THE TAX INSTITUTE

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

By email: BTWG@treasury.gov.au

Dear Christine

Business Tax Working Group Interim Report

The Tax Institute is pleased to provide our submission in response to the Business Tax Reform Working Group's ("**BTWG**") Interim report on the tax treatment of losses ("**interim report**").

Our submission below addresses the issues raised in the interim report by setting out our views on:

- Scope of the interim report and the BTWG's consultation efforts;
- The principles that should in our view drive the tax treatment of losses in Australia; and

  Our proposed reform plan in relation to the tax treatment of losses (including implementation date, transitional measures and our comments on each of the elements set out in the interim report).

Scope of the interim report and the BTWG's consultation efforts

The Tax Institute commends the BTWG on the timely production of the interim report. The breadth and complexity of issues canvassed in the report are a testament to the commitment of BTWG members, as is the completion of the interim report within months of formation of the BTWG.

Public consultation on reform of the tax treatment of losses is essential to ensure that the proposed reforms alleviate existing problems, are easy to implement, do not result in unintended consequences and fulfil the relevant policy intent. In order for such consultation to be effective, the community must have adequate information to consider all of the relevant issues.

We note the references made throughout the interim report to the brief of the BTWG to ensure all recommendations are revenue neutral and the need for offsetting measures to accompany any recommendations that have a revenue impact.

It is our strong view that the short-term revenue impact of proposed reforms should not drive significant tax policy. While the cost of reforms should be taken into account when determining the appropriate timing for implementation, a longer term tax reform plan that is

Level 10, 175 Pitt Street
Sydney NSW 2000
Tel: 02 8223 0000
Fax: 02 8223 0077
info@taxinstitute.com.au
taxinstitute.com.au
ABN 45 008 392 372

independent of immediate revenue concerns is essential to provide certainty in relation to the ultimate direction for and pace of tax reform in Australia.

Nevertheless, we are cognisant of the significance placed on revenue considerations in the BTWG's brief. As such, our capacity to contribute to the BTWG's consultation efforts is severely limited by the lack of available information in relation to either the cost of any of the elements set out in the interim report or the offsetting measures being considered to compensate.

We urge the BTWG (and Treasury where relevant) to make available all such information and then conduct another round of consultation in relation to proposed reforms once stakeholders have had sufficient opportunity to consider the information.

When considering the revenue impact of various measures, we also urge Treasury to take into account the secondary benefits of any proposed reforms i.e. expected gains in efficiency that will result in greater corporate revenues (and therefore an increase in corporate tax liability).

Once such information is made available, we would be pleased to provide a further, detailed and more informed submission on the impact and comparative benefits of each of the elements.

In addition to the proposed reforms set out in the interim report, we also recommend consideration of changes to the administration of losses. Specifically, rather than merely issuing a 'nil' assessment for a company in loss, we recommend that a 'loss' assessment should be issued, stating the amount of the loss, and carrying full appeal and objection rights, and allowing for audit and amendment rights on the part of the ATO, subject to the usual time limits for amendment of assessments. Such an approach would assist with 'cleaning up' losses, and would act to reduce speculative claims for losses, while at the same time delivering certainty to loss-making entities.

Principles that should drive the tax treatment of losses in Australia

The tax treatment of losses should, in our view, be based on a number of key principles. These are set out below.

Simplicity

The tax treatment of losses should be simple in concept and easy to apply for all taxpayers.

Allow recoupment of genuine business losses

The tax treatment of losses should be driven by an understanding that losses are generated due to an arbitrary segregation of business activities into "income years" i.e. based on the presumption that businesses should be permitted to recoup genuine losses without restriction.

Symmetry

The tax treatment of losses should be symmetrical where possible, in order to minimise the impact of the rules on business decisions. That is, the rules should yield the same tax payable from a taxpayer over a period of time, regardless of when the losses are incurred in comparison to the profit, so long as losses are genuinely incurred and recouped.

Allow trading in genuine 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. However, in the shorter term we acknowledge that such a principle should not drive the tax treatment of losses in Australia while comparable international jurisdictions continue to restrict loss recoupment in some form.

Be aimed at addressing tax avoidance concerns

Section 2 of the interim report sets out a number of objectives underpinning the current system for the tax treatment of losses. Specifically, the report differentiates between the objective of countering tax avoidance as separate from integrity concerns (i.e. "ensuring that the structure of the tax law is right so that the tax outcomes of transactions are also right"[1]).

