Business Tax Working Group

Final report on the tax treatment of losses

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Executive Summary

The Business Tax Working Group (Working Group) was established following the Tax Forum in October 2011 to consider what kind of business tax system will best support Australia's future growth prospects, particularly when set against the context of the major structural changes that are occurring within the economy at present.

Australian businesses are under pressure to adapt and change their business models to overcome challenges and make the most of opportunities arising from structural changes underway within the economy. Now more than ever it is important that the tax system does not get in the way of businesses wanting to invest and innovate.

Our current business tax system however, penalises investments that have some risk of failure through its treatment of losses. This penalty against risk taking can influence the kinds of investments undertaken and how much investment occurs.

The Working Group's terms of reference focus on reducing taxes on new investment to encourage Australian businesses to undertake innovation and entrepreneurial activity. We have been asked to focus initially on how changes to the treatment of tax losses might help to relieve the tax burden on new investment. In arriving at this final report on the tax treatment of losses the Working Group has provided the Treasurer an interim report, sought submissions in response to that report and conducted some limited confidential consultation. Later this year we will consider whether other changes, including a further corporate tax rate cut or a move towards a business expenditure tax system, (in particular an allowance for corporate equity) would best support new business investment in the longer term.

The Working Group is also required to identify offsetting savings from within the business tax system for any reforms it recommends. The tight timeframe and the requirement to find savings offsets have posed substantial challenges to the Working Group.

In the limited time available, the Working Group has not had an opportunity to fully evaluate the costs and benefits of discrete reforms to the treatment of losses against alternative policies such as a cut to the corporate tax rate. More time would also have been required to fully assess the potential benefits and risks of different savings options.

Nonetheless, the Working Group considers that loss carry back would be an important reform in the near term as it offers the prospect of improving incentives for investment as well as acting as an automatic stabiliser during an economic downturn. It has been implemented in a number of other jurisdictions and a range of stakeholders have indicated that they see it as a worthwhile initiative. In particular, stakeholders representing small to medium sized businesses, considered that carry back would assist businesses contemplating new investments, the costs and risks of which could result in a period of tax losses.

Under the Working Group's preferred model of loss carry back, refunds would be limited to company franking account balances and the amount of losses available to be carried back subject to a cap of not less than $1 million. While in principle a quantitative cap on loss carry back may limit its effectiveness, it would target the measure to small and medium sized businesses and help to contain the cost to revenue over the longer term. To avoid the need for businesses to amend previous tax assessments it is proposed that loss carry back be delivered through the use of a refundable tax offset.

While recognising that businesses operate through a range of legal structures, the Working Group considers that loss carry back should initially be provided to companies only. There would be significant complexity associated with extending loss carry back to trusts. Sole traders are currently less constrained in their use of tax losses than companies and trusts.

The Working Group also considered carry forward losses – recognising that the ability to carry forward losses is a relevant consideration for many firms pursuing new and innovative business activities. In its deliberations the Working Group was conscious of ensuring the right balance is struck between carry forward arrangements that support appropriate risk taking and innovation and maintaining appropriate loss integrity rules (as underpinned by the existing continuity of ownership test (COT) and the same business test (SBT)).

The Working Group came to a view that aspects of the current rules may stand in the way of the legitimate restructuring efforts of some businesses. That is, the current rules are not effective as a means for determining whether a change to a company's ownership was motivated by a tax avoidance purpose rather than commercial considerations. The SBT in particular too narrowly prescribes the range of activities that a company can engage in without risking forfeiture of its losses. Further, the application of SBT varies with a taxpayer's facts and circumstances making it difficult for taxpayers to determine prospectively whether or not they are likely to satisfy the test.

The Working Group has considered a range of options for reforming the SBT to better target the test and provide taxpayers with greater certainty. In the time available, it has not been able to develop and settle on a preferred approach. However, the Working Group sees merit in pursuing a model that includes, as its central component, modifying the SBT so that it aligns with the modern business environment. In addition, a statutory 'drip-feed' of up to ten years could be allowed on an opt-in basis for companies that fail the COT. This could complement the SBT by offering increased certainty and lower compliance costs in exchange for a slower rate of loss utilisation. The Working Group recommends that the Government commission further work in this area as a matter of priority.

The Working Group also considered whether an uplift factor should be applied to losses that are carried forward, in recognition that the Government retains the tax value of a loss and economically benefits from retaining that loss until its ultimate utilisation against future taxable income, conditional on certain tests being met. In theory, uplifting losses could benefit companies dealing with a temporary shock by ensuring that the value of those losses is maintained over the period leading up to a return in profitability. Consultation with stakeholders suggested that there was some, though limited, interest in this reform. The Working Group considers that such an approach is less likely to influence decision making than a measure like loss carry back that provides an immediate cash flow benefit, or changes to SBT that make it more likely that a loss can be used to offset future income. The Working Group therefore has not recommended a change to introduce an uplift factor.

The Working Group is required by its terms of reference to identify savings from within the business tax system that could offset the costs of any reforms it recommends. The Working Group's interim report on the tax treatment of losses was intended to elicit stakeholder views on reform priorities in this area and help us gain a better understanding of how the current system affects business decision making. It was not possible, at the time, to include any discussion about potential offsetting savings in our interim report. In light of the feedback we received in response to the interim report, the Working Group started to develop more specific reform proposals that could be costed by Treasury. Only in light of this information was the Working Group able to focus on the potential savings task and to undertake some further targeted, confidential consultation. Accordingly, there has not yet been widespread and transparent public consultation about any potential offsetting measures.

As a result of the reforms that followed the Review of Business Taxation, business tax expenditures are not as substantial as they once were. Nonetheless, Treasury provided the Working Group with information largely drawn from the Tax Expenditures Statement and a number of them were canvassed in recent confidential consultation, in particular: changes to the thin capitalisation rules, accelerated depreciation for some assets and industries (including oil and gas assets and assets first used in exploration) and the research and development (R&D) non-refundable tax offset available to companies with annual turnover of $20 million or more.

