but no longer to supermarkets). Peach & Ice Co becomes profitable and seeks to use its tax losses from before the change of ownership.

Peach & Ice Co would not satisfy the similar business test.

With regard to the first factor, to a significant extent, Peach & Ice Co's current business no longer generates assessable income from the assets that were used in the former business. The current business no longer generates income from using its Peach & Ice Co brand name (an intangible asset) on the label of its iced tea products. Likewise, the current business no longer generates assessable income from using the same assets (that is, the manufacturing plant and equipment). The predominant income-producing activity of the current business is the sale of iced tea sourced from its new supplier.

With regard to the second factor, the income-producing activities of the company changed substantially after the ownership change. The former business activities were the manufacture and wholesale distribution of iced tea. The current business income is generated from the purchase and resale of another brand of iced tea. While Peach & Ice Co continues to generate income from the sale of iced tea, there has been significant change to its income-producing activities in that it is now generating all of its income from reselling the iced tea, instead of from manufacturing it.

With regard to the third factor, there is a significant change in the identity of the company's business. The former business's identity is that of a manufacturer and wholesale distributor. The current business's identity is that of a licenced distributor.

With regard to the fourth factor, there is no significant development or commercialisation of the former business's assets, products or processes. The constant between the current and former business is the company's distribution activities. However, there is nothing to suggest the broader business changes and the company's move towards profitability reflects the development or commercialisation of this process.

Peach & Ice Co would not satisfy the similar business test. Although it is still distributing iced tea, this is outweighed by the significance of the change from the business producing its own unique brand of iced tea to reselling another brand of iced tea. Because of this, the company's current business is not a similar business to the former business.

This conclusion would likely be different if Peach & Ice Co merely sold its manufacturing plant and equipment and outsourced the manufacture of its branded iced tea products.

Example 1.4: Similar business test failed

Bob's company (Bob Co) runs a reputable homewares shop on a main street. However, Bob Co has made tax losses over a number of years.

Mary buys Bob Co (causing it to fail the continuity of ownership test). After working as manager of the homewares shop for a while, Mary decides to change it into a shop selling high-end stationery products and art supplies.

Mary has contacts who are stationery wholesalers and is able to negotiate favourable supply contracts with them. Mary also identifies a market for boutique stationery products and art supplies in the local area, and thinks she will be able to take advantage of the high pedestrian traffic of the location. Mary uses the brand name and logo of the homewares shop for the stationery business.

Mary's stationery and art supplies business is very profitable. She seeks to use the tax losses made on the homewares shop while Bob was running it.

Bob Co would not satisfy the similar business test.

With regard to the first factor, the brand name and logo are assets that are used by both the current and former business to generate assessable income. The extent to which these assets were relevant to the derivation of income for the stationery business would be limited. While the goodwill's value would still have been influenced by the brand name and trademark, the extent to which the goods sold by the business has changed suggests that the goodwill would not be the same asset, rather it will likely be a new asset of a new business.

The business's premises is an asset that continues to be used after the ownership change. However, little weight would be given to this factor because the business premises are not central to the identity of either the former business or the current business.

With regard to the second factor, there was a significant change in the nature of the business's income-producing activities. The underlying activities of the current business, purchasing and retailing stationery and art supplies, are far removed from the homewares market. It is not sufficient that income continued to be generated from a business in the retail industry, or that income continued to be generated from customers who are residents of the local area.

The significant changes to the business's activities are also relevant to the third factor. The identity of the former business and the current business are tied to the products that the respective retail businesses sold. There has been a significant change to the identity of the former homewares business because it has changed to being a business that sells stationary and art supplies.

In relation to the fourth factor, there has been no significant development or commercialisation of an asset or process. While Bob Co retained ownership of the retail premises and brand name, there is no development or commercialisation of these assets. The assets continue to be used in the same way to support the retail activities of the new business as they were employed to support the former business.

Overall, the continued use of the same premises and brand name and the fact that the business has taken up a profitable opportunity are not sufficient to outweigh the significant change to the business's identity and to its income-producing activities.

