THE TAX INSTITUTE

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Dear Christine

Discussion Paper: "Improving access to company losses"

The Tax Institute thanks you for the opportunity to provide this submission in response to Treasury's Discussion Paper entitled "Improving access to company losses" (the "**Discussion Paper**").

Overview

The Tax Institute is broadly supportive of the Government's announced policy intention to introduce a limited loss-carry back as described in sections 4.1 to 4.5 of the Discussion Paper.

As we have noted previously, in our view a limited loss carry-back is a positive step towards helping substantial numbers of businesses face increasingly uncertain conditions. In addition, the measure will ensure that within limitation, our tax system will impose the same overall tax liability regardless of the tax year in which a company produces its income or loss, acting as a natural regulator for both business and Government by evening out tax collections.

Nevertheless, we are concerned by the proposals contained in section 4.6 of the paper in relation to the suggested suite of 'integrity rules' that must be satisfied before a loss may be carried-back. Our concern stems from two factors:

- The current Continuity of Ownership Test ("**COT**") and Same Business Test ("**SBT**"), despite being familiar, are nevertheless complex, unwieldy and costly to apply and should therefore be limited in application rather than extended, at least in the longer term; and

- The integrity risk underpinning the supposed need for integrity rules in this context is overstated. To the extent that integrity rules are considered necessary to curb 'trafficking' in defunct companies laden with prior year income and franking credits (and other such behaviours), an extension of the current Part IVA should in our view provide sufficient protection.

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Our specific comments on the Discussion Paper are set out below.

Submission

Section 4.1 Limited carry-back period

We broadly agree that an ability to claim a carry-back of losses against tax paid for the two years preceding the claim year is appropriate and in-line with rules in comparable international jurisdictions.

Section 4.2 A $1 Million Quantitative Cap

In its Final report on the tax treatment of losses (the "**final report**"), the Business Tax Reform Working Group (the "**Working Group**") noted that:

> *"A quantitative cap is also easy to adapt when needed to meet policy objectives. For example, the cap might be increased during an economic downturn to stimulate investment, although frequent changes to the cap could create uncertainty.*
>
> *A quantitative cap can target the benefits of loss carry back to small and medium sized companies struggling with the two speed economy, without relying on legislative definitions around company size and type.*
>
> *Applying a quantitative cap would reduce the overall cost of providing loss carry back and reduce the Government's exposure to large losses incurred by individual businesses, while still providing benefits to all eligible companies.*
>
> *…. the Working Group supports a quantitative cap of not less than $1 million but further analysis could be conducted on the benefits of a higher cap, for example the effect of a $5 million cap on both the cost and impact of loss carry back."*

These comments and conclusions stem partly from the Working Group's Terms of Reference which required the making of recommendations on "revenue neutral reforms to the business tax system [which] will aim to increase productivity, while delivering tax relief to struggling businesses" (emphasis added). In light of these Terms of Reference, both the Working Group's recommendation and the Government's policy decision to limit the loss carry-back is wholly appropriate.

In light of the compliance difficulties caused by the definition of 'small business entity' as that term is used to determine the availability of current 'small business' tax concessions, we are broadly supportive of the use of a quantitative cap in order to effect this limitation.

It is our assumption that the Working Group's recommendation and the Government's decision as to the quantum of the cap (i.e. $ 1 million) was driven partly by current data as to the quantum of taxable income and losses of small to medium enterprises intended to be benefitted by introduction of the measure, as well the impact of the cap on the cost of introducing this measure.

In light of the Working Group's comments as to the diversity of opinion on the appropriateness of the $1 million cap, the likely evolution of Australia's current fiscal

position, and the likely effect of inflation on the actual benefit bestowed by this measure over time, we recommend that:

- The quantitative cap be specified in regulations rather than the tax law so that subsequent increases in the cap are less cumbersome to effect; and

- The Government commit to undertaking a post-implementation review of the appropriateness of this cap on a 5 yearly basis after introduction. Such a review should include a requirement to undertake community consultation, and should be undertaken by an independent body (such as the Working Group if its life is to be extended, or the Board of Taxation).

Section 4.3 Available to companies and entities taxed like companies

We are cognisant of the likely administrative and compliance costs and difficulties, as well as the likely revenue impact of extending loss carry-back to trusts, partnerships and sole traders.