In the time available, the Working Group has not had an opportunity to conduct a thorough assessment of whether a particular savings option when combined with any of the potential loss reform measures would deliver a net-benefit to the economy. Further analysis and consultation is required before any conclusions could reasonably be drawn.

Conclusion

The Working Group considers that loss carry back would be a worthwhile reform in the near term. However, we have not had an opportunity to understand the relative net-benefit of loss carry back compared with other business tax reforms, particularly those we have been asked to look at in the second half of the year. We have also not had an opportunity to consider the potential impact of loss carry back on business behaviour and the macro-economy beyond the analysis set out in this report. The Working Group also recommends that the Government undertake further work to develop a model for reforming the same business test and a more extensive assessment of the costs and benefits of such reforms.

In relation to savings options, Treasury provided the Working Group with a list of options, largely drawn from the Tax Expenditures Statement, which focussed on the largest business tax expenditures. Treasury also provided the Working Group with costings of possible changes to these tax expenditures as well as possible changes to the thin capitalisation rules that could pay for reforms to the treatment of tax losses. The Working Group used this information to conduct some limited, confidential consultation on certain savings options. However, in the time available we have not had an opportunity to fully consider the benefits and risks of one or more or a combination of savings options and we have been unable to consult widely on the extent of any adverse impacts. The Working Group considers that further analysis and consultation is required before any conclusions can be drawn or any decision taken to implement them.

SUMMARY OF RECOMMENDATIONS

Recommendation 1: The Working Group recommends that:

- the Government note the savings options identified in this report; and
- further analysis and consultation be undertaken before taking a decision to implement them.

Recommendation 2: The Working Group considers that loss carry back would be a worthwhile reform in the near term and could be implemented consistent with a model that:

- is limited to companies;
- provides a two-year loss carry back period on an ongoing basis;
- limits the amount of losses that can be carried back by applying a cap of not less than $1 million;
- limits the amount of refunds to a company's franking account balance; and
- is phased in from 2013-14 with an initial one year carry back period.

Recommendation 3: The Working Group recommends that the Government, as a matter of priority, undertake further analysis with a view to developing a model for reforming the same business test. One model for improving the existing loss integrity rules could involve a combination of:

- modifying the existing SBT so that it better aligns with the modern business environment; and
- introducing an alternative statutory drip-feed mechanism calculated on a straight line basis.

Chapter 1: The review process

Key points

- The Business Tax Working Group (Working Group) was asked to consider and make recommendations on the treatment of tax losses ahead of any broader consideration of future directions for the business tax system.
- The Working Group considers that reform of the tax treatment of losses would make a difference to business decision making. However, more time would be needed to fully assess the costs and benefits of such reforms compared to the alternatives, such as a company tax rate cut.
- In arriving at this final report on the treatment of tax losses, the Working Group produced an interim report, sought written submissions in response to that report and undertook further confidential consultation on possible reform options. In the time available, the Working Group has been able to undertake only limited confidential consultation on potential offsetting savings and a comprehensive assessment of the benefits and risks of pursuing the identified savings options has not been possible.
- In addition to the views of stakeholders, the Working Group has had regard to current international practice in relation to the treatment of tax losses.
- The Working Group has chosen to focus on the rules applying to companies. However, the Working Group is mindful that not all businesses, particularly small businesses, operate through a company structure and where possible has considered how a particular reform could be extended.

Building a foundation for business tax reform

The Business Tax Working Group (Working Group) was established following the Tax Forum in October 2011 to consider what kind of business tax system will best support Australia's future growth prospects. This report on the treatment of tax losses should be seen as the first instalment in a two-part exercise that aims to provide a foundation for business tax reform that will help Australian businesses continue to grow and change in response to the challenges and opportunities presented by the volatility of the global economy and the fast-growing economies of Asia.

Our terms of reference require the Working Group to focus on how best to relieve the tax burden on new investment in the short term through changes to the treatment of tax losses.[1] Later in the year we will consider whether a further corporate tax rate cut or a move towards a business expenditure tax system, including an allowance for corporate equity, would best support new business investment in the longer term.

1 Refer to Appendix A for the Business Tax Working Group's terms of reference

The Working Group notes that the timeframe for completing this report was not sufficient to fully explore the net-benefit of potential losses reforms and offsetting savings. In the time provided however, reform options have been identified that are likely to remove impediments in the tax system to business investment and innovation and increase the ability of businesses to respond to changes in economic conditions. Where possible, the Working Group has outlined possible design features that could increase the effectiveness or affordability of its recommendations.

Now more than ever, businesses are under pressure to adapt and change their business models to overcome challenges and make the most of opportunities arising from changes in the Australian and the global economy. This will involve businesses exploring new strategies or diversifying into different markets. This type of activity necessarily involves new investment, for example in machinery, equipment and training of new and existing staff. Such activities will involve expenditure that is not immediately recouped and require businesses to take risks.

The business tax system currently imposes higher effective rates of tax on investments that have some risk of failure. This penalty against risk taking can influence the kinds of investments undertaken and how much investment occurs. Alleviating the tax burden on new investment through reforms to the tax treatment of losses will improve both the quality and quantity of new investment. Policies that remove impediments in the tax system to business investment and innovation will enhance productivity growth in all sectors of the economy, particularly those under pressure to change.

Many losses occur only as a consequence of the arbitrary annual tax accounting period being less than the life of most investments. Investments in machinery, R&D, intangible capital and so forth which record a net taxable income over the project life can show a recorded loss in a particular year (or years) because of lags of more than a year before the investment generates revenues, temporary losses because of a cyclical downturn or natural disaster, or because of close-down costs exceeding revenue. The absence of full refundability means these investments face higher effective tax rates than the statutory tax rate. The key reform option explored in this report is a form of loss carry back. The Working Group has also identified some areas for further work, particularly to ensure that loss integrity rules are appropriate and adapted to the modern commercial environment. Additional reforms to the treatment of losses would have required more substantial savings to be found. Consultations revealed that the support of some stakeholders for changes to the treatment of tax losses is contingent on such changes not compromising the opportunity for more fundamental reforms of the business tax system.