The business continuity test period and the test time

1.36 To satisfy the similar business test, a company must carry on a business throughout the 'business continuity test period' (the current business), and it must be a similar business to the business it carried on immediately before the 'test time' (the former business). ***[Schedule 1, items 8 and 21, subsection 165-211(1) of the ITAA 1997, subsection 269-105(1) in Schedule 2F to the ITAA 1936]***

1.37 In a basic case of carrying forward tax losses, the company would satisfy the similar business test if it carries on a similar business throughout the recoupment year (the 'business continuity test period') to the business that it carried on immediately before the time it failed the continuity of ownership test (the 'test time').

1.38 The similar business test is available to be used for the same purposes that the same business test is currently used. For each of these purposes, individual provisions specify the 'business continuity test period' and 'test time' for which the similar business test must be satisfied. The 'business continuity test period' is equivalent to the 'same business test period' in the current law.

Use of company's tax losses or deductions to avoid income tax

1.39 Division 175 of the ITAA 1997 contains integrity rules for tax losses, net capital gains and bad debts. These integrity rules prevent tax avoidance or income injection schemes that seek to use a company's tax losses or deductions. For example, Subdivision 175-A of the ITAA 1997 contains two integrity rules that prevent income injection schemes. The Commissioner of Taxation may disallow a loss:

- if an amount is injected into a company that would not have been injected if the loss had not been available (section 175-10 of the ITAA 1997); or

- if a person obtains a tax benefit in connection with a scheme, and the scheme would not have been entered into or carried out if the loss had not been available (section 175-15 of the ITAA 1997).

1.40 Similar rules are contained in Subdivision 175-CA of the ITAA 1997 (with respect to unused net capital losses) and Subdivision 175-C of the ITAA 1997 (with respect to unused bad debt deductions).

1.41 Under the current law, these integrity rules do not apply where the same business test is satisfied. The integrity rules are not required to apply because the negative limbs of the same business test (the new business test and the new transaction test in subsection 165-210(2) of the ITAA 1997) would apply to address the relevant integrity concerns.

1.42 The negative limbs are not replicated in the similar business test, allowing companies to legitimately enter into new lines of business without losing access to tax losses. Amendments are made to ensure that Division 175 does not apply where the new business continuity test is satisfied because the relevant company satisfies the same business test in section 165-210 of the ITAA 1997.

1.43 However, Division 175 will continue to apply where the company satisfies the business continuity test because of the application of the similar business test. This ensures that the omission of the negative limbs from the similar business test does not create tax avoidance or income injection opportunities that would minimise a company's tax liability. ***[Schedule 1, items 9 to 11, paragraphs 175-5(2)(b), 175-40(2)(b) and 175-80(2)(b) of the ITAA 1997]***

Example 1.5: Integrity rules

Jones controls the Jones Family Trust as the sole director of the corporate trustee. The trustee of the Jones Family Trust derives income from a range of activities. The trust has recently experienced an increase in its net income.

Jones buys Jewellery Co, a company that carries on a jewellery retail business. The company has large tax losses from previous years. The company is made an object of the Jones Family Trust and Jones, as director of the corporate trustee, resolves to appoint income to Jewellery Co. The appointed income is not a material amount of Jewellery Co's income in each income year. However, over time, Jones reduces the overall income tax payable by his controlled entities by a large amount.

Jewellery Co has never been the beneficiary of a trust previously. As Jewellery Co has derived assessable income from a transaction of a kind that it had not entered into before the change of ownership, it would fail the same business test because of the new transactions test in paragraph 165-210(2)(b) of the ITAA 1997. However, given the limited extent to which the assessable income of Jewellery Co is derived from new activities, Jewellery Co is likely to satisfy the similar business test (as no other changes have taken place to Jewellery Co's business within the business continuity test period).

However, the income injection test in Subdivision 175-A will apply to disallow the deduction of the tax losses of Jewellery Co. This is because Jewellery Co derived assessable income, being the income appointed to it as an object of the Jones Family Trust, which it would not have derived had the tax losses not been available.

The parallel similar business test for listed widely held trusts

1.44 The amendments also supplement the parallel same business test for listed widely held trusts in Schedule 2F to the ITAA 1936 with a parallel similar business test.