Nevertheless, in light of:

- only approximately 30% of small to medium enterprises being structured as companies;

- the significant uncertainty and difficult economic circumstances facing the balance of small to medium enterprises that do not stand to benefit from this measure; and

- the Government-acknowledged need to ensure that the tax system does not result in distortions as to choice of operating entity by businesses

we recommend that the Government commit to undertake further research into the possibility of extending loss carry-back in later years to other business structures.

In this context, we note that the current review being undertaken by Treasury on the taxation of trust income should encompass consideration of the current trust loss rules, and capacity for simplification (as noted in our submission in response to Treasury's Discussion Paper entitled "Modernising the taxation of trust income – options for reform").

Section 4.4 Refunds limited to a company's franking account balance

We support the adoption of the last day of the claim year as the relevant test date with respect to a company's franking account balance.

While such an approach may result in companies obtaining a tax offset even where the company's franking account balance is lower than the amount of the offset at the time that the claim is made (because for example, the company has paid a dividend after the test date but before the claim for the offset has been lodged), as noted in the Discussion Paper such a situation would result in a liability for franking deficits tax, assuaging any integrity concerns. Furthermore, a test date of the last day of the claim year has the advantage of ease of calculation and likely increased reliability of records.

Section 4.6 Integrity rules

Appropriateness of integrity rules

The Discussion Paper contains a high-level description of the rationale for existing loss integrity tests as follows:

> *"The key reason for loss integrity rules is to remove an incentive for tax driven activities involving entities with losses. In particular, the continuity of ownership test prevents 'loss trafficking' — that is, purchasing defunct companies or other companies with losses in order to gain a tax advantage."*

The Working Group similarly described the rationale for the current loss integrity rules in the final report as follows:

> *"In 1944, the continuity of ownership test (COT) was established for private companies to address 'loss trafficking', that is, purchasing companies in order to gain a tax advantage from the carry forward losses. Loss trafficking was described by the Treasurer at the time as the practice 'of buying up shares in practically defunct companies and then operating those companies for purposes other than those for which they were originally registered'."*

However, as noted in The Tax Institute's submission to the Working Group in response to the Group's interim report on the tax treatment of losses:

> *"Ideally, the tax treatment of losses should not unnecessarily restrict trading in genuinely incurred losses. This is because as noted in paragraphs 35 and 36 of the interim report, the purchase of a loss company in order to obtain the tax benefit of losses "provides the same economic outcome as refundability by the Government".*
>
> *Furthermore we note that if trading in genuine losses were internationally common, such a stance would be unlikely to have a significant impact on Government revenue (other than to accelerate the recoupment of genuinely incurred losses) and therefore would not present a significant risk to the integrity of the tax system or create scope for tax avoidance.*
>
> *This is because the variety of measures introduced since the loss integrity measures (such as income tax consolidation) have left minimal opportunities for the generation of artificial losses.*
>
> *We recommend that this principle be borne in mind as an example of the sort of system that Australia and other nations should aim towards in the longer term."*

These comments are equally relevant when considering the appropriateness or need for integrity rules to restrict loss carry-back. We reiterate our comments above in this context and are of the view that ideally the tax treatment of losses (including loss carry-back) should not unnecessarily restrict trading in genuinely incurred losses.

As rationale for subjecting loss carry-back to integrity rules, the Discussion Paper notes:

> *"For loss carry-back, the analogous concern is that taxpayers expecting losses for a new venture might seek to gain a tax advantage by conducting the venture through a defunct or other company with both franking credit balances and prior year tax payments."*

We note that even if a taxpayer purchases such a 'defunct' company in which to conduct a new loss making venture, as the franking credit balances and prior year tax payments represent actual tax paid, no integrity concern should arise unless the relevant loss being carried back has been artificially generated in order to obtain the benefit of a refundable tax offset.

As in the case of carrying-forward losses, we note that the opportunities for such artificial loss generation are minimal in the context of the current tax system.

Furthermore, we understand that loss carry-back is not restricted by loss integrity measures in comparable international jurisdictions (such as the United States and Canada)[1]. We recommend that Treasury undertake further research into the experience of the revenue authorities in these jurisdictions with respect to whether artificial loss generation has been noted in the absence of loss integrity measures.