Loss refundability would achieve economic neutrality but is not practical

Immediate loss refundability (that is, refunding a loss at the taxpayer's marginal tax rate) would decrease the bias against risk taking in the economy and improve cash flows for companies in a tax loss position. However, immediate refundability would also have a significant impact on government revenues including by providing an incentive for taxpayers to illegitimately create losses. Additionally, the Working Group is mindful that other jurisdictions do not provide immediate refundability of losses.

As we stated in our interim report, the Working Group does not consider immediate refundability to be a viable reform option for the tax treatment of losses in the foreseeable future. Instead, the Working Group has used immediate refundability as a benchmark for economic neutrality against which to assess alternative reform options.

Chapter 2 summarises why access to tax losses is important and Chapters 3 and 4 discuss ways of getting closer to the benchmark through loss carry back and loss carry forward.

The Working Group has focussed on corporate tax rules

For this report, the Working Group focussed on companies, as this tends to be the organisational form preferred by businesses undertaking risky investment, particularly those drawing on external capital. Businesses operating through a company structure typically face more constraints on their ability to realise the value of their tax losses than businesses operating through alternative structures (other than for trusts). For these reasons, the Working Group considered it was appropriate to focus its attention and its final recommendations on companies and entities that are taxed like companies.

However, the Working Group is mindful that businesses operate through a range of alternative legal structures, sometimes in combination with a corporate vehicle. Where possible, the Working Group has identified the benefits and risks of extending the reform to such entities. The Government may revisit these issues at a later date. For example, if loss carry back is successfully implemented for companies, the Government could further consider extending it to unincorporated businesses.

The Working Group was also encouraged by stakeholders to consider possible reforms to the trust loss rules. However, the complexity of those rules is such that it would not have been possible for the Working Group to give them adequate consideration in the time available. The Government is aware of the need to update and rewrite the trust loss rules.[2] On that basis, the Government could consider referring such a review to a separate process (such as Treasury's current review of trust rules).

The Working Group has focussed on revenue losses

The reforms considered in this report have potential application to both revenue losses and capital losses. However, the Working Group considers that the case for reforming the treatment of capital losses is a less compelling priority for the Government and has, with one important exception, confined its recommendations to revenue losses. The exception is the discussion of loss integrity rules in Chapter 4 which has application to both revenue and capital losses.

As noted in the Working Group's interim report, capital losses are 'quarantined' meaning that they can be offset against capital gains in working out a net assessable capital gain but cannot be deducted from revenue gains. Some stakeholders questioned whether the quarantining of capital losses continues to be appropriate for companies. They pointed out that companies no longer enjoy the benefit of calculating capital gains using a cost base that is indexed for inflation and are denied the capital gains tax (CGT) discount available to other entities. However, it should also be noted that capital gains are taxed on a realisation basis, potentially giving taxpayers the ability to defer the tax liability indefinitely. This advantage may be seen as justifying a relatively more restrictive approach to the treatment of capital losses than revenue losses.

Although properly reflecting the realisation basis of the capital gains tax regime is an important consideration, the Working Group's decision to focus on revenue losses is based more on practical business considerations. In particular, revenue receipts tend to be regular and are relied on by businesses to meet their day to day cash flow needs. By contrast, capital receipts and capital expenditures tend to be irregular and infrequent. The Working Group considers that targeting the treatment of revenue losses will have the most impact in terms of removing the bias against risk-taking and providing business with increased cash flow when it is most needed.

The Government may wish to revisit the treatment of capital losses at a later stage.

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2 The Treasury, *Modernising the taxation of trust income — options for reform: Consultation Paper*, November 2011, pp 3. Available at: http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=2215.

The international dimension of tax reform is important

There is scope for global corporations to shift profits and costs between different jurisdictions in pursuit of a tax outcome, even with restrictions on transfer pricing and thin capitalisation. Unilateral changes to our tax loss rules that are out of step with the rest of the world may create arbitrage opportunities for companies to locate their tax losses in Australia. This would come at a cost to revenue without any associated gain to the economy as a whole.

This context has influenced the Working Group's consideration in respect of the possible implementation of a loss carry back reform option and approaches to company loss integrity rules.

The treatment of 'black hole' expenditure should be reviewed

In its interim report, the Working Group noted that targeted reforms to the 'black hole' provision in section 40-880 of the ITAA 1997 might complement reforms to the treatment of losses. In particular, it raised the possibility of allowing black hole expenditure to be written off over a shorter period than the current 5 years.

The 'black hole' provision in section 40-880 is a 'provision of last resort' that allows businesses a deduction over five years for capital expenditure that would not otherwise be recognised for tax purposes. Broadly, business expenditure qualifies for the five year write-off where it is not otherwise deductible (either immediately or over time under a capital allowance provision) and is not included in the cost base of a CGT asset. In practice, section 40-880 tends to apply to expenditure relating to the commencement of a business, expenditure to bring about a structural change to an existing business and expenditure that relates to the cessation of a business. These types of expenditure tend to be associated with activities undertaken in periods in which companies incur tax losses, suggesting that improvements to the black hole provisions would complement loss reform.

A number of stakeholders submitted to the Working Group that the black hole provision applies to expenditure that confers no enduring benefit on the taxpayer or that has no obvious connection with any ongoing asset it owns. This means that the choice of the deduction rate is largely arbitrary. While not endorsing the view that black hole expenditure should be immediately deductible, the Working Group believes there may be scope to shorten the deduction period that applies to certain expenditures without offending the policy of section 40-880.

