Institute of Chartered Accountants Australia

6 August 2012

Mr Hector Thompson
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The Treasury
Langton Crescent
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By email: LossCarryBack@treasury.gov.au

Dear Hector

Submission to Discussion Paper, *Improving access to company losses* of July 2012

The Institute of Chartered Accountants in Australia (**Institute**) welcomes the opportunity to provide a submission on the Treasury discussion paper, *Improving access to company losses* (**Discussion Paper**) that was released for consultation on 18 July 2012.

The shortened consultation period for this reform poses difficulties for both Treasury, in designing appropriate law, and for interested bodies such as the Institute, in contributing to that design in a meaningful way. However, the reduced consultation period is also a strong indicator of the importance placed by the Federal Government on the successful implementation of this reform.

Treasury is to be commended for many aspects of the Discussion Paper. Where that is the case the Institute does so in the submission which follows. In the Institute's view the area of greatest conceptual difficulty is the extent, if any, of the design relationship between the existing loss carry forward rules and the proposed loss carry back rules. This is also the area where the difficulties caused by the truncated consultation period come into relief.

Given the short consultation period it is natural to look towards the existing, familiar loss carry forward rules for law design inspiration. However, in the Institute's view there are a number of substantive problems with the design of that law. Many of those problems revolve around ease of application.

If the Federal Government's objective with this reform is to be achieved then ease of application or access is an important design consideration. Therefore, in the Institute's view it is generally better *not* to draw upon the existing loss carry forward rules when designing the new loss carry back rules. If the adage "If it ain't broke, don't fix it" is true, then so too is the corollary "If it is broke, don't build on it".

The shortened time frame might similarly point to an isolated amendment to Part IVA as "a quick fix" to the design of a suitable integrity rule. That approach, in the Institute's view, is similarly misconceived. Part IVA is by definition a rule of general application. In contrast, the proposed loss carry back rules are a targeted reform of limited application. The risk, particularly given the short consultation time frame, is that any amendment to Part IVA might have unintended consequences.

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Therefore in the Institute's view the best approach to deal with the possibility of exploitation of the reform is to design a specific integrity measure for the loss carry back rules. Inevitably, such a rule would need to have regard to some concept of enduring ownership and business activity. But, that reference should *not* be framed by the manner and form in which those concepts appear in the existing loss carry forward rules.

The Institute puts forward two options in the following submission which may form the basis of such a rule. The options are inevitably undeveloped given the limited time for consultation. We are cognisant for the same reason that their scope may be "too tight" or "too loose". But, if the specific integrity measure is drafted to be "lighter in touch", and principle based in design, then it is more likely, in the short term, to achieve the Government's objectives than one which is "heavier in touch" and overly prescriptive. We also recommend that the integrity rules be reviewed after a suitable lapse of time, say 2 years, to determine whether they are operating as intended and by which time the economic imperative may, in any event, have changed.

We would like to take this opportunity to thank Treasury for hosting the stakeholder consultation meeting on 31 July 2012 (**Stakeholder Consultation**), which provided a valuable opportunity to kick start consultation on matters raised in the Discussion Paper, as well as in this submission.

If you would like to discuss any aspect of this submission or require any further information, please do not hesitate to contact me on 02 9290 5609 at first instance.

Yours sincerely

Paul Stacey
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PART A – Comments on issues other than integrity measures

References in subheadings below are to the Discussion Paper.

1. Revenue losses only (section 4.5)

The Discussion Paper states that loss carry-back will be restricted to revenue losses as taxpayers can time the realisation of capital losses. This is not always the case.

In this regard, we wish to draw your attention to the planned changes in relation to bad debts announced by the government as part of the 2012-13 Budget which are currently subject to separate consultation (with submissions due 10 August 2012). These proposed changes are to "ensure a more consistent tax treatment for bad debts between related parties that are not members of a tax consolidated group". Unless a consequential amendment is made as part of the proposals, bad debts may inappropriately convert to capital losses. The Institute is submitting in relation to the need for appropriate targeting of those rules.

2. Delivery mechanism (section 5.1)

We support Treasury's proposal that the loss carry-back be effected through the use of a refundable tax offset in the claim year. This is a cleaner, less complex method of delivery of the initiative than the alternative of having to carry-back a tax loss to an earlier income year.

