2012

EXPOSURE DRAFT

BENEFITS OF THE BOOM LEGISLATION AMENDMENT (LOSS CARRY-BACK) BILL 2012

EXPLANATORY MATERIAL

(Circulated by the authority of the
Deputy Prime Minister and Treasurer, the Hon Wayne Swan MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
IT(TP)A 1997	*Income Tax (Transitional Provisions) Act 1997*
Pay as you go	PAYG
The Commissioner	The Commissioner of Taxation
Working Group	Business Tax Working Group

Chapter 1
Introduction to loss carry-back

Outline of chapter

1.1 The Spreading the Benefits of the Boom Legislation Amendment (Loss Carry-back) Bill 2012 amends the law to allow corporate tax entities to carry-back losses to previous income years. This chapter provides an overview of the loss carry-back measure.

1.2 The loss carry-back measure allows corporate tax entities that have paid tax in the past, but are now in a tax loss position, to choose to obtain a refund of some of the tax they have previously paid.

1.3 The operative rules for the loss carry-back measure are primarily contained in Division 160 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Context of Amendments

1.4 Following the Tax Forum in October 2011, the Government established the independent Business Tax Working Group (Working Group) to consider what kind of business tax system would best support Australia's future growth prospects.

1.5 In its *Final Report on the Tax Treatment of Losses*, the Working Group recommended that loss carry-back would be a worthwhile reform in the near term. In particular, the Working Group proposed a model that:

- is limited to companies;
- provides a two-year loss carry-back period on an ongoing basis; and
- limits the amount of losses that can be carried back by applying a $1 million quantitative cap.

1.6 On 6 May 2012, the Government announced that it would introduce loss carry-back to the income tax law for corporate tax entities.

1.7 The Government issued a consultation paper *Improving access to company losses* in July 2012.

1.8 The introduction of loss carry-back also implements Recommendation 31 of the *Australia's Future Tax System* Review which said:

> *'…companies should be allowed to carry back a revenue loss to offset it against the prior year's taxable income, with the amount of any refund limited to the company's franking account balance.'*

1.9 In announcing the loss carry-back measure, the Government noted that it would encourage companies to adapt to changing economic conditions and take advantage of new opportunities through investment. Loss carry-back allows firms to utilise their tax losses sooner and reduce the extent to which they risk never being able to utilise those losses.

The case for loss carry-back

1.10 Implementing a change of business strategy may involve new investment in machinery and equipment, in the development of new goods and services and in re-skilling of people. These new investment decisions involve some risk taking.

1.11 Policies that facilitate changes in business strategies and support sensible risk taking will enhance productivity growth in all sectors of the economy.

1.12 Under the current tax law, the Government collects, in terms of tax, a share of any profits a company makes in an income year. On the other hand, the Government does not directly share in a company's loss, but rather only allows future tax to be reduced by deducting that loss from future profits. This means that there is an asymmetric treatment of profits compared with losses.

1.13 This asymmetry can mean that a company making a profit in one year followed by a loss in the next year will pay a higher effective tax rate over the two year period than another company that makes the same overall profit in a more consistent fashion.

Example 1.1: Tax outcomes vary according to cash flow risk

Table 1 and Table 2 below show the impact of the tax treatment of losses on the total tax that may apply for two companies' whose total profits are identical. Where a company makes the same total profit in a variable manner, deriving a large profit followed by a loss (Table 1), it will pay more tax over the two year period than a company that makes the same overall profit in a more consistent manner, with two smaller profit years (Table 2).

Table 1.1: Tax treatment for higher risk profit company

	Year 1 $	***Year 2 $***	***Total $***
Profit (loss)	200	-100	100
Tax @ 30%	60	0	60

Table 1.2: Tax treatment for lower risk profit company

	Year 1 $	***Year 2 $***	***Total $***
Profit (loss)	50	50	100
Tax @ 30%	15	15	30

In this example, for two companies earning the same $100 total profit over two years, the company earning it in a more variable manner pays double the tax that the more conservative company pays. The risky company therefore experiences an effective tax rate of 60 per cent, compared with the statutory tax rate of 30 per cent.

1.14 This potential to incur a higher effective tax rate can lower the expected after-tax return on an investment that is under consideration. This can distort the relative attraction of competing projects from a firm's perspective, compared with their value to the economy as a whole.

Example 1.2: Tax treatment of losses can distort investment choices

Table 3 and Table 4 below show the impact of the tax treatment of losses for two possible investment choices that present different levels of risk. One option is a higher-risk investment which has a 40 per cent probability of incurring a loss (20 per cent probability of incurring a loss of $60 and a 20 per cent probability of incurring a loss of $40). The other option is a lower-risk investment that has a certain profit outcome. For simplicity, the investments have one year lives.

Table 1.3: Tax treatment for a low risk investment

Possible before-tax return on an investment ($)	***Prob. of return***	***Before-tax expected return***	***After-tax expected return***
	(%)	***($)***	***($)***
40	*50*	20	14
20	*50*	10	7
Total	**100**	**30**	**21**

Table 1.4: Tax treatment for a high risk investment

Possible before-tax return on an investment ($)	***Prob. of return***	***Before-tax expected return***	***After-tax expected return***
	(%)	***($)***	***($)***
120	*10*	12	8.4
100	*20*	20	14
80	*20*	16	11.2
20	*10*	2	1.4
-40	*20*	-8	-8
-60	*20*	-12	-12
Total	**100**	**30**	**15**

In this example, both investments have a before-tax expected return of $30. However, the expected after-tax return is greater for the low risk investment ($21) than the high risk investment ($15). In practice, this outcome would generally be partially mitigated in future years by allowing any losses to be carried forward.

1.15 The asymmetric tax treatment of profits compared with losses can therefore give rise to a bias against riskier investments, which will tend to divert capital to investments that are of lower value from the perspective of the economy as a whole.

1.16 Reducing the tax system's bias against corporate risk taking could be expected to increase both the quantity and quality of investment, potentially improving the allocation of resources across the economy. This should have positive flow-on effects for productivity, which in turn can support growth in real wages and employment.

1.17 The introduction of loss carry-back gives currently profitable companies greater certainty that, if they incur a loss from undertaking an investment to adjust to changing economic circumstances, they will be able to utilise that loss. This reduces the asymmetry between the taxation of profits and losses.