1.45 This parallel similar business test for listed widely held trusts operates in the same way, and for the same purposes, as the similar business test for companies. The parallel similar business test requires consideration of the same factors as the similar business test for companies. ***[Schedule 1, item 21, section 269-105 in Schedule 2F to the ITAA 1936]***

Consequential amendments

1.46 This measure introduces a new term: 'business continuity test', which encompasses both the same business test and the similar business test. The ITAA 1997 contains a number of references to the 'same business test'. The references to 'same business test' are replaced with references to the 'business continuity test'. ***[Schedule 1, items 1 to 4, 6, 33 to 96, 103, 105, 106, 108 to 112, 114, 116 to 118, 121 to 128, 130, 131, 133, 135, 137 to 139, 141, 143, 145 to 148, 150, 151, 153 to 162, sections 4-15, 25-35, 36-25, 102-30, 165-5, 165-10, 165-13, 165-15, 165-23, 165-35, 165-40, 165-45, 165-93, 165-99, 165-102, 165-115, 165-115AA, 165-115B, 165-115BA, 165-117, 165-120, 165-126, 165-129, 165-132, 165-210, 165-212D, 165-212E, 166-5, 166-20, 166-40, 701-5, 707-125, 707-135, 707-210, 707-400, 709-215, 715-15, 715-50, 715-55, 715-60, 715-70, 715-90, 715-95, 715-355, 715-360, 719-260, 719-265, 719-285, and 719-455, subsection 995-1(1) (definitions of 'business continuity test' and 'same business test') and the heading to Subdivision 165-E of the ITAA 1997]***

1.47 Some references to the 'same business' are replaced with references that encompass both the same business and similar business tests. ***[Schedule 1, items 104 and 113, subsections 707-120(3) and 707-135(1), and subsection 707-135(1) of the ITAA 1997]***

1.48 The ITAA 1997 also contains a number of references to the 'same business test period'. Different same business test periods are set by different provisions. References to the 'same business test period' are replaced with references to the 'business continuity test period', so that those periods can apply in relation to both the same business test and the similar business test. The timeframes covered by the same business test periods are unchanged by this measure. ***[Schedule 1, items 2, 3, 5, 7, 40, 43, 49, 53, 56, 68, 72, 75, 79, 86, 90, 94, 99 to 102, 107, 108, 110, 115, 119, 120, 129, 132, 134, 136, 140, 142, 144, 149, 152, 160 and 161, sections 165-13, 165-15, 165-30, 165-35, 165-40, 165-45, 165-115BA, 165-126, 165- 129, 165-132, 165-210, 166-5, 166-20, 166-40, 415-35, 415-40, 707-125, 707-135, 707-400, 715-50, 715-55, 715-60, 715-70, 715-95, 715-355, 715-360, 719-260, and 719-265, and subsection 995-1(1) (definitions of 'business continuity test period' and 'same business test period') of the ITAA 1997]***

1.49 References to the 'same business test' and 'same business test period' in Schedule 2F to the ITAA 1936 are also replaced with references to the 'business continuity test' and the 'business continuity test period'. ***[Schedule 1, items 14 to 20, and 23 to 32, sections 266-125, 266-135, 268-20, 269-5 and 269-100, subsection 272-140(1) (definition of 'pass the same business test'), and the heading to Subdivision 269-F in Schedule 2F to the ITAA 1936]***

1.50 The current definition of a 'trading stock loss' contains an incorrect cross-reference. An amendment is made to correct this error. ***[Schedule 1, item 163, subsection 995-1(1) (definition of 'trading stock loss') of the ITAA 1997]***

Application and transitional provisions

1.51 The amendments in Schedule 1 of the Bill apply in relation to income years starting on or after 1 July 2015.

When does the similar business test apply?