Lastly, we note that even if such integrity concerns were justified, the potential resulting revenue leakage is likely to be low due to the quantum of the quantitative cap to be applied. In this regard, we urge Treasury to make available greater detail and information on analysis undertaken to determine the revenue that will be protected as a result of making access to the loss carry-back subject to integrity rules.

Constructing the integrity rule

Nevertheless, if integrity rules are considered necessary in order to prevent behaviours akin to loss-trafficking it is our view that an anti-avoidance rule akin to Part IVA of the *Income Tax Assessment Act 1936* ("**Part IVA**") will be sufficient to curb such taxpayer behaviour due to the deterrent effect and the extent to which taxpayers will self-regulate their behaviour to minimise tax risk.

Part IVA

While we recognise the importance of anti-avoidance rules to discourage undesirable tax avoidance behaviour in certain contexts, we note that Part IVA as currently constructed has been troublesome.

Most taxpayers that have been required to actively consider Part IVA especially in the context of a dispute with the Australian Taxation Office ("**ATO**"), have found the experience to be costly and the rules to be complex and difficult to comply with. As

[1] It is unclear whether the Working Group considered this issue when constructing "Appendix D: International Loss Treatment" of the final report. However, our preliminary investigations suggest that loss carry-back is not subject to integrity rules in the United States and Canada. We have not undertaken analysis in respect of other comparable jurisdictions that allow carry-back of losses. However, we would strongly recommend that Treasury undertake such analysis.

such, the use of Part IVA as a model on which to base new anti-avoidance rules should be approached with caution.

Nevertheless, as noted above, should an integrity rule be considered necessary in this context, a general anti-avoidance rule has significant potential benefits in comparison to other available options.

Firstly, such a rule will only apply in limited circumstances (in comparison to the application of COT/SBT which will require all taxpayers to undertake regular, costly testing) and as such should minimise compliance cost.

Secondly, a general anti-avoidance rule should counter integrity concerns due to the deterrent effect. While "the anti-avoidance rules in Part IVA only apply to a particular arrangement when the Commissioner determines that they should apply", appreciation of the potential application of these rules within the broader taxpayer community, coupled with targeted ATO audit and review activity should have the desired effect of significantly discouraging the undesirable tax avoidance behaviour.

In order to yield these benefits, the application of the general anti-avoidance rule to a taxpayer's circumstances should be able to be readily understood and complied with.

As such, consideration should be given to incorporating a 'purpose of the legislation' test, so that a taxpayer will not have breached the anti-avoidance rule if that taxpayer has acted in a manner consistent with the purpose of the relevant legislation. For example, in this circumstance that purpose would be to carry-back a current year loss to offset against prior year income, so that the same overall tax liability is borne regardless of the tax year in which the company produced its income or loss[2].

However, should this option be adopted, we recommend that the mischief that the anti-avoidance rule is intended to target be articulated clearly on introduction of the loss carry-back measure.

Specifically, we recommend that the mere acquisition of a company with accumulated franking credits and prior year income and subsequent incurring of losses by a business run in that company should not result in an application of the anti-avoidance rule, even where the acquirer of the company expected the business to generate losses in the first few income years after acquisition (as is the case for many start-ups).

This is because:

- The introduction of a loss carry-back rule is intended to allow losses and gain to be spread, so that the same tax liability is imposed regardless of the order in which the losses are incurred or income derived (in recognition of "income years" being an arbitrary construct); and

- As noted above, the carrying back of a genuine loss to offset against genuinely derived income on which income tax has been paid should not be an integrity concern.

[2] We have also recommended such a change more broadly (in relation to all of Part IVA) in our submission to Treasury in response to the 2010 Discussion Paper entitled "Improving the operation of the anti-avoidance provisions in the income tax law".

Instead, in order to counter the integrity concerns described in the Discussion Paper, the anti-avoidance rule should only apply where on application of an objective test, it may be concluded that the taxpayer entered into a scheme with the sole or dominant purpose of artificially generating a loss (i.e. a tax loss not matched by an economic loss) in order to obtain a tax benefit that is a loss carry-back offset.

We consider the dominant purpose test contained in the current section 177A of Part IVA to be the most appropriate threshold to apply in these circumstances. Specifically we consider the "whether or not the dominant purpose but not including an incidental purpose" test contained in section 177EA to be too onerous a burden on taxpayers in light of the likely low level of revenue at-risk and narrow scope of the integrity concerns involved (as set out above).

