

3 February 2012

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

Email: BTWG@treasury.gov.au

Dear Sir or Madam,

Re: Submission - Interim report on the tax treatment of losses

First off, we would like to commend the Treasury on the steps that are being taken to review the tax loss recoupment rules and exploring possible options to facilitate access to tax losses. We thank you for the opportunity to comment on the Interim report on the tax treatment of losses (the "**Interim Report**").

By way of background, Pennam Partners is an investment house with, inter-alia, domestic and cross border mandates assisting startups and early stage firms (henceforth collectively referred to as the "**startup sector**") with their capital raising and capital management strategies. Our submission will solely focus on the startup sector and our views on whether the possible reforms highlighted in the Interim Report would be beneficial to the startup sector.

We highlight the fact that the startup sector is different to established businesses in that they are generally pre-revenue and/or pre-profit businesses and notwithstanding that they may be lean operations they are heavily reliant on cash flows to seed finance and progress their ventures. In addition, based on the stylised benchmark scenarios in the Interim Report, a start-up company has the highest effective tax rate amongst the three different stylised companies.

For the aforementioned reasons, we opine that caution should be exercised when considering and drafting new reforms to facilitate access to tax losses to ensure that the new reforms are not skewed towards corporates other than the startup sector. We believe the review should not necessarily be a 'one size fits all' approach and it will be necessary to consider different reforms for the startup sector. We suggest that due consideration be given to developing a tax losses regime tailored to the startup sector where such regime may form part of the small business entity concessions and therefore be limited to small business entities¹.

Element A – remove COT and SBT

Due to their nature, our view is that the startup sector is more at risk of breaching the Continuity of Ownership Test ("**COT**") and the Same Business Test ("**SBT**"). From the time that a startup venture is founded and up until the time it becomes an established business, a startup may experience several rounds of funding. These rounds of funding may substantially dilute the founding shareholders' base thus resulting in the COT not being satisfied and a wastage of accumulated tax losses (which is prevalent in the startup sector).

In the alternative, a startup may seek to rely on the SBT. However, by the time the startup becomes a more established business and is generating profit, its likelihood of meeting the stringent requirements of the SBT is low. The startup would have likely grown in size and its operations would have morphed overtime that, from our experience, it would be difficult for the startup to then meet some of the elements of the SBT.

¹ Section 328-110 of the Income Tax Assessment Act 1997



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We submit that both the COT and the SBT should be abolished for small business entities. Alternatively, at a minimum, we request that the SBT be reviewed and the conditions attached are made more flexible for small business entities.

Element B – loss refundability

We understand that whilst Element B has been incorporated in the Interim Report, the Working Group is not proposing Element B as a viable option due to the significant impact it can have on Government revenue. We broadly agree with the preliminary conclusion reached by the Working Group in relation to Element B for the broad business sector. However, we are of the view that Element B is worthwhile exploring for the startup sector which is in dire needs of funding. Loss refundability will allow loss-making small business entities from receiving additional cash flows on a yearly basis as opposed to carrying tax benefits from unused tax losses that may be wasted in future years due the tax losses integrity rules.

Limiting loss refundability to small business entities would limit the impact on Government revenue and in addition a refundable cap may also be imposed, which means the Government will not suffer a significant drain on its financial resources.

Element C – time limited loss carry back

We believe that implementing a loss carry back rule will be of little or no value to the startup sector given that it is likely that they will not have any tax profitability history. This means they will not be able to avail themselves of the proposed loss carry back mechanism and therefore this proposal represents an imbalance between the startup sector and established corporates. In addition, it is being proposed that the loss carry back amount will be limited to the franking credits of the company. Since franking credits are partly associated with tax profitability and PAYG instalment payments of a company, this proposal is not necessarily catering for the startup sector.

Based on the above submission, we posit that Treasury should develop a separate tax losses regime for the startup sector that will not only allow them to easily access the tax losses in the future but may also provide them with an opportunity to convert part or all of their losses into cash flow.

If you want to discuss the above submission or have any query, please contact us on 03 9221 6219.

Yours sincerely

Yanese Chellapen
Director
Pennam Partners