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Issue 1: Limited benefit for small businesses

In the original discussions of this carry back loss idea there was a limitation on providing this ability to carry back losses to small businesses only. However, in its current form it will be of limited use to small businesses given the way small businesses operate. I don't mean that the majority of small businesses don't use companies (due to poor access to CGT concessions and limited income splitting) but I believe that even small businesses that operate through companies will not see much use in these changes.

This is because the carry back losses are limited to the franking balance (as they should be) but most small business companies pay out the majority of their dividends to the shareholders as franked dividends.

Firstly, there are parts of the tax laws that encourage small businesses to pay out their profits as franked dividends. For example, let me quote from an ATO guide on PART IVA and Personal Services Businesses (being an entity that is not generally effected by the operation of Part 2-42 of the ITAA97):

At http://www.ato.gov.au/content/downloads/NAT8028.pdf:

"If you operate through your company and there is no income splitting and no retention of profits in the company (for example, if the only advantage for income tax purposes is access to greater superannuation benefits) then Part IVA will not apply.

If a bona fide attempt is made to break even, a relatively small amount of taxable income may be returned by the company provided that income is distributed to you by way of a franked dividend in the following year."

Any small business running through a company that has personal services income has already been warned by the ATO to keep its franking balance as close to zero as possible.

Secondly, small business operators do not want to keep retained profits in their business for practical reasons. Whether it is for asset protection reasons (if the company gets sued and there is cash in the company) or whether it is just that small business operators want to use the profits of their company for personal uses, there are strong drivers to pay out franked dividends. It is even good tax planning to buy CGT assets outside of a company (companies have bad access to CGT concessions) so even if the company needs assets it does not retain cash to buy the assets in the company, rather it pays out a franked dividend and buys the asset in other entities.

Finally, it should be noted that the ATO has recently confirmed how easy it is to pay out a franked dividend, even out of current year profits where there are retained losses, or even out of capital reserves (see Taxation Ruling TR 2012/5). This will only confirm that small businesses will pay out franked dividends.

In summary, the policy is going to have limited effect. It would be interesting to look at the franking balances of companies at a year end with less than $2M turnover and compare that to the losses they had incurred in that year. Both these are reported on company tax returns and would give you some real data on whether this policy has any real effect on small businesses operating through companies.

If my concern is borne out in the data that would mean what is being implemented is a minor timing benefit for large companies.

Issue 2: Anti avoidance

This is not the place to change the loss recoupment rules (if they are to be changed they should be fixed globally) so the carry back loss rules should mirror the carry forward loss rules. For example, the COT should be required from the start of the income year to the end of the loss year. It would be interesting to see if drafting this like "The 'carry back loss deduction' is only available if (i) had the 'prior income year' been a 'taxable loss year' and the loss was the same as the taxable income for the prior income year ; and (ii) the 'current year carry back loss' had been a 'taxable income year' where the taxable income was equal to the current year loss; (iii) the loss at (i) could have been offset against the gain at (ii)."

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