Business Tax Working
Group Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

E-Mail: BTWG@treasury.gov.au

Attention: Chris Jordan

2 February 2012

Dear Chris,

Tax Treatment of Business Losses

Thank you for the opportunity to comment on the interim report on the tax treatment of business losses.

The Property Council is the peak body for owners and investors in Australia's $400 billion property investment sector. The Property Council represents members across all four quadrants of property investment - debt, equity, public and private.

The report presents four good options to update the tax treatment of business losses.

However, adopting a few simple recommendations would ensure that the proposals work more effectively and enable property businesses to ride out the challenging economic environment. This will achieve your aims to make the most of the challenges and opportunities arising from transformations in the broader economic environment.

The Property Council's recommendations are, in order of preference:

- **allow all companies to carry back their losses for up to three years;**

  property companies do not generally have diversified activities outside property regardless of their size and cannot use the losses in other parts of their business;

  a three year period will allow companies with longer boom and bust cycles, such as the property industry, to make use of the provisions;

- **do not remove the Continuity of Ownership and Same Business tests** – this is likely to reduce incentives for businesses to expand and/or take additional risks by acquisitions or joint ventures; and

- **uplift tax losses using cost of capital** – business cost of capital is significantly higher than the government bond rate. To help businesses make the most of challenges and opportunities, it is important to use the real cost of capital to business. Otherwise, the uplift rate is too low.

The attached submission outlines our recommendations for appropriately dealing with these issues. We are keen to discuss them with you further at your convenience.

We are keen to meet you to discuss the issues that the tax treatment of losses raises for the property industry and ensure that measures designed to achieve revenue neutrality do not have unintended consequences.

Please do not hesitate to contact Elaine Abery on (02) 9033 1929 or I with any queries.

Yours sincerely

Andrew Mihno

Executive Director International & Capital Markets

Property Council of Australia

0406 45 45 49

Tax Treatment of Business Losses

Property Council of Australia
February 2012

1. Summary

The report provides four possible reforms that could be pursued individually or as elements of a suite of reforms to improve the treatment of losses :

- Element A – remove the continuity of ownership (COT) and same business (SBT) tests and introduce an alternative integrity test.
- Element B - allow losses to be refunded.
- Element C – introduce a time limited form of loss carry back.
- Element D – apply an uplift factor to losses.

We address each of these proposals below. Our primary focus is on Element C as set out in the report which proposes the introduction of a time limited form of loss carry back.

The Property Council generally supports this proposal, subject to:

- the comments set out below regarding the time frame of the carry back; and
- the measures introduced to counter balance the cost to the Revenue of introducing the measure.

2. Background

The property industry's business is a cyclical one as evidenced by the booms and busts of the 1980s, 1990s and recent times. It is very rare where a company in the property industry would have a symmetrical pattern of having one year of profits followed by a loss year and then a reversion to profits in the next and so forth.

Further, large property businesses are truly entrenched in the property industry as a whole. Whilst these businesses may be carrying on a number of different operations e.g. developments, construction project management and/or investments, such operations are still entrenched in a property business as a whole. When there is a downturn in the property market all of these different operations within a business will be affected.

This cyclical characteristic must also be the case for other industries as well the property industry (eg retail industry).

3. Submission

Element C – Introduction of a Time Limited form of Loss Carry Back

As set out in paragraph 103 of the report a Loss Carry Back allows companies to carry current year tax losses back to be offset against previous year's profits, resulting in a refund of tax previously paid. On this basis the report states that a loss carry back is limited to the taxes paid in previous income years.

It is also noted that paragraph 108 of the report makes the point that the Australia's Future Tax System Review recommended a one year carry back for company revenue losses, with the amount of any refund limited to a company's franking account balance.

Furthermore at paragraphs 114 and 115 of the report it is stated that this reform element assumes that loss carry back would be limited to a period of one to three years. Moreover, this is cited to be consistent with international practice as set out in Appendix B to the report.

The Property Council generally supports the loss carry back proposal and wishes to submit the following in relation to its implementation:

- **The period of carry back should be three (3) years.**

  From the property industry's perspective, the proposal of limiting the carry back to one year will not provide a notable incentive to change behaviour in relation to decision making.