1.18 Restricting loss carry-back to those companies that have recently paid tax targets the measure to companies that have had a history of being profitable.

1.19 Loss carry-back also improves companies' cash flow by allowing access to losses in a timelier manner. This promotes sensible risk taking by companies, helping them to adjust to changing economic conditions in a patchwork economy.

Chapter 2
The loss carry-back tax offset

Outline of chapter

2.1 This chapter explains how the loss carry-back tax offset rules operate.

2.2 All legislative references in this chapter are to *the Income Tax Assessment Act 1997* (the ITAA 1997) unless otherwise indicated.

Summary of new law

2.3 The loss carry-back rules provide a corporate tax entity the choice to carry-back all or part of a tax loss from an income year, or the preceding income year, against unutilised income tax payable in either of the two income years preceding the current year. The measure applies to assessments for the 2012-13 and later income years. A one year transitional carry-back period applies for the 2012-13 income period.

2.4 Where the conditions of the loss carry-back rules are satisfied, a corporate tax entity is entitled to a refundable tax offset for the losses it chooses to carry-back.

2.5 The loss carry-back amount is the lowest of:

- the loss carry-back tax offset amount the entity chooses;
- the tax value of the $1 million quantitative cap (currently $300,000), the entity's franking account balance at the end of the current year; and
- the tax liabilities in either or both of the income year immediately before the current year (the middle year) and the income year before the middle year (the earliest year).

2.6 Where a corporate tax entity has net exempt income in the current year, prior year unutilised losses must be applied against these amounts before loss carry-back can be claimed. Where a corporate tax entity seeks to apply a tax loss against a prior year where it has net exempt income, the tax loss is reduced by the net exempt income of the prior year before being converted into an offset.

2.7 The loss carry-back rules include similar integrity rules to those used when a company deducts a prior year tax loss.

Comparison of key features of new law and current law

New law	***Current law***
Tax losses can either be carried forward and deducted against income derived in a later income year or carried back against income of earlier income years to produce a refundable tax offset.	Tax losses can be carried forward and deducted against income derived in later income years.

Detailed explanation of new law

2.8 The loss carry-back refundable tax offset allows a corporate tax entity to carry back a tax loss against income tax payable for the two preceding income years. Loss carry-back is designed to provide a corporate tax entity a refund for its tax losses sooner than is the case under the existing loss carry-forward arrangements. ***[Schedule 1, item 1, section-160-5]***

Entities eligible for loss carry-back

2.9 Loss carry-back is available for corporate tax entities only. ***[Schedule 1, item 1, section 160-10]***

2.10 A 'corporate tax entity' is defined in section 960-115 to mean:

- a company;
- a corporate limited partnership;
- a corporate unit trust; or
- a public trading trust.

2.11 The above entities are taxed like companies.

Loss carry-back gives rise to a refundable tax offset

2.12 A corporate tax entity is entitled to a loss carry-back tax offset if:

- it has an unutilised tax loss for either or both the current year and the middle year ***[Schedule 1, item 1, paragraph 160-10(a)]***;
- it has an unutilised income tax liability for either or both of the middle year and the earliest year ***[Schedule 1, item 1, paragraph 160-10(b)]***; and
- either it has lodged an income tax return for each year of the current year and the last five years (unless the Commissioner of Taxation (The Commissioner) had determined at any stage that it did not have to lodge a return, or it did not exist at any stage during the prior five year period whereby it would not have to lodge a return), or an assessment has been made for every such year. ***[Schedule 1, item 1, paragraph 160-10(c)]***

Utilisation of tax attributes

2.13 An entity ***utilises*** a tax loss to the extent that it deducts the tax loss, applies it against an amount of assessable or net exempt income, or uses it to produce a loss carry-back tax offset with relation to the loss. A tax loss is ***unutilised*** for a given year to the extent that an entity has not utilised the tax loss. ***[Schedule 1, item 1, section 960-20]***

2.14 An entity ***utilises*** its net exempt income where:

- the net exempt income is taken into account for calculating a year's tax loss (if any);
- the net exempt income reduces the amount of a tax loss that can be deducted; and
- a loss is carried back to the year that has net exempt income.

Net exempt income is ***unutilised*** for a given year to the extent that an entity has not utilised the net exempt income. ***[Schedule 1, item 1, section 960-25]***

2.15 An entity ***utilises*** its income tax liability for an income year to the extent a tax loss is carried back to that income year. An income tax liability is ***unutilised*** to the extent that the income tax liability has not been utilised. ***[Schedule 1, item 1, section 960-30]***

Losses eligible for loss carry-back

2.16 Corporate tax entities may carry-back tax losses as an alternative to carrying them forward to deduct in future years. ***[Schedule 1, item 1, section 160-10]***

2.17 Capital losses cannot be carried back because, under a realisation-based capital gains tax regime, allowing carry-back for capital losses would allow corporate tax entities to realise their capital losses but defer their capital gains.

2.18 Generally speaking, a 'tax loss' refers to the amount by which deductions exceed assessable income in a particular income year.

2.19 In the most basic case, an unutilised tax loss can be carried back from the year it arises. ***[Schedule 1, item 1, subparagraph 160-10(a)(i)]***

2.20 An unutilised tax loss from the middle year may also be carried back from the current year in some cases. In this scenario, the loss from the middle year can only be used for loss carry-back to the extent that it has not been used previously for loss carry-back and is not used as a carry-forward loss to reduce the taxable income of the current year. ***[Schedule 1, item 1, subparagraph 160-10(a)(ii)]***

2.21 A corporate tax entity could carry-back losses from both the middle year and the current year. In this case, eligible losses for the current year include the current year loss (if any) and the unutilised part of the middle year's loss. A corporate tax entity can choose between using the unutilised part of the middle year loss to reduce taxable income in the current year, and applying it for the purposes of carry-back. ***[Schedule 1, item 1, paragraph 160-10(a)]***

2.22 Tax losses not used for loss carry-back in the current year are available to reduce any taxable income in that year or a future year, according to the usual Division 36 rules for deducting prior-year losses.

Example 2.1: Eligible losses

Super Syed Pty Ltd has the following history:

Year	***Taxable income/ (loss)***	***Tax liability***	***Refundable offset***	***Loss carried forward***
2014-15	$2 million	$600,000	0	0
2015-16	($5 million)	0	$300,000	$4 million
2016-17	$3 million	0	$300,000	0

In 2015-16, Super Syed incurs a $5 million tax loss. Super Syed carries back $1 million of the loss with a tax value of $300,000 against its 2014-15 income tax liability.

