The Institute of Public Accountants

Treatment of losses

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Partnership beyond numbers

IPA INSTITUTE OF PUBLIC ACCOUNTANTS

Introduction

The IPA welcomes the opportunity in providing a submission to the Business Tax Working Group consultation paper **"Interim report on the tax treatment of losses"**. Current tax loss treatment for companies hinders productivity and is long overdue for change.

The review of the current treatment of losses is an important development and represents a significant potential change for businesses operating through company structures.

The IPA is one of the three professional accounting bodies in Australia, representing over 22,000 accountants, business advisers, academics and students throughout Australia and internationally. The IPA prides itself in not only representing the interests of accountants but also small business and their advisors. The IPA was first established (in another name) in 1923.

The IPA's submission has been prepared with the assistance of the IPA Faculty of Taxation. We are grateful for their contribution and guidance. The IPA submission has also benefited from consultation with IPA members who have expressed their views and concerns. We are also grateful to all those who have taken the time to provide their input.

We look forward to discussing further and in more detail the IPA's recommendations with the Government and Treasury.

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Yours faithfully

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Executive Summary

The IPA has long advocated for a change in the treatment of tax losses and fully supports the review into the current tax loss rules by the Business Tax Working Group. Whilst the current tax loss rules apply to all corporate tax entities, we believe there is strong merit to restrict the availability of loss carry back arrangements to small businesses at first instance if budgetary constraints do not allow for an extension of such a measure more broadly. Our submission focus is on improving the treatment of losses for the small business community that operate their affairs through a corporate structure. Reforms are needed to deliver tax relief to struggling businesses facing structural changes in a volatile environment.

Larger entities have the ability to weather a rough patch in financial performance or can apply losses to other parts of their business, if they have diversified operations.

Small businesses operating through companies tend to experience cash flow problems as the current treatment of losses restricts business cash flow. Small companies generally have limited resources to cope with adverse trading conditions and may require short term liquidity to meet day-to-day liabilities. This is the major short coming of the current tax loss treatment rules for small corporate businesses, the inability to claw back some previously paid taxes.

Current policy settings that govern the current tax loss treatment for losses hinder the ability of businesses to adapt and change which impacts on productivity. Risk taking, investment and innovation are discouraged under the present rules.

These impediments add to the current structural challenges facing businesses as they evolve in a volatile economic environment. Current treatment of losses can exacerbate some of the challenges facing business as the current rules do not assist in helping corporate businesses in adapting and changing to the economic environment.

It is Important for a growing economy such as ours, to have tax policy settings that are designed not to hinder risk taking and innovation by business.

The IPA believes that small companies should be able to offset losses made in a particular income year against taxable income from the preceding year. Small companies could then receive an immediate tax refund to the extent the company paid tax in the previous year and this would be particularly beneficial for small companies under financial stress. The cost of implementing small business loss carry back would not be significant and would represent targeted measure to small businesses struggling to cope with structural changes in the economy. The Business Tax Working Group can continue to work on improving current tax loss treatment for larger corporates which must be funded from the identification of offsetting savings due to fiscal constraints imposed by the terms of reference for the review.

Introductory comments

The current system treats gains and losses asymmetrically. Gains are taxed as they accrue while losses are not refunded, but can be carried forward and used against future income subject to stringent loss rule tests. This treatment can be contrasted with the GST, where the government will refund to taxpayers the amount of input GST that exceeds output GST.

Current treatment restricts cash flow for businesses in a loss position which in turn reduces the ability for a business to invest and respond to challenges by making necessary structural changes. This asymmetric tax treatment of profits and losses can distort taxpayer decision making with undesirable economic consequences, particularly in terms of risk taking.

Loss incurred by sole traders and partnerships results in a considerable degree of loss utilisation as these entities are able to flow through their losses to owners without having to carry them forward to be used against future income.
Loss utilisation for companies is more problematic as some companies may never be able to gain the benefit of such losses due to a variety of reasons, and therefore any policy change which improves loss utilisation will have revenue implications.

Reform tax loss treatment for small companies

Small companies should be able to carry back revenue losses against prior year's taxable income. There should be an immediate tax refund to the extent that the business paid tax in the previous year, which should encourage further risk taking and entrepreneurial activity. Companies will be more willing to invest if they knew that if they subsequently make a loss they may be able to realise the benefit of that loss immediately.

Existing rules limit loss utilisation and discourage risky investments. Other countries provide such relief as part of their tax system which provides an automatic stabilizer during downturns. Our loss rules create disincentives for businesses to change as this could put their losses in jeopardy under loss utilization rules. They can have the effect of locking companies into suboptimal operations and structures to protect the ability to use their carried forward losses in the future.

The interim report considers the merits of restricting the availability of loss carry back arrangements to businesses of a certain size. It highlights the fact that larger companies with diversified operations have an increased ability to utilize losses. Capping the amount of losses that could be carried back, or restricting the carry back to businesses within a specified turnover threshold are options put forward by the interim report as a way of targeting the measure to small and medium sized businesses.

As an integrity measure any refunds should be limited to a company's franking account balance and the loss carry back could be limited to a period of one to three years.

The existing small business definition for tax purposes (entities with less than $2 million turnover) can be used to restrict the carry back of losses to these entities at first instance whilst broader policy settings are being refined for larger entities. Approximately one third of small businesses operate through a corporate structure.

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