Of these objectives, we consider the deterring of tax avoidance to be paramount. In contrast, integrity concerns (such as preventing the artificial generation of losses or loss duplication) should not be a primary objective of loss recoupment rules. This is because:

- as noted above, the current income tax system leaves few opportunities for the generation of tax losses; and

- the current rules aimed at ensuring integrity in the tax system (such as the loss duplication rules) are overly complex to apply, rarely achieve their objective and frequently need to be considered even in situations where no substantive integrity risk exists, resulting in increased compliance costs.

[1] See the ATO's view of the difference between "integrity" measures and "tax-avoidance" measures in relation to the loss duplication measures in the ATO's Workshop Discussion Paper entitled "The "loss integrity" measures: topical issues and frequently asked questions", CTA Worskhop 24 November 2000 paragraphs 1.10 and 1.11, page 4 as quoted in Raymond Yu's paper entitled "Tax Losses: An examination of the landscape pre and post consolidation", page 22.

While the interim report is focussed on losses incurred by companies, the principles set out above should equally guide the tax treatment of losses incurred by trusts. For further detail, please see The Tax Institute's submission to Treasury in response to the Consultation Paper entitled 'Modernising the taxation of trust income - options for reform'.

Proposed reform plan

In light of the work program of the BTWG, the reform plan for the tax treatment of losses should be considered in two tranches:

Tranche 1: A simplification project in relation to the current Continuity of Ownership Test ("**COT**") and Same Business Test ("**SBT**") and repeal of the loss duplication measures, akin to element A as set out in the interim report.

Tranche 2: Consideration of broader reform options such as elements C and D as set out in the interim report.

Tranche 1

We strongly recommend that tranche 1 of the proposed work program be embarked upon as soon as possible, as:

- This tranche of reforms can be considered and implemented independently of other major business tax reform projects; and

- Such reforms are long overdue and especially relevant in the current economic conditions where a significant number of businesses have either already or are likely to incur losses.

We recommend consideration be given to removing the COT and SBT altogether, to be replaced with the proposed alternative integrity measure described in the interim report akin to the current available fraction rules in the context of losses transferred to the head company of a consolidated group.

However, we note that these rules in their consolidation context are difficult to apply and may cause a significant increase in compliance burden for taxpayers who currently operate outside the context of consolidation. As such, if this option is implemented, we recommend that the applicable available fraction method be simplified and be accompanied by a taxpayer education campaign.

An alternative model may give rise to a bright line test based on capital, income or business asset injections i.e. below a certain threshold there is no change, and after that there is a staggered impact whereby a certain injection of capital will require the losses to be spread over a certain number of years. This model has some of the features of the available fraction regime but avoids some of the inherent complexity.

We also recommend 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 of the *Income Tax Assessment Act 1936*) where taxpayers have acted

with the dominant purpose of subverting the policy intention underpinning the loss recoupment rules.

These recommendations are based on a number of ongoing problems with the application of these measures in their current form, as set out below.

Continuity of ownership test

The COT is difficult to apply and frequently artificially restricts transactions related to the shares in the loss entity. An example is the manner in which the same share rule has been drafted (so that the issue of new shares pro-rata to shareholders gives rise to a *prima facie* failure of COT, but subject to a savings provision which is cumbersome and can give rise to capricious results).

In contrast, the notional shareholder rule is a positive example of how a loss regime can be simplified. Such a rule should have wider application than the widely held entities currently covered. If the continuity of ownership test is to be retained, we recommend that it be simplified in this manner.

Same business test

The current SBT significantly impacts on business decisions and operations as many taxpayers seek to artificially restrict business operations in order to satisfy either of these tests to preserve their tax losses. This impact has been exacerbated by the narrow interpretation of the SBT in case law, especially in comparison to international standards.

The current same business test is inordinately complex and involves six sub-tests:

1. overall same business test (sec 165-210(1));
2. income from a new business test (sec 165-210(2)(a));
3. expenditure on a new business test (sec 165-210(3));
4. income from a new transaction test (sec 165-210(2)(b));
5. expenditure from a new transaction test (sec 165-210(3));
6. activity prior to test time anti-avoidance test (sec 165-210(3)).

This complexity gives rise to economic stagnation where a party consciously tries to fit within the guidelines and often a capricious loss of carry-forward losses where they do not.

If the SBT is to be retained, it should be replaced with a “not substantially dissimilar business” test which has low complexity and would promote dynamic businesses. This test could be supplemented by a purpose-test to deal with loss trafficking if required.