In 2016-17 Super Syed deducts $3 million of the unutilised 2015-16 tax loss to reduce its taxable income to nil under Division 36. Super Syed still has $1 million of its 2015-16 loss eligible for carry-back. It chooses to carry it back to apply against the $300,000 unutilised income tax liability of the 2014-15 income year.

Tax losses ineligible for carry-back

2.23 Some tax losses cannot be carried back. Amounts deemed to be a tax loss because the corporate tax entity has excess franking offsets for that year (see section 36-55) are not eligible for carry-back. The reason for this exclusion is that excess franking offsets represent payments of tax and are not economic losses. ***[Schedule 1, item 1, subsection 160-30(b)]***

2.24 Tax losses transferred under Division 170 are also ineligible for loss carry-back. This restriction and the operation of loss carry-back for losses transferred to a consolidated group are explained below. ***[Schedule 1, item 1, paragraph 160-30(a)]***

The loss carry-back period

2.25 From the 2013-14 income year onwards a loss carry-back refund can be claimed against tax liabilities of either of the two years preceding the current year.

2.26 A transitional one year carry-back period is provided for the 2012-13 income year. This means that a loss carry-back refund is only able to be claimed for the 2012-13 income year against tax paid for 2011-12. ***[Schedule 1, item 31, section 160-5 of the Income Tax (Transitional Provisions) Act 1997 (IT(TP)A 1997)]***

The choice to claim carry-back

2.27 Claiming loss carry-back is optional. This mirrors the existing choice corporate tax entities have about whether to deduct their tax losses (see subsections 36-17(2) and (3)). ***[Schedule 1, item 1, paragraph 160-10(d)]***

2.28 A corporate tax entity has the option to claim loss carry-back using any current year tax loss of that year and/or any unutilised tax loss of the middle year. The corporate tax entity can also choose to only claim loss carry-back for a part of either the current and/or middle year loss. ***[Schedule 1, item 1, paragraph 160-10(a) and section 160-25]***

2.29 Where the corporate tax entity has an unutilised tax liability in both the middle and earliest income years, the entity can choose to apply an unutilised tax loss from the current year, or a part thereof, to either or both of these years. The corporate tax entity may also choose to apply all or a part of the unutilised tax loss of the middle year to the unutilised income tax liability of the earliest year. ***[Schedule 1, item 1, paragraph 160-10(b) and section 160-25]***

2.30 A corporate tax entity claims a loss carry-back tax offset by notifying the Commissioner of Taxation (the Commissioner) in the approved form:

- that it wishes to claim the offset;
- of each loss year that it wishes to carry an amount back from;
- of the amount of each such loss; and
- of each year it wishes to carry it back to.

The approved form would usually be the corporate tax entity's income tax return. ***[Schedule 1, item 1, subsections 160-25(2)]***

2.31 The corporate tax entity must claim the offset by the time it lodges its tax return for the current year, or within such further time as the Commissioner allows. ***[Schedule 1, item 1, subsection 160-25(2)]***

How the loss carry-back tax offset is calculated

2.32 A loss carry-back offset is calculated in the following manner.

2.33 The ***earliest year carry-back amount*** is the total amount of the unutilised tax losses from the current year and the middle year that the entity chooses to carry-back to the earliest year. ***[Schedule 1, item 1, subsection 160-15(1), step 1]***

2.34 The ***middle year carry-back amount*** is so much of the unutilised tax loss of the current year that the entity chooses to carry back to the middle year. ***[Schedule 1, item 1, subsection 160-15(1), step 1]***.

2.35 Next, each of those carry-back amounts is reduced by any unutilised net exempt income in the year it is carried back to. These calculations produce a ***reduced earliest year carry-back amount*** and a ***reduced middle year carry-back amount***. ***[Schedule 1, item 1, subsection 160-15(1), step 2]***

2.36 The corporate tax entity's ***earliest year offset component*** is the lesser of the reduced earliest year carry-back amount multiplied by the corporate tax rate, and the unutilised income tax liability for the earliest year. Likewise, the entity's ***middle year offset component*** is the lesser of the reduced middle year carry-back amount multiplied by the corporate tax rate, and the unutilised income tax liability for the middle year. ***[Schedule 1, item 1, subsection 160-15(1), step 3]***

2.37 The corporate tax rate used to derive the amount of the loss carry-back tax offset components is the current year's corporate tax rate. ***[Schedule 1, item 1, subsection 160-15(1), step 3]***

2.38 The amount of the entity's loss carry-back tax offset is the sum of its earliest year offset component and the middle year offset component. ***[Schedule 1, item 1, subsection 160-15(1), step 3]***

Limits on the loss carry-back offset

2.39 The maximum loss carry-back tax offset is the least of the:

- the chosen amount of loss carry-back offset;
- the tax value of the quantitative cap ($1 million);
- the franking account balance at the end of the current year; and
- the sum of the unutilised tax liabilities in the years the losses were carried back to.

[Schedule 1, item 1, section 160-15(1), step 4]

Quantitative cap

2.40 The maximum potential value of the loss carry-back refundable tax offset in any year is the tax value of the $1 million quantitative cap. For example, with a $1 million cap and a 30 per cent tax rate, the maximum potential refund would be $300,000. ***[Schedule 1, item 1, subsection 160-15(1), step 4(c)]***

2.41 More than $1 million could be carried back to years that have net exempt income so long as the amount remaining after being reduced by that net exempt income does not exceed $1 million.

Franking account balance

2.42 The maximum amount of the loss carry-back tax offset for a year (currently $300,000) is limited by the surplus balance of the corporate tax entity's franking account at the end of the current year. That is, the loss carry-back tax offset cannot exceed the value of past taxes paid that have not been distributed to shareholders as franking credits. ***[Schedule 1, item 1, subsection 160-15(1), step 4(b)]***

2.43 A company may have a surplus in its franking account balance because it has retained its taxed profits or has received franked dividends.

2.44 Limiting the loss carry-back tax offset to the value of the franking account at the end of the current year is designed to avoid the past payment of tax providing a double benefit. This double benefit could otherwise arise because shareholders received an imputation credit in relation to company tax that, because of loss carry-back, the company had effectively no longer paid.