1.52 Broadly, the similar business test applies for income years beginning on or after 1 July 2015. ***[Schedule 1, items 8, 13, 21, 22 and 164, subsection 165-211(1) of the ITAA 1997 and subsection 269-105(1) in Schedule 2F to the ITAA 1936]***

1.53 The similar business test applies to:

- tax losses incurred by companies for income years (loss years) beginning on or after 1 July 2015 — the company may choose to apply the same business test or the similar business test; ***[Schedule 1, item 8, paragraph 165-211(1)(a) of the ITAA 1997]***

- net capital losses made for income years beginning on or after 1 July 2015; ***[Schedule 1, item 8, paragraph 165-211(1)(c) of the ITAA 1997]***

- working out a company's taxable income and tax loss, and net capital gain and net capital loss, in an income year beginning on or after 1 July 2015 because a change of ownership has occurred in that income year (see Subdivisions 165-B and 165-CB of the ITAA 1997); ***[Schedule 1, item 8, paragraphs 165-211(1)(b) and (c) of the ITAA 1997]***

- unrealised losses in relation to CGT assets where the income year immediately before the one in which a change of ownership or control occurred is an income year beginning on or after 1 July 2015 (see Subdivision 165-CC of the ITAA 1997); ***[Schedule 1, item 8, paragraphs 165-211(1)(a), (b) and (c) of the ITAA 1997]***

- debts incurred in income years beginning on or after 1 July 2015 that the company writes off as bad. ***[Schedule 1, item 8, paragraph 165-211(1)(d) of the ITAA 1997]***

Example 1.6: Timing for bad debt deductions

Credit Co incurs a debt in the 2013-14 income year. It undergoes a change of ownership in the 2016-17 income year, failing the continuity of ownership test. Credit Co writes-off the debt as bad in the 2017-18 income year.

To obtain a deduction for the bad debt in the 2017-18 income year, Credit Co must satisfy the same business test. This is because the debt was incurred in an income year beginning before 1 July 2015.

Credit Co satisfies the same business test, and is able to obtain a deduction for the bad debt that it has written off for the 2017-18 income year.

Credit Co makes a tax loss in the 2017-18 income year. The deduction for the bad debt forms a part of this tax loss.

Credit Co undergoes another change of ownership that causes it to fail the continuity of ownership test again. It then makes a large profit in the 2019-20 income year and seeks to use its tax loss from the 2017-18 income year.

Because this tax loss is for an income year beginning on or after 1 July 2015, Credit Co can use this loss if it satisfies the similar business test. This includes the part of the loss that resulted from the deduction of the bad debt.

However, Credit Co may choose to apply the same business test in working out whether it can use losses for the 2017-18 income year if this is more convenient for the company. For example, if Credit Co can show that it carried on the same business since at least the test time for the bad debt, then it may be administratively easier to apply the one test rather than to apply both the same business test and the similar business tests.

1.54 Where the similar business test applies, a company may choose to instead apply the same business test. Although the similar business test is generally easier to satisfy, there may be administrative reasons that mean that the company would prefer to apply the same business test. For example, if a company has losses to which the same business test applies and losses to which the similar business test applies, the company may find it more convenient to apply the same business test to all of its losses.

Consolidation — losses transferred from a joining entity

1.55 Section 707-140 of the ITAA 1997 treats a tax loss (or net capital loss) transferred from a joining entity to a head company as having been made by the head company in the income year in which the transfer happens.

1.56 Section 707-140 is amended to prevent the similar business test from being applied to a tax loss (or net capital loss) that was originally incurred by the joining entity for an income year beginning before 1 July 2015. ***[Schedule 1, item 12, subsection 707-140(1A) of the ITAA 1997]***

Listed widely held trusts

1.57 For listed widely held trusts, the parallel similar business test in Schedule 2F of the ITAA 1936 applies with respect to:

- a tax loss for a loss year starting on or after 1 July 2015; ***[Schedule 1, item 21, paragraph 269-105(1)(a) in Schedule 2F to the ITAA 1936]***
- the working out of net income and tax losses for an income year starting on or after 1 July 2015 for the purposes of Division 268 in Schedule 2F to the ITAA 1936; and ***[Schedule 1, item 21, paragraph 269-105(1)(b) in Schedule 2F to the ITAA 1936]***

- with respect to the writing off of bad debts, a debt incurred in an income year starting on or after 1 July 2015. This includes debts that are extinguished by a debt/equity swap, where the debt is incurred in an income year starting on or after 1 July 2015. ***[Schedule 1, item 21, paragraphs 269-105(1)(c) and (d) in Schedule 2F to the ITAA 1936]***

1.58 Where the similar business test applies, a listed widely held trust may choose to instead apply the same business test. Although the similar business test is generally easier to satisfy, there may be administrative reasons that mean that the trust would prefer to apply the same business test.