A shorter write-off period for certain black hole expenditures may provide much needed cash flow to a business during its start-up phase, or may assist in funding restructuring. Different considerations arise for businesses being wound up. As noted in the interim report, the effect of an extended write-off period for shut-down expenses is that deductions are often wasted because of a lack of future income for the deductions to offset. A shorter write-off period, especially if combined with a loss carry back as discussed in Chapter 3, would reduce this wastage.

The Working Group does not propose to recommend reforms to section 40-880 as part of this report. However, the Working Group confirms that it agrees with stakeholders that the treatment of black hole expenditure warrants further attention.

The Working Group will give further consideration to the treatment of black hole expenditure, along with the broader issue of capital allowances generally, as part of its consideration of longer term reforms to the tax system.

The Working Group was asked to identify offsetting savings

The terms of reference require the Working Group to identify offsetting savings to fund any recommended reforms to the treatment of tax losses and for recommendations to adopt a particular long-term direction for the business tax system.

The Working Group's consideration of options to reform the treatment of losses and offsetting savings has been based on estimates of their potential revenue impact prepared by Treasury consistent with normal costing guidelines.[3] Treasury has costed the introduction of loss carry back along the lines discussed in this report (see Chapter 3) at $450 million over the forward estimates period. For illustrative purposes, the cost over the forward estimates period of $450 million would be broadly equivalent to savings over the forward estimates from a 0.125 percentage point increase in the company tax rate from 1 July 2013. The cost of any reforms to the same business test (as discussed in Chapter 4) will depend on the model ultimately adopted.

The task of identifying the costs of particular reforms and the savings available from business taxation or spending options has been challenging. Business tax expenditures are not as extensive since the removal of accelerated depreciation for most industries that followed the Review of Business Taxation.[4] The most recent Tax Expenditures Statement (TES)[5] reveals that there are significant tax expenditures in relation to the research and development (R&D) tax offsets, the concessionary treatment for certain expenditure related to exploration and prospecting and the concessionary treatment of certain depreciating assets used in certain industries. In addition to large tax expenditures, Treasury also raised changes to Australia's thin capitalisation rules as a potential savings option. Potential offsetting savings are set out in Appendix B.

Some targeted, confidential consultation on potential savings options in these areas was undertaken with a group of stakeholders as part of a round of confidential consultation conducted in March 2012 (as discussed below). While useful in helping the Working Group to continue progressing its thinking, it did not constitute widespread and transparent public consultation on specific savings options that would have been required for the Working Group to make clear recommendations in this report.

In the time available, the Working Group has not been able to thoroughly assess the potential adverse impacts on taxpayers from removing existing business tax concessions. Accordingly, we have been unable to form a view on what the net-benefit of such options might be if they were pursued in combination with particular business tax reforms. The Working Group considers that further analysis and consultation is required before it can reach any particular conclusions.

3 Treasury has assessed the revenue impacts of reform options and potential offsetting savings identified by the Working Group over the forward estimates period in accordance with its approach to the costing of budget proposals and election commitments (see the election commitment costing guidelines available at: http://electioncostings.gov.au/). The Working Group understands that these costing estimates are generally based on micro-simulation modelling using Australian Taxation Office company tax return data spanning 2003-04 to 2009-10. More recent significant changes in actual business investment, profits and loss utilisation that depart from what was seen in the data time period may result in significant changes in the impacts of these proposals. While the Treasury has not provided costings beyond the 2012-13 Budget forward estimates period, it has provided an indication of the cost or savings at 'maturity', being when the financial impact is no longer affected by transitional factors.

4 Review of Business Taxation, *A Tax System Redesigned: More certain, equitable and durable, Report*, July 1999, pages 305-327.

5 The Treasury, 2012, *Tax Expenditures Statement 2011*, Canberra. It should be noted that although the TES was used as a way of identifying potential savings, the costs in the TES do not represent the actual savings to the budget from their removal. The TES estimates compare the current concessional treatment to a mature alternative (that is, non-concessional TES benchmark) and do not reflect behavioural responses. On the other hand, budget estimates consider the timing of how the new system would be implemented and sometimes include behavioural responses.

The Working Group has undertaken consultation

The Working Group has engaged with stakeholders in two ways: first by inviting written submissions in response to its interim report and second by following up with a round of more limited targeted, confidential consultation meetings.

The interim report was released on 11 December 2011, with interested members of the public given eight weeks to make written submissions. The interim report was necessarily a high-level document outlining the current tax treatment of losses, highlighting the potential impacts of the current tax treatment of losses on decision making and cash-flow and providing information on possible reforms.

In response to the interim report, the Working Group received 24 submissions.[6] The Working Group would like to thank all of those organisations and individuals who made submissions. Some expressed disappointment that the Working Group's interim report did not contain an indication of likely costs and possible savings options. The Working Group preferred to first gain an understanding of business views about possible reforms before developing specific savings proposals to offset the costs of those reforms. It was also not possible, at the time, to include any discussion about the potential offsetting savings in the interim report. Only in light of this information was the Working Group able to focus on the potential savings task and to undertake some further targeted, confidential consultation. Accordingly, there has not been widespread and transparent public consultation about any potential offsetting measures.

After considering written submissions, the Working Group undertook a round of confidential consultation meetings with stakeholders in Melbourne, Sydney, Brisbane and Perth. The confidentiality of these discussions permitted Working Group members to be more open in testing the trade-offs involved in alternative packages of reforms and potential sources of offsetting savings than would otherwise have been the case. The Working Group thanks those organisations and individuals that made themselves available for this process.

Conclusion

The Working Group's interim report on the tax treatment of losses canvassed a range of possible reform options. Based on the response to that interim report and further analysis, the Working Group has come to some more considered views about what reforms to the tax treatment of losses would be worthwhile pursuing.

The same level of analysis and consultation has not been possible in relation to potential offsetting savings options in the time available. The Working Group considers that further analysis and consultation is required before any conclusions can be drawn.

Recommendation

Recommendation 1: The Working Group recommends that:

- the Government note the savings options identified in this report; and
- further analysis and consultation be undertaken before taking a decision to implement them.