For example, Canada refers to earning substantially all its income from a properties or services similar to the one that incurred the loss, the United States refers to “..continuing the historic operations or using a significant portion of the historic business assets” and the United Kingdom refers to a “major change in the nature or conduct of a trade”.

Loss duplication rules

The current measures aimed at preventing loss duplication:

- Are overly complex, difficult to apply and unnecessarily broad in application. By way of example, the anti-multiplication rules contained in Section 165-CD are exceedingly complex provisions;

- Do not justify the equity and economic efficiency intended to result from these rules, owing to the complexity faced by taxpayers in implementation;

- Are inequitable in their application i.e. as currently structured, the rules are not symmetrical (i.e. the rules deal only with losses and do not address situations where gains are double-taxed);

- Are uncertain in application i.e. it is unclear what an “appropriate adjustment” would be in many cases where the rules do apply;

- Are increasingly irrelevant in a consolidation context; and

- Have in many instances moved away from their original objective of safeguarding the structural integrity of the tax system.

In the absence of further supporting information we note that in our view this tranche of reforms is likely to be largely revenue neutral.

Tranche 2

Full loss refundability

As noted above, in our view short-term revenue considerations should not drive long term tax policy. As such, it is our view that revenue considerations are an insufficient reason to rule out the implementation of element B as set out in the interim report.

Nevertheless, we do not support the introduction of full loss refundability in the Australian tax system at this stage. This is because no other nation with comparable economic features has introduced such a generous treatment. Therefore it is foreseeable that a comparably generous treatment in Australia will encourage companies to shift losses to Australia.

Carry-back for revenue losses

We recommend the introduction of a limited carry-back for revenue losses, as recommended in the report of the *Australia's Future Tax System Review.* Such a limited loss carry-back will allow a partially symmetrical treatment of losses and will allow Australia to become a more competitive international taxation system.

The introduction of this measure is overdue. As such, the measure should be implemented in a timely fashion. Our recommendation is of course subject to the specific offsetting

revenue saving measures that will need to be implemented to ensure this measure is revenue neutral.

Applying an uplift factor to carry-forward losses

Element D is theoretically attractive as a method by which to allow recognition of the time value of carried forward losses. We note that this theory has been successfully applied in a number of situations including the Minerals Resource Rent Tax and the uplift factor allowed to be applied to infrastructure losses. Nevertheless, we do not reccomend the introduction of such a measure at this stage. This is because such a treatment would sit at odds with the balance of the tax system which continues to operate on a historical basis. This measure could also become complex and difficult to apply over time. This option may be worth considering a later stage in the reform process.

Timing

In our view, tranche 2 reforms are overdue (especially when considered in light of international comparisons as set out in the interim report) and in need of relatively urgent implementation owing to the current Australian economic conditions.

Nevertheless, as the tranche 2 reforms represent a relatively substantial structural change to the tax treatment of losses, we are cognisant of the potential impact of these reforms on other proposed reforms to the business tax system being considered by the BTWG (such as the implementation of an allowance for corporate equity ("**ACE**")).

We recommend that consideration of broader business tax reform options by the BTWG not be unnecessarily restricted by a decision to implement tranche 2 reforms.

Conversely, while we are aware that the implementation of an ACE will represent a major shift in business tax policy, we recommend that tranche 2 reforms not be unnecessarily delayed in anticipation of this much more fundamental overhaul of the business tax system which is likely to subject to longer delays prior to implementation.

Application date – tranches 1 and 2

We recommend that tranche 1 reforms be applied on a prospective and retrospective basis (i.e. that the reforms apply to all losses that have not been recouped as at the date of implementation, regardless of when those losses were incurred).

This is because:

- Applying the reforms to losses incurred after the date of implementation only will continue to restrict funding choices and business operations of taxpayers that continue to be subject to COT and SBT in respect of losses already incurred; and

- Prospective application only will result in taxpayers that have already incurred losses and continue to do so after the implementation date being subject to two

different sets loss recoupment rules. Such a system will significantly increase the compliance burden of such taxpayers.

The appropriate implementation date for tranche 2 reforms will depend on the cost and proposed offsetting revenue saving measures required to be implemented. When such information is made available, we would be pleased to make a further submission setting out our views.

Where any reforms are applied on a prospective basis only, we recommend the introduction of transitional measures in relation to the treatment of losses already incurred.

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If you would like to discuss this matter, please contact me on 02 8223 0011 or The Tax Institute's Tax Counsel, Deepti Paton, on 02 8223 0044.

Yours sincerely

Ken Schurgott
President