2.45 Another reason that loss carry-back is limited by the surplus balance of the franking account is to minimise a negative franking account balance, which creates a liability to franking deficits tax. This reduces administrative churn in the tax system, whereby companies receiving a carry-back offset would subsequently have to return some, or indeed all, of it as franking deficits tax.

2.46 There is a debit to the company's franking account balance for each loss carry-back tax offset claimed. This debit is recorded when the assessment of the refundable tax offset is made. ***[Schedule 1, item 1, section 160-20]***

Exception for certain permanent establishments

2.47 If the corporate tax entity is a foreign entity with a permanent establishment in Australia, the franking account balance restriction does not apply. This ensures that loss carry-back does not discriminate against permanent establishments that are not within the Australian imputation system and so will not have a franking account balance to support the offset. ***[Schedule 1, item 1, subsection 160-15(2)]***

Tax liability in middle or earliest year

2.48 A corporate tax entity must have an unutilised income tax liability in either the middle or the earliest year in order to carry a loss back. In other words, the company must have been assessed as owing an amount of income tax for either the middle or earliest year. ***[Schedule 1, item 1, paragraph 160-10(b) and subsection 160-15(1), step 3]***

2.49 The unutilised income tax liability in the middle or earliest year does *not* refer to the amount of *unpaid* tax referable to either the middle or earliest year. So, payment of tax, whether by pay as you go

(PAYG) instalments or otherwise, does not affect the tax liability figure of the year the loss is carried back to. Rather, the income tax liability refers to the amount of income tax to which the corporate tax entity is assessed for either year (as mentioned in step 4 of the method statement in subsection 4-10(3)). ***[Schedule 1, item 2, subsection 960-30(1)]***

2.50 It is not necessary for that tax liability to have been paid. However, the Commissioner's usual practice is to apply an amount owed to a taxpayer towards any amount the taxpayer owes to the Commissioner before an actual refund would be paid.

2.51 Each part of a tax liability can only be used *once* to support a loss carry-back. This ensures that the tax value of the loss carried-back utilises the corresponding amount of the tax liability of the year it is carried-back to. ***[Schedule 1, item 2, subsection 960-30(3)]***

Example 2.2: Loss carry-back amount single year shock

Proudnose Pty Ltd has the following history:

Year	***Taxable income/(loss)***	***Tax liability***
2014-15	$600,000	$180,000
2015-16	($1 million)	0
2016-17	$3 million	$900,000

In 2015-16, Proudnose can carry-back some of its loss against the tax liability of 2014-15. It can't carry-back the maximum $1 million because the tax value of that ($300,000) is more than the 2014-15 tax liability. So, it can carry-back up to $600,000, using the whole 2014-15 tax liability ($600,000 x 30 per cent corporate tax rate = $180,000).

In 2016-17, the remaining $400,000 of the 2015-16 loss can be used as a deduction against the taxable income of that year. It cannot be carried-back to 2014-15 because there is no unutilised tax liability left in that year.

Example 2.3: Loss carry-back amount sustained (two year) shock

Cavendish Pty Ltd has the following history:

Year	***Taxable income/(loss)***	***Tax liability***
2014-15	$5 million	$1.5 million
2015-16	($1.5 million)	0
2016-17	($2 million)	0

In 2015-16, Cavendish can carry-back up to $1 million of its loss for that year against the tax liability of 2014-15. It decides to do so, producing a loss carry-back tax offset of $300,000 ($1 million x 30 per cent corporate tax rate in this example) and using up $300,000 of the 2014-15 tax liability. Since it has no tax liability for 2015-16, the $300,000 is refunded to it.

In 2016-17, the company can carry-back the remaining $500,000 from 2015-16 or $1 million of its 2016-17 loss, or a little bit of each (to a total of $1 million), against the remaining 2014-15 tax liability. It chooses to carry-back the $500,000 from 2015-16 and another $500,000 from 2016-17. This again produces a $300,000 offset that is refunded to it.

The loss from 2015-16 is fully used up and there is still $1.5 million left of the 2016-17 loss that can be used as a deduction for later years. It can no longer be used as a carry-back loss because there is no year left that it can be carried back to (2014-15 being too far back by 2017-18).

Example 2.4: Loss carry-back amount, multi-year approach

Neversink Corp. has the following history:

Year	***Taxable income/(loss)***	***Basic tax liability***	***Offsets***	***Final tax liability***
2014-15	$1 million	$300,000	$90,000	$210,000
2015-16	($1 million)	0	0	0

In 2015-16, Neversink can carry-back some of its loss against its 2014-15 tax liability. Even though its $300,000 basic tax liability for 2014-15 was the same as the tax value of the maximum $1 million it can carry-back, its final liability was reduced to $210,000 because it had available a $90,000 tax offset in that year because of some R&D expenditure. Therefore, it can only carry-back $700,000 of its 2015-16 loss because the tax value of that is $210,000 ($700,000 x 30 per cent corporate tax rate) and would match the liability available. The remaining $300,000 of its loss can be deducted against taxable income of later years.

Net exempt income

2.52 Where a tax loss arises in the current year, that loss is reduced by the amount of the year’s net exempt income (if any) in the course of determining the amount of the tax loss (see subsection 36-10(3)). Net exempt income is the exempt income of a taxpayer less the amounts that would be deductible if the exempt income had been assessable income (see section 36-20). Loss carry-back does not alter this treatment.

2.53 Where there is net exempt income in the current year and an unutilised loss in the middle year, the corporate tax entity will need to apply that unutilised loss against the net exempt income of the current year. This reduces the amount of unutilised loss from the middle year available for loss carry-back. To the extent there are unutilised prior year losses relating to earlier income periods, these would be applied first to reduce net exempt income in the current year (see subsection 36-17(7)).

2.54 Where a corporate tax entity chooses to apply loss carry-back against a prior year in which the corporate tax entity had net exempt income, the loss carry-back amount for the current year is reduced by the unutilised net exempt income of the prior year before being converted into an offset. The tax losses so reduced are treated as utilised and are unavailable for further loss carry-back or as carry forward losses. ***[Schedule 1, item 1, subsection 160-15(1), step 2]***

2.55 Where there is net exempt income in the middle year, but not the earliest year, or vice versa, a corporate tax entity will have the choice whether to apply the current year tax loss to the year that had net exempt income. The entity may carry a current year tax loss back to the earliest year without reducing the loss by the middle year's net exempt income.