6 A list of public submissions can be found at Appendix C.

Chapter 2: The tax treatment of losses

Key points

- The utilisation of tax losses currently depends on the subsequent profitability of a company and whether the company meets certain integrity rules. As the pattern for utilising a tax loss differs between companies in different situations, the benefits of different reform options will depend on a company's circumstances.
- The current treatment of tax losses increases the effective tax rate on certain investments (those with some probability of causing a business to incur a tax loss), in theory biasing business decisions against such investment.
- The tax treatment of losses creates a bias against risk taking, the adverse impact of which may be greater in a volatile economic environment in which businesses are increasingly required to be flexible and innovative.
- The tax treatment of losses reduces the quantity and quality of potential investment and also has a detrimental impact on business cash flows when businesses are under stress.
- Perfectly symmetrical treatment of profits and losses could be achieved by allowing full loss refundability.[7] The Working Group has ruled out full refundability as a viable reform in its interim report and instead uses it as a benchmark to assess other reform options.

Loss creation and utilisation generally follows the business cycle[8]

Tax losses arise when a business's allowable deductions exceed its assessable income. When a tax loss must be carried forward into a future income year, the real value of the loss is reduced, unless it is indexed or uplifted over the carry forward period.

The aggregate carried forward loss balance for all companies has steadily increased over time from around $100 billion in 1999-2000 to around $170 billion in 2009-10.[9, 10] To put this into perspective, the current aggregate carried forward loss balance represents almost 8 per cent of aggregate company income (before expenses) each year. As theory would suggest, the data indicates that the aggregate carried forward loss balance appears to be negatively correlated to changes in real gross domestic product. For example, difficult business conditions during 2008 saw a reduction in loss utilisation and an increase in losses added by companies.

7 A pure symmetrical tax treatment would require a company in taxable profit to pay a certain percentage of company tax on that taxable profit and would allow a company in tax loss to be refunded at the same rate as it was taxed. For example, a company in taxable profit would pay 30 per cent of the taxable profit as company tax and a company in tax loss would be refunded 30 per cent of the tax loss.

8 Data has been extracted from the company tax record file data and should be read as providing an indication of broad trends only.

9 Source: ATO data.

10 For comparison, nominal GDP in 1999-2000 was approximately $660 billion, nominal GDP in 2009-10 was around $1.3 trillion and corporate income tax paid in 2009-10 was estimated in Budget Paper No.1 as $53.2 billion

The utilisation rate of total company losses (total company losses used in a year as a percentage of total company losses added in that year) has decreased from approximately 53 per cent in 2006-07 to around 28 per cent in 2009-10. This has been predominantly attributable to a substantial increase in losses being added, which has increased over the period by about 69 per cent.

Looking at a longer time period, the amount of company losses added to the carried forward balance each year is on average around three times the amount of losses that is utilised. In dollar terms, over the last 15 years, the average annual amount of company losses added each year was around $33 billion, while the average amount utilised each year was around $11 billion.

In 2009-10, the finance and insurance sector and the mining sector together accounted for approximately 48 per cent of the $170 billion company carried forward losses, representing 27 per cent and 21 per cent of total accumulated losses respectively. The manufacturing sector accounted for the third largest percentage of accumulated losses, approximately $14 billion, representing 8 per cent of total accumulated losses.

From 2006-07 to 2009-10, there has been relatively slow growth in the proportion of carried forward losses residing in the finance and insurance and manufacturing sectors, while the mining industry had the fastest growth in the proportion of carried forward tax losses, increasing from around $17 billion in 2006-07 to just under $35 billion in 2009-10. The growth in losses being carried forward by the mining sector coincides with heavy investment from the mining boom and may reflect the long lead times before profit, which is typical of mining investments.

The biggest changes in loss carry forward stocks over the period 2006-07 to 2009-10 occurred for large companies (companies with a turnover between $100 million and $250 million) and for very large companies (companies with a turnover of greater than $250 million). Losses being added for these companies increased over this period by approximately 24 per cent and 30 per cent respectively. Despite this increase in losses added for those companies, micro companies (those with a turnover of less than $2 million) still had the second largest aggregate carried forward loss balance in 2009-10 of around $40 billion.

The treatment of losses matters more for some companies than others

Companies may be in a tax loss position for many different reasons and the length of time they are in a tax loss position will vary depending on the different factors at play. For example, a company may experience temporary changes in assessable income or expenses as a result of a natural disaster, which result in the company temporarily incurring a tax loss.

Alternatively, a company may experience multiple years in a tax loss position because of lower income caused by reduced demand for the company's product, or because of large upfront expenditure in its start-up phase.

The worked examples below illustrate companies in different positions. They are used throughout the report to show the impact of the different reform options on companies that have different business cycles and tax profiles. All of the examples assume a corporate tax rate of 30 per cent in 2012-13 and a corporate tax rate of 29 per cent thereafter.

1) A start-up company with significant upfront expenditure but little to no income in its early years of operation. The company faces the prospect of significant income in later years if the upfront investment proves successful but there is also a substantial risk of the investment failing.

2) A viable company temporarily in loss because of a temporary shock (if the business' position was viewed over a five year period it would not be in loss). This cameo is intended to represent a business in an industry that faces seasonal and cyclical fluctuations.

3) A once profitable company facing a sustained change in its operating environment that needs to consider changing business strategies or shutting down.

4) A company investing to upgrade its product line in order to attract more customers. This company makes losses due to reduced assessable income and increased deductions as a result of refurbishments and staff training.

5) A terminal company that has never had positive taxable income. This is what may happen to the start-up company if its investment does not pay off.

6) A consolidated group of companies that is able to spread income and deductions across the group.

Worked example 1: A start-up company

After undertaking extensive research and development, AAA Pty Ltd (AAA) has developed a way to turn algae into biodegradable plastic. AAA believes there is a market for the plastic and wants to start manufacturing the plastic. AAA has large initial expenditure on equipment needed in the production process.