Modified/simplified continuity of ownership and same business tests

It is our view that a general anti-avoidance provision alone should be sufficient (if not excessive) to ensure the integrity of operation of the loss carry-back rules due to the likely deterrent effect of such a provision.

However, should an additional/alternative set of integrity rules be considered necessary, our comments on the proposed modified/simplified COT and SBT are as follows.

The need for symmetry between the integrity rules that apply when carrying back or carrying forward losses should not be driven by any consideration other than simplicity i.e. for the reasons stated above, the integrity concerns in respect of loss carry-back are in our view overstated, both in an absolute sense and as in comparison to the loss carry-forward context.

Nevertheless, we acknowledge the valid point in the Discussion Paper that the extension of the application of the existing COT and SBT will, in the shorter term, be easier as the law is already familiar to companies. We also acknowledge that the test period for the purposes of applying these tests would need to be configured as described in paragraph 43 of the Discussion Paper.

Despite the above, the complexity of the COT and SBT and significant compliance and administrative costs incurred by taxpayers in complying with these rules cannot be overstated. Furthermore, taxpayers are generally required to bear such costs regardless of whether the taxpayer had any (objective or subjective) purpose of subverting the law. This of course results in taxpayers who have no tax avoidance purpose unjustly bearing the cost of complying with rules intended to dissuade only a small percentage of taxpayers that may seek to avoid tax. Such cost seems disproportionate to the likely quantum of revenue protected by the application of such integrity rules.

As such, we strongly recommend that the Government commit to further "reviewing the continuity of ownership and same business tests to give greater weight to simplicity and certainty objectives" as noted in the Discussion Paper as a recommendation of the *Australia's Future Tax System* Review.

We also concur with the recommendation of the Working Group that "the Government, as a matter of priority, undertake further analysis with a view to developing a model for reforming the same business test." Such reform is essential not only to simplify the

current rules, but also to prevent the artificial restriction of business growth/evolution that the current same business test encourages.

In addition to the above, we reiterate our recommendation in our submission to the Working Group on the interim report on the tax treatment of losses that “the current loss duplication rules be repealed and replaced with a broader anti-avoidance measure that may be applied at the discretion of the Commissioner (such as Part IVA) where taxpayers have acted with the dominant purpose of subverting the policy intention underpinning the loss recoupment rules.”

Once these integrity rules have been reformed thus, the revised rules can be applied in respect of carried-forward losses. If the Government decides to apply the current COT and SBT to losses carried back, the revised rules should also apply in that context.

Section 5.1 Delivery mechanism

We broadly agree that the proposed loss carry-back delivery mechanism (i.e. by way of refundable offset rather than amended assessment) will provide the greatest ease of implementation.

We recommend that the choice to carry back a loss be open and revocable so that the carry-back of any additional loss resulting from subsequent amendments to the taxpayer’s return also occurs via an election to carry back the further loss, rather than via an amended assessment, in order to allow companies the necessary flexibility to manage their tax affairs.

Section 5.2 Losses eligible for carry-back

We broadly support the quarantining of loss carry-back to revenue losses only, as recommended in the report of the *Australia’s Future Tax System* Review.

Section 5.3 Tax liability in chosen eligible profit years

It appears from the Discussion Paper as though a loss carry-back tax offset may be applied in respect of an outstanding tax liability for either primary tax or penalties/interest even where either:

- the company has applied for an exercise of the Commissioner’s discretion to reduce the relevant liability; or
- where the company is involved in a dispute with the ATO in respect of the liability.

We broadly agree that such a mechanism will in most circumstances generate the most appropriate result. However, it is foreseeable that an automatic application of the loss carry-back offset in this manner will in some circumstances frustrate the underlying policy intention of the measure i.e. to assist struggling businesses with a cash injection of a refund of tax paid in prior years.

As such, we recommend that Treasury and the ATO (in the context of tripartite consultation) ensure that the drafting and administration of this measure results in the Commissioner having a discretion not to apply the offset automatically in respect of outstanding tax liabilities where doing so would be inappropriate in the circumstances.

Section 5.4 Net exempt income

Further consideration should be given to the policy underpinning the interaction proposed between the loss carry-back measure and net exempt income of prior years in the Discussion Paper. In this regard, we note that the application of carried forward losses against net exempt income results in a significantly less onerous outcome for taxpayers due to the lack of limitation of the quantum of a carried-forward loss that may be utilised in any given income year.