3. Net exempt income (section 5.4)

The Institute submits that it is not necessary to reduce the eligible losses by any net exempt income (NEI).

Sections 11-5 and 11-15 of the *Income Tax Assessment Act 1997* (**ITAA 1997**) set out in summary the listing of all the provisions under the Act that give rise to exempt income. These provisions are overwhelmingly directed to the exempt income received by individuals.

Exempt income relevant to companies includes:

- certain annuities and lump sums which are paid to an injured person under a structured settlement
- certain distributions from an early-stage venture capital limited partnership
- certain distributions from a pooled development fund
- certain profits or gains from disposal of shares in a pooled development fund
- eligible income under the recent shipping reforms.

The Institute recognises that the current carry forward rules require that losses be offset against NEI. The suggestion was made in the Stakeholder Consultation that NEI should be similarly carved out under the loss carry back rules for reasons of symmetry. We agree that symmetrical treatment is generally desirable because it reduces complexity. However, that is not always the case and is not sufficient reason where it produces an outcome contrary to a measure's intended policy.

The Institute understands that the Government's intended policy here is to provide a cash benefit to struggling businesses, particularly small businesses. The reduction of the eligible loss amount by the amount of NEI by definition reduces the amount of the cash benefit. This appears contrary to the Government's public announcements that an amount of up to $1 million of losses will be eligible to be carried back, not an amount of up to $1 million of losses less any NEI. Such a qualification in "the small print" may inadvertently generate cynicism amongst those very businesses the reform is intended to benefit. Moreover, the NEI was likely received as a result of other Government programs designed to assist those very same businesses and it would appear that they are then penalised for such assistance under the loss carry back rules. It is also noted that the inclusion of this additional step in the loss carry back tax offset calculation makes the calculation under these rules *more complex*. This, in turn, will make it harder for smaller businesses to access the loss carry back regime. Remember that a generally accepted failing of the current loss carry forward rules is that they are unnecessarily complex, thereby making them a false comparison on the complexity point.

Further, the Institute expects that the impact of the relevant exempting provisions summarised in sections 11-5 and 11-15 of the ITAA 1997 would be minimal on the corporate tax base, although the ATO may be in a better position to ascertain the impact of NEI on loss utilisation and advise what amount is actually ‘in the system’.

Accordingly, the Institute submits that there is no need to replicate the requirement to deduct NEI in the loss carry-back regime.

For the sake of completeness, and as correctly noted by Treasury during the stakeholder meeting on 31 July 2012, we note that items that might have been exempt income in the past are now more properly treated as non-assessable non-exempt (NANE) income. Therefore the limited scope of NEI currently means, in our view, that the net revenue impact of the Institute’s proposal to be minimal. Thus the benefit of greater simplicity outweighs the likely minimal tax revenue impact, in our view.

4. Choice to claim loss carry-back (section 5.5)

The Institute agrees that the loss carry-back choice should be optional. We also consider that the loss carry-back should not be by way of a binding election but rather be as evidenced in the tax return as lodged to maintain flexibility. This will better accommodate changing outcomes as a result of audits, amendment (such as loss carry-back at a later stage by making a choice or by way of amending the relevant income tax return), etc.

The choice to carry-back should be designed to allow not just the choice to carry-back a loss but also allow a choice as to the amount to be claimed back. That is, the first choice is to determine whether a loss is carried forward or carried back but if carry back is chosen, then a secondary choice is as to the amount so carried back (and to what year (if relevant)). The secondary choice will of course always be subject to the capping mechanisms in place (the lesser of limit).

5. Applicable company tax rate (section 5.6)

The Institute is attracted to Treasury’s proposal to use the company tax rate that applies in the loss utilisation year as this would be simpler than the other proposals put forward. However, this will erode the dollar value of the $1 million cap if company tax rates reduce which should be borne in mind in reviewing the amount of the cap going forward.

In this respect, and on a more general front, the Institute recommends that the $1 million cap should be regularly reviewed over time or indexed to ensure that it keeps its “value”. Indeed, the Institute considers that reviewing the cap is more effective than attempting to marry up tax rate changes which will only add to complexity. To this end, it might be preferable for the dollar value of the cap to be included in the *Income Tax Assessment Regulations 1997*, rather than the ITAA 1997 so that it is relatively easier to amend in future years.