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

Access to losses

1.59 Schedule 1 to this Bill is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

1.60 Schedule 1 to the Bill amends the Income Tax Assessment Act 1997 and the Income Tax Assessment Act 1936 to supplement the same business test with a more flexible similar business test. The similar business test improves access to losses for companies (and certain trusts) that have changed ownership and allows those companies and trusts to seek out opportunities to innovate and grow without losing access to losses.

Human rights implications

1.61 Schedule 1 to this Bill does not engage any of the applicable rights or freedoms.

Conclusion

1.62 This Schedule is compatible with human rights as it does not raise any human rights issues.

Chapter 2
Intangible asset depreciation

Outline of chapter

2.1 Schedule 2 to this Bill amends the ITAA 1997 to provide the choice to self-assess the effective life of certain intangible depreciating assets rather than using the statutory effective life in working out the decline in value.

Context of amendments

2.2 The current law mandates the effective life to be used for certain intangible depreciating assets in calculating their decline in value, which may not necessarily reflect the period of time that the assets provide economic benefits to the taxpayer.

2.3 On 7 December 2015, the Government announced a package of measures designed to incentivise and reward innovation as part of its National Innovation and Science Agenda. One of those measures is to allow taxpayers to self-assess the effective life of certain intangible depreciating assets.

2.4 This measure will better align the taxation treatment of those assets with the actual period of time that the assets provide economic benefits. It also aligns the treatment of those intangible depreciating assets with that of tangible assets.

2.5 These amendments implement the measure to allow self-assessment of the effective life of certain intangible depreciating assets.

Summary of new law

2.6 The new law allows a taxpayer to choose to self-assess the effective life of intangible depreciating assets listed in the table in subsection 40-95(7) rather than using the statutory effective life specified in the table. The choice can be made in relation to intangible assets the taxpayer starts to hold on or after 1 July 2016. The intangible assets to which this choice applies are:

- a standard patent;
- an innovation patent;
- a petty patent;
- a registered design;
- a copyright (except copyright in film);
- a licence (except one relating to a copyright or in house software);
- a licence relating to a copyright (except copyright in a film);
- in-house software;
- a spectrum licence;
- a datacasting transmitter licence; and
- a telecommunications site access right.

2.7 The effective life is used to calculate the decline in value of the intangible asset.

2.8 The new law also allows the taxpayer to recalculate the effective life in later income years if the effective life the taxpayer has been using is no longer accurate because of changed circumstances relating to the nature of the asset's use.

2.9 If the cost of the asset increases by at least 10 per cent in a later income year the taxpayer must recalculate the effective life of the asset.

2.10 The taxpayer must also recalculate the effective life of the asset for the income year that the taxpayer starts to hold it if:

- the taxpayer is using an effective life because of the associate or same user rule in subsection 40-95(4) or (5); and
- the asset's cost increases after the taxpayer starts to hold it in that year by at least 10 per cent.