Example 2.5: Net exempt income in a prior year

Dupont & Dupond Pty Ltd has the following history:

Year	***Taxable income/(loss)***	***Net exempt income***	***Tax liability***
2014-15	$5 million	$100,000	$1.5 million
2015-16	($3 million)	0	0
2016-17	$500,000	0	0

Dupont & Dupond's 2015-16 tax loss can be carried back to offset its tax liability for 2014-15. It can carry-back the maximum $1 million in this case because there is a large enough tax liability in 2014-15. If Dupont & Dupond wants to obtain the maximum loss carry-back refundable tax offset it will have to carry-back $1.1 million of tax losses to the 2014-15 period ($100,000 to absorb the net exempt income, and a further $1 million loss carry-back amount to achieve the maximum possible refundable tax offset of $300,000).

In 2016-17 Dupont & Dupond could *deduct* up to $900,000 of its 2015-16 loss ($3 million – $1.1 million – $1 million) against its taxable income of 2016-17. However because it has only $500,000 in taxable income, it can only deduct $500,000 of this amount, reducing its tax liability to nil.

Dupont & Dupond could also choose to carry-back another $1 million from 2015-16 because its unused tax liability in 2014-15 is still $1.2 million ($1.5 million–$300,000). Therefore it could again get the full $300,000 offset because the net exempt income was utilised the previous year, so will no longer reduce the offset.

Example 2.6: Net exempt income in the current year, unutilised loss from the previous income year.

Bukowski Pty Ltd has the following history:

Year	*Taxable income/(loss)*	*Net exempt income*	*Tax liability*
2014-15	$5 million	0	$1.5 million
2015-16	($1 million)	0	0
2016-17	$2 million	$100,000	$600,000

Bukowski chose not to claim its loss carry-back tax offset in 2015-16 to preserve its franking credits. In 2016-17 $100,000 of net exempt income is utilised by the 2015-16 year loss. This leaves $900,000 in losses eligible for carry-back in 2016-17, with a tax value of $270,000. That will leave Bukowski with a final tax liability in 2016-17 of $330,000.

Example 2.7: Net exempt income in the current year with prior year losses from outside the carry-back period

Rimbaud Pty Ltd has the following history:

Year	*Taxable income/(loss)*	*Net exempt income*	*Tax liability*
2013-14	($50,000)	0	0
2014-15	$5 million	0	$1.5 million
2015-16	($1 million)	0	0
2016-17	$2 million	$100,000	$600,000

Rimbaud has a $50,000 tax loss in 2013-14 which it chooses not to utilise in 2014-15 to preserve its franking credits.

In 2016-17 Rimbaud wants to claim a loss carry-back offset with respect to its 2015-16 tax loss. Rimbaud must first use its $50,000 2013-14 tax loss against its net exempt income in 2016-17. Then it must utilise $50,000 of its 2015-16 tax loss against the unutilised 2016-17 net exempt income before it is able to carry-back the unutilised $950,000 in 2015-16 tax losses to the 2014-15 income period. That will produce a tax offset of $285,000, reducing its 2016-17 tax liability to $315,000.

The relationship between loss carry-forward and loss carry-back

2.56 Corporate tax entities must deduct losses from prior years in the order in which they arose (see subsection 36-17(7)). No similar ordering rules apply to using losses for the loss carry-back tax offset. That is, there is no requirement that an eligible loss must be carried back to the earliest year first, or that the earliest loss must be carried back first.

2.57 However, the deduction of tax losses occurs before the loss carry-back refundable offset is worked out. In terms of sequencing, the deduction of a prior year's tax loss occurs as part of working out a corporate tax entity's taxable income for the current year (section 4-10). A corporate tax entity can chose to apply prior year losses to reduce its taxable income to zero (subsections 36-17(2), (3) and (4)). The loss carry-back tax offset is then applied *after* the corporate tax entity has calculated its basic income tax liability for the year (subsection 4-10(3)).

Losses can only be utilised once

2.58 Each part of a loss can only be used once. So, if some part of a loss is carried-back to an income year, that part of the loss cannot be carried-back again to that or any other income year. Nor can it be used as a deduction under Division 36. Similarly, if some part of a loss is used as a deduction under Division 36, that part of the loss cannot ever be carried-back. ***[Schedule 1, item 2, section 960-20]***

Example 2.8: Loss utilisation

BostleCo Pty Ltd has the following history:

Year	***Taxable income/(loss)***	***Tax liability***
2013-14	($1 million)	0
2014-15	$5 million	$1.5 million
2015-16	($3 million)	0
2016-17	$2 million	$600,000

In 2015-16, BostleCo could choose to carry-back $1 million of its loss against its tax liability of 2014-15. It would probably do so, producing a loss carry-back tax offset of $300,000 ($1 million multiplied by the corporate tax rate in the current year, 30 per cent in this example). Since it has no tax liability for 2015-16, that amount would be refunded to it.

In 2016-17, $1 million of the remaining $2 million of the loss from 2015-16 could be claimed as a carry-back loss or the whole $2 million could be used as a carry-forward loss to be deducted in 2016-17 or in a later year. BostleCo would probably choose to carry-back $1 million to 2014-15, generating a $300,000 tax offset for 2016-17. It would also seek to deduct $2 million of its prior year losses in that year. Because of the ordering rule in subsection 36-17(7), it would have to deduct the carry-forward loss from 2013-14 first, leaving the last $1 million from 2015-16 to be deducted as well. It would then have reduced its taxable income for 2016-17 to nil, so its tax liability for that year would also be nil, allowing its offset to be refunded.

If instead it chose in 2016-17 not to carry anything back to 2014-15, it would not have got a refund but it would still have $1 million of its loss left from 2015-16 that could be used as a deduction for future years. By 2017-18, it would be too late to use it as a carry-back loss.

Consolidation and transferred tax losses

Head entity of a consolidated or MEC Group

2.59 Loss carry-back is available to the head company of a consolidated group or multiple entry consolidated group (MEC group), just like any other corporate tax entity.

Transfer case

2.60 Consolidated groups and MEC groups cannot access loss carry-back in relation to losses brought into the group by a joining entity. To allow them do so would add considerable complexity to the loss carry-back measure and would be at odds with the overall principles of the tax consolidation regime.