6. Calculating the loss carry-back tax offset (section 6)

The Institute agrees with the "Foundational Scenarios" put forward by the Treasury at the meeting 31 July 2012 (attached an Appendix). These allow flexibility for companies in determining whether to carry-back losses and if so, the amount of the carry-back and the target year(s).

7. No outstanding tax returns (section 8.1)

Paragraph 69 states that to access loss carry-back, tax assessments must have been made for all of a company's prior income years. As discussed during the Stakeholder Consultation we understand that if a company was not required to lodge a return in an earlier year, for example because it had no business in that earlier year, this would not preclude the company from accessing loss carry-back. In other words, the rule in paragraph 69 of the Discussion Paper will only apply if a company was required to lodge a return in a prior year(s).

On a wider point, the Institute believes that the relevant pre-requisite for access to loss carry-back should be that lodgments/assessments for the target year and claim years are in place. Income years outside the rolling period (and certainly pre 1 July 2012) are not directly relevant. However, if Treasury has other concerns driving this requirement, these should be stated in the explanatory memorandum.

PART B – Integrity measures

1. Simplified integrity rules are important

The Institute agrees with the Discussion Paper's preference for simplified integrity rules.

The Institute recommends *against*:

a) using the existing long form continuity of ownership test (**COT**) in Division 165 of ITAA 1997. Those rules currently require detailed tracing and record-keeping on a prospective basis, which are difficult for many private companies which have interests owned by family trusts and family members with generational change or with multiple share classes.

   Treasury is working on proposals for amendment of the existing COT rules by reference to investors with multiple share classes, including an exposure draft of a Division 167 "Special provisions for companies whose shares have unequal rights to dividends, capital distributions or voting power". The issues are challenging and the rules are intricate.

   Currently, where a company derives a loss in a year then it is aware of the need to trace its ownership forward for loss carry forward purposes. However in the loss carry-back rules, if the Division 165 rules applied retrospectively, the company might have had no indication in its earlier taxable year that is needed to institute comprehensive ownership tracing retrospectively from a later loss year.

   While some private companies will be able to comply with Division 165 (eg if there is a simple ownership structure), in many cases there will be compliance problems.

b) using the three continuity of business and same business tests contained in Subdivision 165-E - The same business test (**SBT**). As the Business Tax Working Group (**BTWG**) identified, that test is very challenging for any company facing difficult market conditions and having to restructure its business.

c) including the specific integrity rule (**SIR**) within Part IVA of the *Income Tax Assessment Act 1936* (**ITAA 1936**) , such as occurred for example with s.177EA. We prefer to see any SIR within the new Division introducing the loss carry-back refundable tax offset.

Considering the form of a simplified SIR, we note that Division 175 of ITAA 1997 comprises some specific integrity rules to counter scenarios where companies comply with the technical requirements of the COT or SBT in inappropriate circumstances. Division 175 is expressed using high level concepts. However, Division 175 is expressed as a Commissioner of Taxation discretion which is not appropriate in today's self-assessment system, and for example the drafting of the proposed Division 167—"Special provisions for companies whose shares have unequal rights to dividends, capital distributions or voting power" is designed to be self-executing, without a Commissioner of Taxation discretion.

Before proposing some potential drafting, we highlight the revenue risks which we consider are likely to cause surprises or unanticipated revenue costs.

2. Revenue risks

Treasury has suggested that there is a risk that parties proposing a venture with start-up losses will seek out existing companies with franking account balances. While we accept that this is a risk, in our view the extent of that risk can be overstated. This is due to the fact of the $1 million loss cap itself. Such a relatively low ceiling will undermine the cost-benefit calculation which underpins such sharp practice in many instances. Further, the risk is sharply reduced where the relevant company has a continuing business or continuing assets.

The Institute perceives the main risk, as outlined in the Stakeholder Consultation, to be one of loss injection into dormant companies. This can be more comprehensively described as the availability of a loss carry-back regime might encourage persons (not previously appropriately connected with a company) to acquire companies which have existing franking accounts, most notably dormant or inactive companies, for the purpose of injecting subsequent losses so as to obtain a loss carry-back refundable tax offset.