AAA is new to the market and although the team has expertise in making the algae plastic, AAA takes a while to increase the number of supply contracts it has with wholesalers of plastic goods who want to buy the algae plastic.

AAA's sales increase exponentially over the first three years of operation (2012-13 to 2014-15). Despite sales increasing and the business doing well, AAA does not have positive taxable income until the fourth year of operation (2015-16), because of the deductions and the carried forward losses associated with the large initial outlays of the business. AAA's taxable income increases from that point on.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$0	$1,000,000	$5,000,000	$7,000,000	$8,000,000	$10,000,000
Expenses — excluding depreciation	($2,000,000)	($2,000,000)	($2,000,000)	($2,000,000)	($2,000,000)	($2,000,000)
Deductions — depreciation	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)
Deductions — carry forward losses	$0	$0	($2,000,000)	($3,000,000)	$0	$0
Taxable income	($3,000,000)	($2,000,000)	$0	$1,000,000	$5,000,000	$7,000,000
Tax payable	*$0*	*$0*	*$0*	*$290,000*	*$1,450,000*	*$2,030,000*
Total carry forward losses	$3,000,000	$5,000,000	$3,000,000	$0	$0	$0

Worked example 2: A company facing a temporary shock

Bread Pty Ltd (Bread) operates a successful bakery that sources all of its wheat from nearby farms (local suppliers). Bread normally pays $464,000 in taxes every year ($480,000 in 2012-13) because it has relatively stable income and expenses.

In 2015-16 a flood causes substantial damage to the premises out of which Bread Pty Ltd operates its business. Bread faces substantial costs to repair the damage caused to ovens and also faces the cost of replacing the water-damaged machines and the loss of income over the days the shop was closed. In addition to these costs, the price of wheat has increased because of the devastating impact that the flood has had on the nearby wheat crops.

A combination of reduced revenue (assessable income), increased expenses and the deductions associated with the depreciation of Bread's new equipment, causes Bread to be in a tax loss position (a loss of $600,000) in 2015-16.

The clean-up process following the flood commences and Bread is returns quickly to operating as normal. As Bread is now able to claim tax depreciation deductions for its new capital equipment and deductions for its carry forward losses, it has no taxable income in 2016-17. In 2017-18 Bread returns to positive taxable income.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$2,000,000	$2,000,000	$2,000,000	$1,200,000	$1,800,000	$2,500,000
Expenses — excluding depreciation	($200,000)	($200,000)	($200,000)	($1,000,000)	($500,000)	($200,000)
Deductions — depreciation	($200,000)	($200,000)	($200,000)	($800,000)	($800,000)	($800,000)
Deductions — losses	$0	$0	$0	$0	($500,000)	($100,000)
Taxable income	$1,600,000	$1,600,000	$1,600,000	($600,000)	$0	$1,400,000
Tax payable	*$480,000*	*$464,000*	*$464,000*	*$0*	*$0*	*$406,000*
Total carry forward losses	$0	$0	$0	$600,000	$100,000	$0

Worked example 3: A company facing a sustained shock

XYZ Pty Ltd (XYZ) manufactures widgets. XYZ's revenue is influenced by the international price of widgets (over which XYZ has no influence). There is currently strong international demand for widgets and XYZ is experiencing strong revenues.

From 2012-13 to 2014-15, XYZ has strong revenues and has deductions representing ordinary business expenditure and also deductions for depreciation allowances claimed for the machinery used to produce the widgets.

As a result of the strong Australian dollar and technical advancements made by international competitors, XYZ's widgets become relatively less competitive and XYZ experiences a substantial decrease in its revenues. After deducting ordinary business expenditure and deductions for depreciation allowances, XYZ is left in a loss position ($500,000) in 2015-16.

The prolonged impact of the strong Australian dollar and continual technological advancements by competitors continues to decrease the relative competitiveness of XYZ's widgets resulting in the revenues of the business declining further. In 2016-17 XYZ decides to undertake a feasibility study to decide whether it should shut down or change its business strategy. It subsequently decides to change the business from producing widgets to producing the equipment used to make widgets and providing consulting services related to widget production.

In 2016-17, XYZ faces increased expenses and deductions related to these changes, resulting in a tax loss of $2,000,000. Then, in 2017-18, XYZ starts to sell its widget making equipment (but does not make any capital gains or losses) and starts providing consulting services. However XYZ has zero taxable income because it utilises its carry forward losses.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$3,000,000	$3,000,000	$2,000,000	$1,000,000	$500,000	$1,000,000
Expenses — excluding depreciation	($500,000)	($500,000)	($500,000)	($500,000)	(2,500,000)	($500,000)
Deductions — depreciation	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)	$0	($100,000)
Deductions — losses	$0	$0	$0	$0	$0	($400,000)
Taxable income	$1,500,000	$1,500,000	$500,000	($500,000)	($2,000,000)	$0
Tax payable	*$450,000*	*$435,000*	*$145,000*	*$0*	*$0*	*$0*
Total carry forward losses	$0	$0	$0	$500,000	$2,500,000	$2,100,000

Worked Example 4: A company investing to upgrade its product line

Especial Hotels Pty Ltd operates three five star hotels in different capital cities around Australia.

To attract greater numbers of international visitors and business clients, Especial decides to undertake a substantial refurbishment of all three hotels. This will involve replacing all beds and other furniture, upgrading all in-room televisions and fridges and installing a new range of light fittings and lamps.

Especial is also looking to distinguish itself on the basis of its service, particularly to overseas visitors. Subject to available cash flow, it would like to use the period of refurbishment to offer some of its staff the opportunity to upgrade their skills (for example, through learning a new language).

This plan is developed over the course of 2012-13 and 2013-14 where Especial has taxable income of $6.25 million and $5.25 million respectively. At the end of 2014-15 Especial has a franking account balance of $5 million.