2.61 Similarly, when an entity with prior year tax liabilities joins a consolidated group or MEC group, the group will not be able to carry back any tax loss against tax previously paid by the joining entity. An entity can only carry its losses back against its own tax liabilities.

2.62 The franking account balance of a joining entity will, under the normal rules, accrue to the head company immediately upon joining. No special restrictions apply to the group using those franking credits for loss carry-back purposes. The group must however be aware of the general anti-avoidance rules relating to a consolidated group obtaining an imputation benefit under section 177EB of the *Income Tax Assessment Act 1936* (ITAA 1936).

Transferred losses for non-consolidated groups

2.63 Loss carry-back is not available for losses transferred to an entity under Division 170. That Division allows losses to be transferred where an Australian branch of a foreign bank is involved, so that it can compete on equal terms with consolidated groups. The restriction on the use of these transferred losses for loss carry-back purposes ensures that loss carry-back has consistent application between consolidated groups and non-consolidated groups where the loss or income company is an Australian branch of a foreign bank, or a non-bank foreign financial entity. ***[Schedule 1, item 1, paragraph 160-30(a)]***

Loss integrity rules

2.64 This section explains how the amendments alter the operation of the Division 165 loss utilisation rules. Specifically, a corporate tax entity cannot choose to carry-back an unutilised loss where it fails to satisfy the 'continuity of ownership' or 'same business' tests of Division 165 as modified for loss carry-back purposes. ***[Schedule 1, item 1, section 160-100]***

2.65 Under the Division 165 rules a corporate tax entity satisfies the continuity of ownership test if the same persons have maintained underlying beneficial ownership of more than 50 per cent of all voting, dividend and capital rights throughout the ownership test period. The ownership test period runs from the start of the loss year until the end of the year in which the loss is deducted.

2.66 Where the continuity of ownership test is failed, a company may nonetheless be able to deduct a tax loss in a later income year if it has undertaken the 'same business' throughout the later income year that it undertook immediately prior to failing the continuity of ownership test.

Modified continuity of ownership test

2.67 For loss carry-back purposes, the continuity of ownership test is modified so that the ownership test period runs from the beginning of the year the loss is carried back to until the end of the current year. This ensures symmetry between the operation of loss carry-forward and loss carry-back, and that the rules apply identically across the test period for both loss carry-back and loss carry-forward. ***[Schedule 1, item 1, section 160-100]***

Same business test

2.68 Where a corporate tax entity fails the modified continuity of ownership test it may still claim a loss carry back refundable tax offset if it satisfies the same business test. As with carried forward losses, the corporate tax entity must have maintained the same business throughout the current year that it carried on just before it failed the the continuity of ownership test. ***[Schedule 1, item 1, section 160-100]***

Example 2.9: Application of the modified loss utilisation rules

McCarthy Pty Ltd has the following history:

Year	*Taxable income/(loss)*	*Tax liability*
2014-15	$5 million	$1.5 million
2015-16	$5 million	$1.5 million
2016-17	($6 million)	0

McCarthy experiences a tax loss in 2016-17 that it can choose to carry-back to either the 2014-15 or 2015-16 income periods. In order to obtain maximum benefit from its 2016-17 tax loss, McCarthy seeks to carry-back the 2016-17 loss to the 2014-15 year first. For the purposes of the continuity of ownership test, the ownership test period runs from the beginning of the 2014-15 income year to the end of 2016-17, the current year.

Assuming that there is a sufficient change of ownership during the 2014-15 income year, McCarthy must carry on the same business in the 2016-17 period that it carried on immediately prior to the change of ownership. McCarthy must also not derive assessable income from a new business or transaction of a kind that it had not undertaken prior to the change of ownership in 2014-15 at any time in the 2016-17 period. McCarthy can apply its 2016-17 loss to 2015-16 because it satisfies the continuity of ownership test and to 2014-15 if it satisfies the same business test.

Part year loss rules

2.69 Where a corporate tax entity experiences a change of ownership and fails the same business test within the current year, it will be able to carry-back a loss in part of the year arising before it failed the continuity of ownership test if it could have done so if that part of the year had been the whole of the year. ***[Schedule 1, item 1, subsection 160-100(3) and paragraph 160-100(2)(a)]***

2.70 The proposed modification to the part-year loss rules is intended to mitigate any disincentive associated with selling a loss making company before the end of a loss year. If the part-year loss rules were not modified to accommodate the loss carry-back scenario, there would be an incentive for shareholders to retain ownership of a loss making company until the end of a loss year.

Example 2.10: Application of the part-year rules

Frost Pty Ltd has the following history:

Year	*Taxable income/(loss)*	*Tax liability*
2014-15	$4 million	$1.5 million
2015-16	(3 million)	0
2016-17	$2 million	600,000

In 2015-16 the Frost wishes to carry-back $1 million of its tax loss to 2014-15. In preparing its 2015-16 tax return it discovers that it failed the COT at 31 December 2015. It also discovers that it has not carried on the same business from before the changeover time, and for the remainder of the 2015-16 income period. $1.5 million of notional tax loss was incurred before 31 December 2015, and $1.5 million of notional tax loss was incurred after this date. Frost cannot carry any portion of the post-31 December 2015 notional tax loss backwards against its 2014-15 income tax liability. However, it can carry $1.5 million of its pre-31 December 2015 loss back to its 2014-15 income tax liability.

Conversely, Frost can carry forward its post 31 December 2015 tax loss to deduct against future years' assessable income. It is prevented from carrying forward its pre-31 December 2015 notional tax loss.