For completeness we note that:

a) there is a risk of taxpayers selling loss-making assets in companies to associated entities so as to maximise the companies' losses for carry-back. However, in our view, Part IVA already adequately deals with this risk – note for example the Federal Court application of Part IVA to counter a related-party loss scheme in *Cumins v Commissioner of Taxation [*2006] FCA 43 (6 February 2006). The UK loss carry-back rules for terminal losses contain a SIR to deal with this situation. However, the UK has no general anti-avoidance rule (GAAR). Accordingly, no such equivalent SIR is needed for Australia in our view.

b) considering non-commercial (private) losses, it seems to us that the level of private or non-commercial losses in corporations is minimal

c) the UK limits loss carry-back in relation to losses on futures contracts. There is a possibility of loss carry-backs of losses under isolated financial arrangements, but again that is only a problem in our view in cases of dormant companies with ownership changes, and again Part IVA would cover this adequately.

To summarise the key revenue risk, we submit, is of dormant companies having ownership changes with a subsequent loss injection not associated with the prior business of the company with no continuing business activity. Accordingly, it is appropriate that the loss carry back rules contain a SIR.

However, care is needed in drafting the SIR so that it does not frustrate scenarios where:

a) the company might have franking account attributes arising from distributions of trust income attributable to a trust in which the company is a beneficiary or unit holder and there is a ‘continuity of ownership’;

b) the company might have franking account attributes and might have wound down or ceased some of its business but has continuity of ownership. The UK and Ireland in their loss carry-back rules have an express recognition of cessation scenarios;

c) where the ownership change is due to succession planning (that is, ownership and control passes from Mum and Dad through their trust or other structures) to the next generation; and

d) new investors are brought into the company to provide growth finance, especially if the company’s core business has struck financial difficulties, where the company might embark on diversification of its business to create new revenue streams, which might be unsuccessful.

3. One potential drafting proposal

One approach is along the following lines: Because it includes reference to a continuity of ownership in some situations, this introduces some complexity due to consideration of tracing through interposed entities, interposed trusts and generational change issues.

Simplified outline of the loss carry-back integrity measure

A company can carry-back eligible losses in the manner set out in ... The eligible losses do not include injected losses, that is losses arising from deductions available to the company, in circumstances where there is no continuing business in a company between the income year and the loss year and where the benefit of the loss carry-back tax offset does not reasonably accrue to the continuing shareholders. The continuity of business determination recognises, at a time of significant change in the business and financial environment, a company might adjust its business activities so that: a) the business of a company will change through the introduction of new activities which might generate losses. Losses associated with a changed or new activity cannot be carried back if there has been a major new ownership in the company, b) the company might reduce or eliminate unprofitable or unattractive business activities which might lead to the generation of losses, or c) a company might incur expenses in the loss year in relation to a business which ceased in the earlier income year. An ownership change in a private company made in the context of succession planning or a generational change will not result in a change of continuing shareholders for the purpose of this test.

Deduction injected into company because of availability of loss carry-back refundable tax offset

(1) The company cannot carry-back a loss for a *loss year to the extent that the company would not have incurred the loss, outgoing or expenditure (the injected loss) if it would not be entitled to a loss carry-back refundable tax offset for the current or a future year.

(2) Despite (1) the company can carry-back the loss, if it is reasonable to conclude that the company has continued to carry on a business. This determination will recognise that a company's business will evolve having regard to:

(a) changes to the business of a company through the introduction of new activities to diversify or expand its operations
(b) the cessation of unprofitable or unattractive segments of its business

(3) Despite (1), the company can carry-back the loss if the *ultimate continuing shareholders benefit from the loss carry-back refundable tax offset that has arisen or might arise from the loss, outgoing or expenditure being incurred, to the extent it is fair and reasonable having regard to their respective *shareholding interests in the company.

Note 1: This provision will allow a carry-back where the losses arise after a company has ceased a business, but *ultimate continuing shareholders benefit from the loss carry-back refundable tax offset that has arisen or might arise from the loss, outgoing or expenditure being incurred, to the extent it is fair and reasonable having regard to their respective *shareholding interests in the company.