In comparison, the application of a $1 million loss carry-back cap against net exempt income of prior years may result in significant wastage of the cap, and therefore frustrate the underlying policy intention of the measure, As such, we submit that carried-back losses should not be required to be first applied to reduce net exempt income.

Section 5.5 Choice to claim loss carry-back

We recommend that:

- A choice to carry-back a loss be open and revocable.
- Taxpayers be allowed the choice to determine which income year a carried-back loss is applied in respect of, which loss is carried-back in respect of an income year, and in both cases to choose how much of the loss is carried back (subject to the quantitative cap).
- A choice to carry-back a loss be allowed to be made at any time within the amendment period in respect of the earliest income year to which the carried-back loss is applied.
- The choice to carry-back a loss be made via a separate form that may be (but is not required to be) lodged with the income tax return in order to allow taxpayers the greatest degree of flexibility.

Section 5.6 Applicable company tax rate

We recommend that the company tax rate prevailing at the end of the utilisation year (claim year) be used to calculate the loss carry-back tax offset in order to minimise the compliance burden of this measure.

We note that as losses can only be carried back for a maximum of two years, any changes in company tax rate between the start of the income year and end of the loss year are unlikely to be significant. As such, choosing this option will in all likelihood result in a tax benefit that is approximately (even if not exactly) equivalent to “what would have been enjoyed had the company had sufficient taxable income in the loss year to prevent a loss arising”.

Section 8.1 No outstanding tax returns

We recommend that this test be formulated with reference to whether the relevant company has fulfilled its obligations to file tax returns in respect of the income years that remain open for amendment at the end of the claim year, rather than with

reference to whether a "tax assessment" has been made for *all* of a company's prior income years.

This is because:

- The contents of tax returns lodged (or the would-be contents of tax returns that have not been lodged) for income years prior to this period will have no bearing on the appropriateness of the quantum of the company's taxable income in the income year/s or taxable loss in the loss year/s. While the failure to lodge these returns will result in the franking account balance of the company being inaccurate, the franking account is likely to be understated (rather than overstated) in these circumstances.

- A company's capacity to access loss carry-back should not be forfeited entirely as a result of failing to file tax returns that potentially relate to a time substantially before the claim year. This is especially so as the ultimate owners of the company may have changed significantly between the income year in respect of which lodgment obligations remain unfulfilled, and the claim year, and the purchasers of the company may not have had sufficient access to prior year records (at the time of acquisition) to determine whether *all* lodgment obligations had been satisfied throughout the life of the company.

Section 9.1 Head company current year loss

We request clarification that the same rules that apply for stand-alone entities will broadly apply to the head company of a consolidated group, so that the head company will be able to choose to carry back a loss against prior year taxable income of the head company (rather than "against tax previously paid by the group"), subject to the qualification in paragraph 55 of the Discussion Paper (i.e. that "any loss carry-back tax offset will be applied in the usual way to reduce any outstanding tax liability the taxpayer has before a refund would be paid.")

Section 9.2 Joining entity holds current year loss

We broadly agree with the proposed interaction of this measure with the consolidation regime as set out in the Discussion Paper, as allowing the carry-back of losses transferred to the head company:

- will result in unnecessary complexity; and

- may be inappropriate if the transferred loss was incurred earlier than in the loss years that would have been allowable outside the consolidated context (because the relevant loss had been 'refreshed' on transfer).

Nevertheless, we note that the law with respect to the effect of a joining entity's claim to carry-back a loss in respect of a period prior to entering the consolidated group will need to be carefully drafted. This is because the choice by a joining entity to claim a loss carry-back may (and is in fact likely to) be made after entering into the consolidated group, and the consolidated group's allocable cost amount calculation in respect of the acquisition will be affected by how much of the joining entity's carry-forward losses are to be transferred to the head company (rather than carried-back).

In this regard, we note that the ATO will need to embark on a significant education campaign on implementation of this measure prior to undertaking compliance activity with respect to the appropriate application of loss carry-back rules in the consolidated context, especially in respect of small to medium enterprises.

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Should you wish to discuss any of the above, please do not hesitate to contact either me or Tax Counsel, Deepti Paton on 02 8223 0044.

Yours sincerely

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President