

# Tax tactics



Tax advice is usually something business owners think about when they are making money, not losing it. Yet expert tax advice can be crucial for businesses that have made a loss.

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An economic downturn may present a one-off opportunity to use capital gains tax concessions.

The economic downturn has hit some parts of the retail sector hard. Some retailers may be experiencing serious trading losses for the first time and their

senior managers may have never experienced such a profound slump. This environment poses some unique tax issues and challenges. It also presents some opportunities.

A retail business may be contemplating, or have thrust upon them, one or more of the following:

- A restructure of the business or its operations (including acquiring a struggling competitor);

- An injection of capital, whether debt or equity (potentially from alternative sources as nervous business bankers put the squeeze on lending);

- Sale of a non-core asset;
- Entering into external administration, receivership or liquidation.

Tax will play an important part in each of these events. In some cases tax issues will be the difference between getting a deal done or not.

A crucial tax issue, especially during a downturn, is the preservation of tax losses. Tax losses can be used as deductions in later financial years when a business has recovered and is profitable again. In previous decades there was a thriving market in Australia for tax losses. However, Parliament has responded and Australia now has highly complex tax loss integrity rules that must be satisfied to preserve losses.

There are a plethora of rules to be considered. Rules dealing with income injection, family trust elections, the continuity of ownership and same business tests, value shifting, debt forgiveness and anti-tax avoidance rules (specific and general) can all have an impact of tax losses. To complicate matters, the rules apply differently to trusts, companies, partnerships

and variations thereof. However, with foresight and planning tax losses can be preserved for when the economy picks up.

## Restructuring a business

There may be substantial consolidation in the retail sector. Unsound processes or excessive back office expenses can be hidden during the boom times, but a downturn can expose a poor business operational model. Some businesses may benefit from consolidating the revenue of another business with its fixed overhead costs.

Any business restructure or reorganisation may impact on the preservation of tax losses. Seemingly minor changes to a business can have adverse consequences.

A recent Federal Court case is a good illustration. A company owned a Sydney hotel and was taken over by new owners. The company had tax losses and was required to meet the 'same business test' to preserve them. Under the previous ownership the company contracted out the operation of the hotel to a separate entity under a management agreement. The new owners cancelled this agreement and carried on the hotel business themselves via the old company. To the general public there was absolutely no change to how the hotel was run. However, the Court ruled (subject to appeal) this new management structure was in breach of the same business test. This highlights the care that needs to be taken when reorganising a business with tax losses.

For a business wishing to acquire another business, preserving the tax losses of the target can substantially reduce the bottom line cost of the deal. Likewise, businesses likely to be acquired may be able to command a better price if its tax losses remain intact.

An economic downturn may be an opportune time to restructure a business. Sometimes business owners outgrow their original structure and a reorganisation might help succession planning, asset protection or business efficiency. Such reorganisations often involve capital gains tax (CGT), stamp duty and GST issues.

An economic downturn may mean business owners can access generous small business CGT concessions that previously were not available. To access the concessions, a \$6 million net asset value test or a \$2 million turnover test must be satisfied. Current economic conditions may mean business assets, including business goodwill, have reduced in value, potentially bringing some businesses (and associates connected to the business) within the \$6 million test. Similarly, turnover may have suffered bringing it below the \$2 million threshold.

Not only might the CGT small business concessions allow a restructure to be done with little or no CGT, an 'uplift' in the cost base of an asset may be obtained in a tax-neutral manner. This will reduce any capital gain in the future when potentially the CGT small business concessions are no longer available. An economic downturn may present business owners with a one-off opportunity to use these concessions and obtain a cost base uplift. It could be a good time to check the balance sheet.

## Injection of capital

Some retailers may need an injection of capital to survive or grow. Injecting capital into businesses with losses requires great care. For example, the subscription of new shares to raise capital can result in a change in the shareholding of a company. This can have an impact on the 'continuity of ownership test' for a company with tax losses. Advice should be sought in advance of a share offering. If it will fall foul of the rules, there are a number of sensible alternatives available.

## Sale of a non-core asset

A sale of a non-core asset may need to be done because a business needs the capital. Alternatively, an under performing investment or branch of the business may be dragging down the profitable core business.

The disposal of an under performing asset could be sold at a loss, especially if it is perceived as a fire sale. If the investment or non-core business is held in a separate

entity to the profitable core business, capital or revenue losses may be 'trapped'.

The (deductible) losses of one entity may be able to soak up the (taxable) profits of another, greatly improving the after tax result of a distressed asset sale. However this requires forethought as, amongst other things, complex tax 'income injection' rules must be satisfied.

## External administration, receivership or liquidation

Some loss-generating businesses cannot be salvaged without entering into external control. The role of the external controller is to either do a deal with creditors, or sell off all or part of the company's assets.

A deal with creditors, such as a Deed of Company Arrangement (DOCA), will commonly result in a portion of the creditors' claims being compromised. This can have an adverse impact on the use of tax losses of the company going forward.

Commercial debt forgiveness rules apply when a debt owed by an entity with tax losses is forgiven, waived or otherwise compromised. The value of the debt or portion of the debt forgiven will result in a corresponding reduction in the tax losses of the debtor.

Whether the rules apply or not will crucially depend on how the DOCA or debt compromise document is drafted. Often the tax losses from a collapsed business are the only 'asset' of any value remaining.

If those losses can be preserved and used in the future, this may alleviate some of the bitter pain of losing a business or working capital. To prevent those losses being eroded when a deal is done with creditors, tax advice should be obtained prior to any debt being compromised or the DOCA being submitted to creditors.

In summary, a downturn in some segments of retail may be the catalyst for a brighter future. Those that start planning now for a recovery will be better placed to take advantage of the good times than those that don't. •

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