Example: The Nash Business Trust carries on in Year 1 an automotive parts business, the income of which is distributed to Nashco Pty. Ltd. as beneficiary. Nashco Pty. Ltd. is owned by the Nash Family Trust. Nashco Pty. Ltd. pays company tax. In Year 2 the automotive parts business ceases and Nashco Pty. Ltd. commences to conduct business as a sports equipment manufacturer. Nashco Pty. Ltd. makes a loss in Year 2. Because the Nash Family Trust and continuing beneficiaries are the continuing shareholders of Nashco Pty. Ltd., the loss is available for carry-back.

Note 2: The carry-back is available notwithstanding the introduction of new investors to add to the capital structure of a company which is restructuring or adapting to changed circumstances, where the *ultimate continuing shareholders continue to benefit to a fair and reasonable extent.

(4) This section sets out how to identify the ***ultimate continuing shareholders*** of a company

(a) The ***ultimate continuing shareholders*** are the persons who had direct and indirect shareholding interests in the company both immediately before the loss, outgoing or expenditure was incurred, and immediately afterwards.

(b) For this purpose, the company can trace the indirect shareholding interests through interposed discretionary trusts and unit trusts. No precise trust tracing rules are specified here.

(c) There is a modification where changes in the ultimate ownership of shares in a private company, or interests in a trust, arose in the context of a family's succession planning or a generational change (**succession change**) in respect of that private company and the shareholders of the private company or beneficiaries benefiting under a family trust after the succession change (**successor ultimate continuing shareholders**) are the children or family of the shareholders of the private company or beneficiaries of the family trust benefiting before the succession change (**the predecessor ultimate continuing shareholders**). In such a case, the company can consider that the *ultimate continuing shareholders will be taken to benefit from the loss carry-back refundable tax offset that has arisen or might arise from the loss, outgoing or expenditure being incurred, to an extent that is fair and reasonable having regard to their respective *shareholding interests in the company.

Example: Higgsco Pty Ltd carries on in Year 1 a fashion retail business. Higgsco Pty. Ltd. is owned by the Higgs Family Trust. Higgsco Pty. Ltd. pays company tax and the primary beneficiaries of the Higgs Family Trust are Mr and Mrs Higgs. In Year 2 Mr and Mrs Higgs retire, the fashion retail business ceases and Higgsco commences to conduct business as a sports equipment manufacturer. Higgsco Pty. Ltd. makes a loss in Year 2. The Higgs Family Trust is operated by the son and daughter in law of Mr and Mrs Higgs. The loss is available for carry-back.

4. Second proposal for alternative test to the COT/SBT

The Discussion Paper, and earlier reports prepared by the BTWG on the tax treatment of losses, recognise the current continuity of ownership and same business tests for loss recoupment purposes are a complex set of provisions.

The introduction of the new loss carry-back proposals raises the question of whether retaining these provisions for the carry-back of losses necessarily achieve the stated policy outcome of these proposals, particularly for small businesses.

It also provides an opportunity for Treasury to reformulate an alternative test to the COT/SBT for losses, which is simpler and coherent, whilst maintaining the integrity of the proposals.
Under the current SBT, the taxpayer is required to continue to operate the same business in order to be able to recoup the loss incurred. The problem with a prohibitive SBT is that where non-tax factors suggest that the business making the loss should be abandoned, the tax policy of restricting the usages of losses to those carrying on the same business during the relevant period distorts the efficiency of the taxpayer's choices. As a result, this would be contrary to the intended policy outcome of reducing disincentives to sensible risk taking and encouraging growth and investment.

It is noted that some countries like the US do not have a COT or SBT for the loss carry-back purposes.

However, if Treasury believes some form of ownership or same business test should be retained for loss carry-back, we suggest an alternative to the current COT/SBT such that the current complexities and problems associated with applying these tests in their current form do not frustrate the policy intent of the loss carry-back proposals. Our proposition is that instead of applying the COT and SBT in its current form to loss carry-back, an 'asset continuity' test may be adopted as a proxy for carrying on the same business, leveraging from the principles of the US model.[1]

Given the short time frame for consultation, we have not been able to further develop these principles, other than at a conceptual level, and Treasury would need to further test the principles in an Australian context.