Comparison of key features of new law and current law

New law	*Current law*
To calculate the decline in value of certain intangible depreciating assets, a holder of the asset can choose to self-assess the effective life rather than use the statutory effective life.	To calculate the decline in value of certain intangible depreciating assets, a holder of the asset must use the statutory effective life.
Unless the asset is copyright, licence relating to copyright or in-house software, a subsequent holder of certain intangible depreciating assets must use the remaining statutory effective life for the prime cost method formula, if the holder does not choose to self-assess the effective life.	Unless the asset is copyright, licence relating to copyright or in-house software, a subsequent holder of certain intangible depreciating assets must use the number of years remaining in the effective life of the former holders for the prime cost method formula.
If a subsequent holder of certain intangible depreciating assets self-assesses the effective life of the asset, the holder is not able to adjust the prime cost method formula.	No equivalent.
If in a later income year, the effective life used for certain intangible depreciating assets is no longer accurate due to a change in circumstances relating to the nature of the use of the asset, a holder of the asset is able to recalculate the effective life.	A holder of the asset is not able to recalculate the effective life.
If the cost of the intangible depreciating asset increases by at least 10 per cent in a later income year, a holder of the asset must recalculate the effective life.	A holder of the asset is not able to recalculate the effective life.
A new holder must recalculate the effective life for the income year that they start to hold certain intangible depreciating assets, if the cot of the asset increases by at least 10 per cent and the asset: • is acquired from an associate; • continues to be used by the former user; or • has a new user who is an associate of the former user.	A holder of the asset is not able to recalculate the effective life.

Detailed explanation of new law

2.11 The amendments provide a taxpayer with the ability to choose to self-assess the effective life of certain intangible depreciating assets they hold, or apply the existing statutory effective life specified in the table in subsection 40-95(7). The effective life is then used in calculating the decline in value of the intangible depreciating asset. ***[Schedule 2, items 8 and 10, subsection 40-95(7) and paragraph 40-105(4)(a)]***

2.12 In self-assessing the effective life of the asset, the taxpayer must work out the effective life in accordance with section 40-105, which includes taking into account:

- how they expect to use the asset;
- the estimated period of time that the asset can be used by any entity to derive income at its start time (for a taxable purpose, for producing exempt income and non-assessable non-exempt income or for the purpose of conducting research and development activities);
- the likelihood of the asset becoming obsolete; and
- the estimated time when the asset is scrapped or abandoned.

2.13 A depreciating asset starts to decline in value from its start time, which is generally when the taxpayer first uses the asset or has installed the asset ready for use for any purpose.

2.14 If the taxpayer chooses to self-assess the intangible depreciating asset's effective life, the choice must be made for the income year in which the asset's start time occurs. ***[Schedule 2, item 9, subsection 40-95(7A)]***

2.15 The choice must be made by the day the taxpayer lodges their income tax return for the income year, unless a later time is allowed by the Commissioner of Taxation.

2.16 The choice applies to that income year and all later income years, except where a choice is made to recalculate the effective life under subsection 40-110(1) due to its circumstances of use having changed (see paragraph 2.20).

Associate and same user rules

2.17 Subsections 40-95(4) and (5) continue to oblige a taxpayer to use an effective life equal to the effective life of the former holder that is yet to elapse at the time the new holder starts to hold the asset if a depreciating asset:

- is acquired from an associate, who has deducted or could have deducted the decline in value of the asset;
- continues to be used by the same user; or
- has a new user who is an associate of the former user.

2.18 These rules will apply consistently to intangible depreciating assets listed in the table in subsection 40-95(7). Consequently, the new holder of the asset does not have the choice to self-assess the effective life of the asset or use the statutory effective life in the table in subsection 40-95(7). ***[Schedule 2, item 9, subsection 40-95(7B)]***

Example 2.1

Amy acquired a standard patent on 1 July 2017 for $150,000. She self-assesses the effective life of the standard patent to be 15 years and works out the decline in value to be $10,000 per annum.

Amy deducts the decline in value of the standard patent for the 2017-18, 2018-19 and 2019-20 income years.

On 1 July 2020, Amy sells the standard patent for $120,000 to an associate, Michael.

Michael is not able to choose to self-assess the effective life or use the statutory effective life for the standard patent, because the associate rule in subsection 40-95(4) would apply to him. He must use the effective life Amy has been using that is yet to elapse at the time he starts to hold the standard patent.

On 1 July 2020, there are 12 years yet to elapse on the effective life that Amy has been using, so Michael must use an effective life of 12 years for the standard patent in working out his decline in value.

2.19 However, the new holder must use the effective life applicable to the asset in the table in subsection 40-95(7), where the asset continues to be used by the former user or has a new user who is an associate of the former user and:

- the new holder does not know and cannot readily find out which effective life the former holder was using; or
- the former holder did not use an effective life.