Other administrative rules

A corporate tax entity must have lodged returns over the past five years

2.71 A corporate tax entity must have lodged an income tax return for the current year and each of five years immediately preceding the current year in order to claim loss carry-back. ***[Schedule 1, item 1, subparagraph 160-10(c)(i)]***

2.72 In some cases, the Commissioner might have advised the entity that it did not need to lodge a return for a year (see section 161 of the ITAA 1936). Not lodging a return for such a year does not disentitle an entity to a loss carry-back tax offset. A common case where an entity is not required to lodge a return would be where the entity had not existed for the entire period. ***[Schedule 1, item 1, subparagraph 160-10(c)(ii)]***

2.73 Although corporate tax entities are subject to the full self-assessment regime under which an assessment is made automatically when a corporate tax entity lodges its return (see section 166A of the ITAA 1936), it is possible for the Commissioner to have assessed a corporate tax entity for an income year without it having lodged a return for that year (see sections 167 and 168 of the ITAA 1936). In such cases, the Commissioner can rely on that assessment for the purposes of establishing the accuracy of the corporate tax entity's losses and liabilities, so not having lodged a return for that year also does not disentitle an entity to a loss carry-back tax offset. ***[Schedule 1, item 1, subparagraph 160-10(c)(iii)]***

Interest on overpayments and late payments

2.74 A loss carry-back tax offset forms part of the tax assessment of the current year. Loss carry-back alters neither the tax liability of the middle or earliest year to which a loss is 'carried back' nor the consequences of a failure to have paid that liability by the due date. It follows then that claiming loss carry-back against a particular middle or earliest year does not:

- give rise to 'interest on overpayments' in relation to the tax liability assessed for either the middle or earliest year; or
- reduce any general interest charge or shortfall interest charge arising from a failure to pay the original (or any subsequent amended) assessed liability of the middle or earliest year.

Amended assessments

2.75 A loss carry-back tax offset is recoverable where a review of a corporate tax entity's tax affairs leads the Commissioner to conclude that the corporate tax entity was not entitled to it. If a corporate tax entity's assessment for the current or middle year is amended, then:

- if the amendment results in the corporate tax entity having a reduced loss or no loss (because it increases assessable income or reduces deductions) in the middle or current year, the amount of the loss carry-back tax offset that the corporate tax entity is entitled to may be reduced (potentially to nil); and/or
- if the amendment results in the corporate tax entity having an increased loss, the corporate tax entity may qualify for an additional loss carry-back tax offset.

2.76 If a corporate tax entity's assessment for either the middle or earliest year is amended, then:

- if the amendment results in the corporate tax entity's tax liability being reduced, this could affect the loss carry-back amount for the current year and so may require the assessment for the current year to be amended to provide a lower loss carry-back tax offset; and/or

- If the amendment results in the corporate tax entity having a higher taxable income in that year, this could affect the loss carry-back amount for the current year and so may allow the assessment for the current year to be amended to provide a higher loss carry-back tax offset.

2.77 If a corporate tax entity did not claim loss carry-back for a current year in which it could have, or claimed a smaller amount than it was potentially entitled to, it can seek an amendment of its assessment accordingly, subject to the usual amendment periods.

2.78 A corporate tax entity may also request an amendment where the loss for one income period is reduced, but it could have chosen to carry-back a loss from another income year instead. The same can be true where the unutilised income tax liability for a gain year is reduced, but a loss could have been carried back to the unutilised income tax liability of another gain year.

2.79 In all cases, the corporate tax entity's carried-forward losses pool is adjusted to reflect the increase or decrease in the amount of loss carry-back used in recalculating its loss carry-back tax offset. Changes to the amount of a corporate tax entity's tax offset will alter the corporate tax entity's franking account at the date on which the amendment is made. ***[Schedule 1, item 1, section 160-20]***

Chapter 3
Consequential amendments and transitional provisions

Outline of chapter

3.1 This chapter explains the amendment of existing provisions in the tax law that are necessary as a result of implementing the loss carry-back measure. It also explains when the measure begins to apply and the transitional arrangements for the 2012-13 year.

3.2 All legislative references in this chapter are to the *Income Tax Assessment Act 1997* (the ITAA 1997) unless otherwise indicated.

Consequential amendments

Guide material

3.3 Most Divisions, and many Subdivisions, in the ITAA 1997 begin with guide material to provide readers with an overview of the Division or Subdivision. Some of that guide material is amended to reflect the fact that tax losses can be carried back to produce a tax offset, as well as being deducted against future assessable income, and the fact that the rules about continuity of ownership apply equally to the use of a tax loss in that way. ***[Schedule 2, items 29 and 30, sections 165-1 and 165-5]***

Refundable tax offset rules

3.4 The amendments extend the list of tax offsets that are subject to the rules about refundable tax offsets to include the loss carry-back tax offset. This ensures that any part of a taxpayer's loss carry-back tax offset that is not needed to reduce a basic tax liability to nil can be refunded to the taxpayer. ***[Schedule 2, item 28, section 67-23, table item 14]***

Deducting tax losses

3.5 The current law says that no part of a tax loss can be deducted more than once. The rules about deducting tax losses are amended to provide that any part of a tax loss that is carried-back to a target year cannot also be deducted. This is done by extending the definition of 'utilise' in relation to a tax loss to include carrying it back to produce a tax offset. That ensures that each part of a tax loss can only be used once. The current definition of 'utilise' is also relocated to the concepts part of the income tax law. ***[Schedule 1, item 2, subsection 960-20(2) and Schedule 2, item 35, subsection 707-110(2)]***

3.6 When the amount of a tax loss that a corporate tax entity can deduct in a year changes after it lodges its tax return, any choice it could have made about deducting the tax loss can be remade (see subsections 36-17(10) to (12)). The amendments ensure that the ability to remake that choice also arises when there is a change to the amount of a tax loss carried back to an earlier year. ***[Schedule 2, item 27, paragraph 36-17(10)(d)]***

3.7 A number of provisions are amended to make clear that, when they refer to a tax loss, they are referring to an *unutilised* tax loss. ***[Schedule 2, items 18 to 26, 31 and 33 subsections 36-17(2), (5) (example), (7), (8) and (9), paragraphs 36-17(3)(a) and (b), 36-17(4)(a), 36-17(10)(a), 165-115R(3)(a) and 165-115R(4)(a)]***

The general anti-avoidance rule

3.8 The amendments modify the income tax general anti-avoidance rule in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) so that it applies to schemes to obtain a loss carry-back tax offset.

3.9 The general anti-avoidance rule works by identifying a scheme and a tax benefit that is produced for a taxpayer by the scheme. The Commissioner can cancel the tax benefit if it can be concluded (after examining eight listed factors) that someone entered into the scheme for the dominant purpose of providing the taxpayer with the tax benefit.