The principles of this alternative test, at a high level, would be follows:

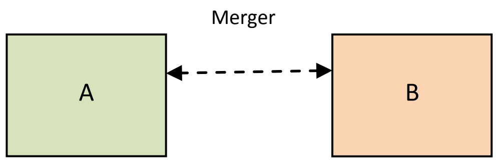
- Remove COT entirely
- Allow the loss carry-back for the loss entity in the claim year if the loss entity satisfies the 'asset continuity' test. Under a 'asset continuity' principle, the test is satisfied if the loss

[1] It should be noted the asset continuity test model is based on special rules in the US that must be satisfied to obtain a tax free corporate reorganisation. US IRC 368, Treasury Regulations 1.368-1. These provisions provide an exception to the general rule that a gain or loss must be recognised if upon the exchange of property the new property differs materially from the old property. To obtain the exemption the 'continuity of business enterprise' test needs to be satisfied. There are two components to this test: a business continuity test or an asset continuity test.

entity continues to use a 'significant portion' of its assets as it did in the earlier profit year. For simplicity, identification of 'assets' may be defined by reference to assets as shown in the accounts of the entity seeking to recoup the losses.

"Significant" continuity of assets may, for example, include a threshold of 30 percent of the entity's total assets.[2] A quantitative test may provide greater certainty than a pure qualitative test in determining whether an entity satisfies the asset continuity test.

The US Treasury Regulations provide an example on the application of the asset continuity test. This is illustrated as follows:



B previously imported parts. A & B now merge
B continues to buy imported components but retains A's equipment as backup source of supply.

Under US Treasury Regs, use of equipment as backup source supply constitutes use of significant portion of A's historic business assets.

This asset continuity approach could also be used in place of the continuity of business discussion in the first drafting proposal set out above. A less preferred approach would be for it to be a second chance mechanism if the first drafting proposal was not satisfied.

[2] We understand that in the US, the test of "significant" under is a facts and circumstances test but as a matter of practice, continuity of a third of the entity's assets has been applied as a rule of thumb.

Foundational Scenarios — All amounts expressed in $profit/loss terms (not tax/offset) — Abstracts from choices, franking balance and net exempt income

Scenario		Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Claims
A	**Carry back from claim year (Yr 2) to profit year (Yr 1)**	Profit	Loss				Carry back $1m of Yr 2 loss to Yr 1
	Applies to 2012-13 claim year (transitional rule of one year carryback only)	1,500,000	1,200,000				Claim year (Yr 2) tax offset $300,000
B	**Carry back from claim year (Yr 3) to both preceding profit years (Yr 1 & Yr 2)**	Profit	Profit	Loss	?		Carry back $800k of Yr 3 loss to Yr 1
	'Falling into loss'	800,000	1,000,000	1,000,000			Carry back $200k of Yr 3 loss to Yr 2
	Prefer to use Yr 1 profit first, to preserve Yr 2 profit for possible Yr 4 claim						Claim year (Yr 3) tax offset $300,000
C	**Two claim years (Yr 2 & Yr 3) target one profit year (Yr 1)**	Profit	Loss	Loss			Carry back $1m of Yr 2 loss to Yr 1
	'Two bites at the cherry' where unutilised profit remains in target year	2,300,000	1,000,000	1,000,000			Carry back $1m of Yr 3 loss to Yr 1
							Claim year (Yr 2) tax offset $300,000
							Claim year (Yr 3) tax offset $300,000
D	**Two claims (Yr 2 & Yr 3) for one loss (Yr 2)**	Profit	Loss	Loss			Carry back $1m of Yr 2 loss to Yr 1
	'Backspin' unutilised Yr 2 loss to supplement eligible losses in Yr 3	2,300,000	1,200,000	800,000			Carry back $800k of Yr 3 loss to Yr 1
							Backspin $200k of unutilised Yr 2 loss to Yr 1
							Claim year (Yr 2) tax offset $300,000
							Claim year (Yr 3) tax offset $300,000
E	**Two claims (Yr 2 & Yr 3) for one loss year (Yr 2)**	Profit	Loss	Profit	?	?	Carry back $1m of Yr 2 loss to Yr 1
	'Backspin' unutilised Yr 2 loss despite large profit in Yr 3	2,300,000	1,200,000	2,000,000			Backspin $200k of unutilised Yr 2 loss to Yr 1
	Prefer to carry back unutilised Yr 2 loss, to preserve Yr 3 profit for possible Yrs 4 & 5 claims						Claim year (Yr 2) tax offset $300,000
							Claim year (Yr 3) tax offset $60,000