The refurbishment is planned to commence in 2014-15 with the largest of the three hotels and involves closing parts of the hotel during the refurbishment. In April 2016, Especial plans to launch an advertising campaign promoting its refurbished rooms.

Especial plans to refurbish its other hotels in 2015-16. A further advertising campaign would be rolled out once the refurbishment of all three hotels is completed early in 2016.

As a result of the refurbishment Especial would have substantially less assessable income and larger deductions than in previous years. As a result, it would make a tax loss of $5 million in 2014-15 and $3.95 million in 2015-16.

Under the current income tax law, Especial would build up a stock of carry forward tax losses. Provided it doesn't experience a change in majority ownership these tax losses can be used to reduce Especial's taxable income in future years.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$25,000,000	$25,000,000	$12,000,000	$15,000,000	$20,000,000	$30,000,000
Expenses — excluding depreciation	($18,000,000)	($19,000,000)	($16,100,000)	($18,000,000)	($19,000,000)	($18,000,000)
Deductions — depreciation	($750,000)	($750,000)	($900,000)	($950,000)	($1,800,000)	($1,800,000)
Deductions — losses	$0	$0	$0	$0	$0	($9,750,000)
Taxable income	$6,250,000	$5,250,000	($5,000,000)	($3,950,000)	($800,000)	$450,000
Tax payable	*$1,875,000*	*$1,522,500*	*$0*	*$0*	*$0*	*$130,500*
Total carry forward losses	$0	$0	$5,000,000	$8,950,000	$9,750,000	$0

Worked example 5: A terminal company

After assessing the global market for sprockets, CCC Pty Ltd (CCC) believes that there is an emerging market for new and innovative sprockets. Based on a feasibility study, CCC begins to buy and construct the equipment it needs to commence making the new and innovative sprockets.

When CCC launches the sprockets into the market, sales increase slowly. After the second year of operation the demand for the sprockets grows rapidly. Although CCC's sprockets have become quite popular, CCC does not have taxable income in its first two years of operation due to the upfront expenses, ongoing business expenses and its carry forward losses.

In its third year of operation, a new universal sprocket is launched into the market by a competitor meaning that CCC's sprockets are no longer the sprocket of choice for its customers. Demand for CCC's sprocket decreases dramatically and CCC decides to shut down.

In all three years CCC was in operation it was in a tax loss position.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$500,000	$5,000,000	$1,000,000	-	-	-
Expenses — excluding depreciation	($3,000,000)	($2,000,000)	($500,000)	-	-	-
Deductions — depreciation	($1,000,000)	($1,000,000)	($1,000,000)	-	-	-
Deductions — losses	$0	($2,000,000)	$0	-	-	-
Taxable income	($3,500,000)	$0	($500,000)	-	-	-
Tax payable	*$0*	*$0*	*$0*	-	-	-
Total carry forward losses	$3,500,000	$1,500,000	$2,000,000	-	-	-

Worked example 6: A consolidated group

Consol is a consolidated group that consists of Head Co and three subsidiaries — a hardware company (Hardware Co), a grocery company (Grocery Co) and also a mining and exploration company (Mining Co).

Head Co is the only entity recognised for income tax purposes with its taxable income worked out as if the consolidated group was a single entity.

In 2015-16, there has been decreased demand for products relating to complete DIY jobs. This causes the sales of hardware products to dramatically decrease, resulting in the hardware company being in a tax loss.

Despite the hardware company being in a tax loss position, Head Co is not in a tax loss position because Hardware Co's tax loss can be deducted from the assessable income of Grocery Co and Mining Co.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Grocery Co						
Assessable Income	$2,000,000	$2,000,000	$2,000,000	$2,000,000	$2,000,000	$2,000,000
Expenses	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Taxable income	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Hardware Co						
Assessable Income	$1,000,000	$1,000,000	$1,000,000	$400,000	$100,000	$100,000
Expenses	$500,000	$500,000	$500,000	$500,000	$500,000	$500,000
Taxable income	$500,000	$500,000	$500,000	($100,000)	($400,000)	($400,000)
Mining Co						
Assessable Income	$2,000,000	$3,000,000	$4,000,000	$5,000,000	$5,000,000	$5,000,000
Expenses	$1,500,000	$1,500,000	$1,500,000	$2,500,000	$3,000,000	$3,000,000
Taxable income	$500,000	$1,500,000	$2,500,000	$2,500,000	$2,000,000	$2,000,000
Head Co						
Consolidated income	$2,000,000	$3,000,000	$4,000,000	$3,400,000	$2,600,000	$2,600,000
Deductions — losses	$0	$0	$0	$0	$0	$0
Taxable income	$2,000,000	$3,000,000	$4,000,000	$3,400,000	$2,600,000	$2,600,000
Tax payable	*$600,000*	*$870,000*	*$1,160,000*	*$986,000*	*$754,000*	*$754,000*
Total carry forward losses	$0	$0	$0	$0	$0	$0

The business tax system treats profits and losses asymmetrically

The existing tax system treats profits and losses asymmetrically by taxing a profit in the year it is derived, while only allowing taxpayers to access the tax value of a loss by carrying it forward at its original value and using it to deduct against future assessable income.[11] As the tax loss is required to be carried forward until it can be utilised, the value of the tax loss erodes over time, with a longer carry forward period resulting in a greater erosion of value. A perfectly symmetrical treatment of losses and profits would require the income tax value of a loss to be refunded in the year the loss is incurred (that is, a cashing out of tax losses) or the uplift of losses at an appropriate rate and a refund at the cessation of a business.

Australia is not unique in this asymmetrical treatment. It is common practice in other jurisdictions to require a loss to be carried forward rather than to pay the income tax value of a tax loss to taxpayers in the year the loss is incurred (through a refund from the Government).

The asymmetric treatment of profits and losses is reinforced by the loss integrity rules which must be satisfied by a company before it can use its losses. The loss integrity rules test for continuity of ownership, and if that test is failed consideration is given to the business activities undertaken.[12] These rules can lead to losses being 'trapped' and not able to be used.