3.10 A 'tax benefit' is defined as being an amount not being included in the taxpayer's assessable income, a deduction or capital loss being incurred by the taxpayer, or a foreign income tax offset being allowable to the taxpayer. The amendments extend that definition to also include a loss carry-back tax offset being available to the taxpayer. ***[Schedule 2, items 2, 10 and 11, subsection 6(1), (definition of 'loss carry-back tax offset') and paragraphs 177C(1)(bc) and (g) of the ITAA 1936]***

3.11 As with the existing tax benefits, the tax benefit from gaining a loss carry-back tax offset does not apply if the offset arises from making a choice expressly provided for by the income tax law unless the scheme was entered into for the purpose of enabling the choice to be made. ***[Schedule 2, items 12 to 15, subsection 177C(3) and paragraph 177C(2)(e) of the ITAA 1936]***

3.12 If Part IVA is satisfied, the Commissioner of Taxation (the Commissioner) can cancel the tax benefit by making a determination to do so. The possible determinations, which separately cover each type of tax benefit, are extended to include determinations in relation to tax benefits from a loss carry-back tax offset. ***[Schedule 2, item 16, paragraph 177F(1)(d) of the ITAA 1936]***

3.13 When the Commissioner makes a determination to cancel a tax benefit, he or she can also make the compensating adjustments needed to put any taxpayers into the position they would have been in if the scheme had not been entered into. The amendments allow the Commissioner to make compensating adjustments to provide taxpayers with a loss carry-back tax offset that would have been available apart from the scheme. ***[Schedule 2, item 17, paragraph 177F(3)(e) of the ITAA 1936]***

Franking accounts

3.14 Generating a loss carry-back tax offset results in the entity's franking account being debited by the amount of the offset (with a minor exception for foreign resident corporations). The amendments therefore update the list of franking debits. ***[Schedule 2, item 34, subsection 205-30(1), table item 7AA]***

Objections

Refund from tax offsets is part of an assessment

3.15 A corporate tax entity that claims a loss carry-back tax offset should be able to object to the amount of any refund arising from the offset. Therefore, the amendments extend the definition of 'assessment' to include the amount of a refund arising from the taxpayer's refundable tax offsets. ***[Schedule 2, items 1 and 3, subsection 6(1) definitions of 'assessment' and 'tax offset refund' of the ITAA 1936]***

3.16 The main effect is that the right to object to an assessment is extended to cover objections to the amount of the refund from the taxpayer's refundable tax offsets (see subsection 175A(1) of the ITAA 1936). It also means that the amount of a tax offset can only be changed through the amendment of an assessment and must therefore occur within the time limits for amending an assessment (see section 170 of the ITAA 1936).

3.17 A number of consequential amendments are made because of the change in the meaning of 'assessment' to include refunds arising from refundable tax offsets. Most of those merely add extra words to properly reflect the extended meaning of 'assessment'. ***[Schedule 2, items 5 to 8, sections 166 and 167, subsection 168(1) and paragraph 166A(3)(c) of the ITAA 1936]***

Returns of full self-assessment taxpayers

3.18 One amendment that does a little more is the amendment to require the returns of full self-assessment taxpayers to include the amount of the refund they can get from their refundable tax offsets. The returns of full self-assessment taxpayers (mostly companies) are *deemed* to be assessments made by the Commissioner when they are lodged (see subsection 166A(3) of the ITAA 1936). Therefore, it is important that their returns contain all the information that an assessment needs to include. At the moment, the required information includes an entity's taxable income and the tax payable on that income. The amendments extend it to also require the amount of the entity's refund arising from its refundable tax offsets (which is now part of an assessment). ***[Schedule 2, item 4, paragraph 161AA(ba) of the ITAA 1936]***

Objections in 'nil' tax liability cases

3.19 Another significant amendment deals with the rule that limits objections for an entity assessed as having no taxable income or no tax liability, by only permitting objections that seek to increase the liability. The amendment permits objections in such cases to also contest the amount of the entity's refund arising from its refundable tax offsets. Without that amendment, there would effectively be no right to object to the amount of that refund in the most important case, where an entity has no tax liability. ***[Schedule 2, item 9 subsection 175A(3) of the ITAA 1936]***

Defined terms

3.20 The amendments add a number of definitions to the income tax law for the purposes of the loss carry-back tax offset measure. In some cases, existing definitions are expanded and relocated to reflect their extra application to loss carry-back. ***[Schedule 1, item 2, Subdivision 960-B and Schedule 2, items 1 to 3 and 36 to 50, subsection 6(1) of the ITAA 1936 (definitions of 'assessment', 'loss carry-back tax offset' and 'tax offset refund') and subsection 995-1(1) of ITAA 1997 (definitions of 'current year', 'earliest-year carry-back amount', 'earliest year offset component', 'income tax liability', 'loss carry-back choice', 'loss carry-back tax offset', 'middle year carry-back amount' and 'middle year offset component', 'reduced earliest year carry-back amount', 'reduced middle year carry-back amount', 'tax offset refund' , 'unutilised income tax liability', 'unutilised net exempt income', 'unutilised tax loss' and 'utilise')]***

3.21 An asterisk is added to an occurrence of the expression 'tax loss' to indicate that it is a defined term. ***[Schedule 2, item 32, paragraph 165-115R(3)(c)]***

Application and transitional provisions

Application

3.22 The loss carry-back measure applies to companies' income tax assessments for the 2012-13 income year and later years. ***[Schedule 1, item 3, section 160-1 of the IT(TP)A 1997]***

3.23 Income years normally match financial years, running from 1 July to the following 30 June, but some entities will have 'substituted accounting periods'. These are periods used in substitution for the financial year, often for companies that want to match their Australian tax accounting periods with those of related foreign entities.

3.24 For such entities, the loss carry-back measure will apply to the substituted period they use for the 2012-13 income year (and for later years) and so could start before or after 1 July 2012.

Transitional arrangements for 2012-13

3.25 Tax losses can usually be carried back to either of the two years preceding the year for which the tax offset is being claimed. However, they can never be carried back before the 2011-12 income year. Therefore, in the 2012-13 income year, tax losses can only be carried back for one year. ***[Schedule 1, item 3, section 160-5 of the IT(TP)A 1997]***

3.26 This transitional rule is consistent with the recommendation of the Business Tax Working Group's 2012 *Final Report on the Tax Treatment of Losses* that loss carry-back be phased in with an initial one year carry-back period.

3.27 The Working Group's recommendation was based on reducing the budgetary costs of introducing the measure while still encouraging new investment by allowing the scheme to commence from 1 July 2012.