[Schedule 2, items 6 and 7, subsections 40-95(6) and (6A)]

Recalculation of effective life

2.20 Where there are changes, in a later income year, to the circumstances relating to the nature of the use of an intangible asset that is in the table in subsection 40-95(7) that the taxpayer starts to hold after 1 July 2016, the effective life of the asset may be recalculated. This is only available where the change in use makes the effective life that is being used inaccurate. ***[Schedule 2, item 13, subsection 40-110(5)]***

2.21 If the cost of the asset increases by at least 10 per cent in a later income year the taxpayer must recalculate the asset's effective life. ***[Schedule 2, items 11 to 13, subparagraphs 40-110(2)(a)(iii) and (iv) and subsection 40-110(5)]***

2.22 The taxpayer must also recalculate the effective life of the asset for the income year that the taxpayer starts to hold it if:

- the taxpayer is using an effective life because of the associate or same user rule in subsection 40-95(4) or (5); and
- the asset's cost increases after the taxpayer starts to hold it in that year by at least 10 per cent.

[Schedule 2, item 13, subsection 40-110(5)]

2.23 This treatment is consistent with the treatment of tangible depreciating assets.

2.24 A recalculation of the effective life of an intangible depreciating asset must be done under section 40-105 using self-assessment (see paragraph 2.12).

Consequential amendments

Adjustment to the prime cost method formula

2.25 If a holder of an intangible depreciating asset is not the first holder of the asset, subsections 40-75(5) and (6) provide that the new holder needs to adjust the prime cost method formula to take into account the period that all former holders have held the asset. This adjustment does not apply to copyright, a licence relating to copyright or in-house software.

2.26 That is, instead of using the statutory effective life in the table in subsection 40-95(7), the new holder must use the period remaining in that effective life as at the time the holder starts to hold the asset.

2.27 Subsections 40-75(5) and (6) are being amended to ensure that it applies only in situations where the new holder uses the statutory effective life specified in the table in subsection 40-95(7). This is the case regardless of whether the former holder used the statutory effective life or self-assessed effective life. ***[Schedule 2, items 1 to 5, subsections 40-75(5) and (6)]***

Tax cost setting under the consolidation regime

2.28 When an entity joins or leaves a consolidated group, its assets become or cease to be the assets of the group. The tax cost of the asset of the head company or leaving entity is set at the asset's tax cost setting amount.

2.29 The meaning of *tax cost is set* in section 701-55 is being amended so that it continues to apply appropriately to intangible depreciating assets listed in the table in subsection 40-95(7). ***[Schedule 2, items 14 to 16, paragraph 701-55(2)(d)]***

Application and transitional provisions

2.30 The new law applies to intangible depreciating assets, listed in the table in subsection 40-95(7), that a taxpayer starts to hold on or after 1 July 2016. That is, the current law continues to apply to these intangible depreciating assets that a taxpayer holds before 1 July 2016. ***[Schedule 2, items 8, 10 and 13, subsection 40-95(7), paragraph 40-105(4)(a) and subsection 40-110(5)]***

2.31 In this regard, the new law is beneficial to affected taxpayers as it allows taxpayers to choose an effective life for an intangible depreciating asset that reflects the actual economic life of the asset, rather than using the statutory effective life.

STATEMENT OF COMPATIBILITY WITH HUMAN RIGHTS

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

Intangible asset depreciation

2.32 Schedule 2 of this Bill is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview

2.33 On 7 December 2015, the Government announced a package of measures designed to incentivise and reward innovation as part of its National Innovation and Science Agenda. One of those measures is to allow taxpayers to self-assess the effective life of certain intangible depreciating assets.

2.34 Schedule 2 of the Bill amends the ITAA 1997 to provide taxpayers with the choice to self-assess the effective life of certain intangible depreciating assets they start to hold on or after 1 July 2016, rather than using the statutory effective life currently specified in the law.

Human rights implications

2.35 Schedule 2 of the Bill does not engage any of the applicable rights or freedoms.

Conclusion

2.36 Schedule 2 of the Bill is compatible with human rights as it does not raise any human rights issues.

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Schedule 1: Access to losses

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