  As set out earlier, the property industry's business is a cyclical one as evidenced by the booms and busts of the 1980s, 1990s and recent times. It is indeed a very rare scenario where a company in the property industry would have a symmetrical pattern of having one year of profits followed by a loss year and then a reversion to profits in the next and so forth.

  Moreover, most businesses in the property industry would experience "multiple loss years or volatility of tax profile over a number of years rather than moving regularly from profit to loss (and back again)" to quote the Working Group's own comments at paragraph 115 of the report.

  The Property Council strongly endorses the Group's proposition that a three year carry back period would provide greater opportunities for carry back to occur and a better smoothing impact on the tax treatment of companies. Such a period should also have the effect of influencing decision making in respect of new projects/developments.

- **The Property Council agrees that a company's capacity to carry back a current year loss should be restricted to its franking account balance.**

- **The availability of loss carry back arrangements should be available to all businesses.**

  It is noted at paragraph 145 of the report that the Working Group observes there may be merit in restricting the availability of the loss carry back proposal to businesses of a certain size, in particular, small and medium sized businesses. Furthermore, examples of the United States and United Kingdom experiences in relation to small and medium sized businesses in this regard are provided at paragraphs 117 and 118 of the report.

  One of the rationales for limiting the carry back arrangement to small and medium sized businesses appears to be based on the expectation that larger companies with diversified operations would have an increased ability to utilise losses as profits from certain operations within their business could be offset by losses resulting from other operations in the business structure.

  The Property Council submits this expectation does not hold in many circumstances, particularly property, as it fails to recognise that a large property business is truly entrenched in the property industry as a whole. It may have other operations but these are also within the property industry. Take for example the large property groups that are listed on the Australian Securities Exchange. They may be carrying on a number of different operations e.g. developments, construction project management and/or investments, however, such operations are still entrenched in a property business as a whole. When there is a downturn in the property market all of these different operations within a business will be affected. This would also apply in many other industry sectors. Therefore, it does not necessarily follow that the larger companies will have the benefits of diversification and be able to utilise losses better where their businesses are wholly within one industry.

Accordingly, it is submitted that the loss carry back arrangements should be available to all businesses irrespective of size.

Element A – Remove COT and SBT

The the proposed removal of the Continuity of Ownership and Same Business tests coupled with the application of an available fraction rule may be very difficult to apply in practice. Moreover, it may prove to be detrimental in the scenario where a company acquires an interest in another company which has carried forward losses.

Currently where a tax consolidated group of companies acquires a 100% interest in another property company which has losses and joins the consolidated group, the losses transferred to the head company are already subject to an available fraction rule as set out in the report.

However, take for example the scenario where the first company acquires a less than 100% interest in another company which has tax losses (and therefore precluded from forming/joining a tax consolidation group). Currently, notwithstanding that the second company may fail the COT test it is still able to recoup its losses in full without any restriction providing it satisfies the SBT.

If the proposal as currently set out in the report is implemented, that is, remove COT and SBT and apply an available fraction rule to less than 100% acquisitions, this would mean that in the example above, the tax losses may not be able to be utilised at the same rate as under the current rules and therefore any incentives for businesses to expand and/or take additional risks by acquisitions or further joint ventures would be removed.

Element B – Loss Refundability

The proposal has appeal and potential benefits in principle. It is also noted that no other jurisdiction offers immediate refundability of tax losses.

However, the Property Council also acknowledges that the potential costs of implementing this proposal will be significant and accordingly, is not a viable option.

Element D – Application of an uplift factor to losses

Paragraph 122 of the report notes that an uplift factor set by reference to the ten year government bond rate could be applied to tax losses as they are carried forward.

This proposal has appeal in principle. However, it is submitted that the proposal in its present form would not have any significant impact on business planning decisions having regard to the low benchmark rate to be set as the uplift factor.

Commercially, the uplift factor should be set closer to a company's cost of capital for the proposal to provide any real benefits. In addition, if this measure is introduced we recommend that it be introduced with one or more other proposals.

4. Conclusion

Again, we commend the Government for undertaking a review on how the business tax system can be improved to enable business to make the most of the challenges and opportunities arising from transactions in the broader economic environment.

We are grateful for the opportunity to provide comments on the issues raised in the report by the Working Group.

We request a meeting with the Working Group to further discuss the issues that the tax treatment of losses raises for the property industry.