Immediate refundability is the appropriate benchmark for loss reforms

Providing perfectly symmetrical treatment of profits and losses would involve the Government refunding the tax value of losses at the same rate and over the same timeframe as it would otherwise require the payment of taxes. For example, a purely symmetrical tax treatment may require a company in taxable profit to pay 30 per cent as company tax and allow a company in tax loss to be refunded 30 per cent of the tax loss. It should be noted, however, that this would only be perfectly symmetrical treatment where business income is being measured consistently in both cases. This is not the case for, example, where certain assets have been given concessionary tax depreciation arrangements, resulting in an asset's depreciation for tax purposes not matching its economic depreciation (that is, the effective tax rate is lower than the statutory rate).

Full loss refundability would provide for immediate lost recoupment and therefore would come at a significant cost to the Budget. A further consequence of immediate refundability, is the potential for tax avoidance, particularly if refunds were made on the basis of assessments that were later amended.

The Working Group is also mindful that other jurisdictions do not provide immediate refundability of losses. Therefore, notwithstanding Australia's transfer pricing and thin capitalisation arrangements, immediate refundability may encourage companies to move their losses to Australia.

The requirement of revenue neutrality for any loss reforms recommended by the Working Group and the cost and integrity concerns stemming from immediate refundability have led the Working Group to not propose immediate refundability (the Government refunding the tax value of a loss) as a viable reform option for the treatment of losses in the foreseeable future and the focus has instead been on reforms that move towards (but without achieving) immediate refundability.

11 Business Tax Working Group, 2011, *Interim report on the tax treatment of losses*, The Treasury, Canberra. (Available at http://www.treasury.gov.au/documents/2261/PDF/BTWG_Interim_Report.pdf).

12 Division 165 and Division 166 of Part III of the *Income Tax Assessment Act 1997* (Cwth) (ITAA 1997).

The Working Group has used immediate refundability as an economic benchmark against which to assess alternative reforms for improving the tax treatment of losses with the aim of reducing the bias against risk taking.

The treatment of losses restricts business cash-flow in a downturn

The current tax treatment of losses can be seen as the Government withholding its share of the cash flow impact of a loss, leaving businesses to bear the full impact of a loss in the year it is incurred. The current tax treatment of losses delays (and in the extreme case of zero future assessable income, denies) the cash flow benefit for businesses associated with accessing the tax value of a loss.

This cash flow impact can be detrimental to a business' future economic prospects, especially where the company requires short-term liquidity to meet day-to-day outgoings. It also reduces the ability of a business to make investments in new equipment, research and development, staff training and development and other activities that help to increase the viability of the business in the long-term and add to productivity. Poor cash flow can also limit its access to commercial funding through debt and equity markets.

Improving loss recoupment would enhance the automatic stabiliser role of company tax to the extent that affected businesses are credit constrained, by providing a cash injection to allow expenditures that could not otherwise be made. As would be expected with an automatic stabiliser, the smoothing effect on business investment would be accompanied by greater volatility in government revenue as the impact of refunding amounts to those in a loss position would be more pronounced during a downturn in the economy. However, government revenues would improve more quickly as businesses recover.

The bias against risk taking reduces the quantity and quality of investment

An income year is an arbitrary time period, likely to be shorter than the life of an investment. Requiring businesses to bring to account their financial position at the end of an income year can result in a tax loss in that year, despite the business being profitable over the life of an investment. Businesses in this position face a higher effective tax burden as the use of that loss is restricted, notwithstanding the fact that the business may not have incurred a loss over a longer time frame or even over a different snapshot in time.

In the worked examples introduced earlier, the arbitrary income period is the cause of the losses in scenarios one, two, three, four and six.

Where there is a probability of a business incurring a tax loss in an income year, the current tax treatment of losses can be viewed as either: increasing the effective tax rate on investment above the marginal tax rate that would otherwise apply; or lowering the expected after-tax return on investment. In this way, the current tax treatment of losses influences business decision making by creating a bias against riskier investments. A lack of uplift means that the full value of a carry forward loss is not used, and the risk that the loss may not be able to be used because of the operation of the current integrity tests, deters investments that may incur a tax loss. As a result, some investment that may be optimal or socially desirable given the prevailing tax rate may not be undertaken.

When considering the deployment of scarce resources, businesses must assess whether a possible investment provides sufficient returns over time for the risk involved, compared to other potential investments. In doing so, businesses often assess expected future returns from a potential investment against a 'hurdle' rate of return. This hurdle rate takes into consideration the project's risk and the opportunity cost of forgoing other projects. The tax treatment of losses influences the net present value of future cash flows and the effective rate of return compared to the hurdle rate of return. In this way the tax treatment of losses may influence business investment decisions.

The current asymmetric tax treatment of profits and losses increases the necessary pre-tax return for more risky investments, with the difference between the necessary pre-tax and post-tax rate of return increasing with increasing risk. This tax wedge reduces the investment in more risky investment, relative to a tax system that treats profits and losses symmetrically.

The tax system's bias against risky investments may divert capital to less risky, lower value investments. The bias against business risk taking is likely to be particularly detrimental to productivity in Australia's current circumstances that require businesses to be flexible and innovative, and to be able to take advantage of new opportunities presenting themselves in the changing global environment.

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

Box 2.1 Effective tax rates of low and high risk investments

The two tables below (Table 1 and Table 2) show the impact of the tax treatment of losses on the effective tax rates that apply for two possible investment choices where the statutory tax rate is 30 per cent. The higher-risk investment choice 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).

Assuming the value of the loss is not recouped, the higher-risk investment faces a 50 per cent effective tax rate. Of course, if the company is able to access the tax value of the loss, the effective tax rate will be greater than 30 per cent, but less than 50 per cent.

Table 1: Tax impact on low-risk investment choice

Possible before-tax return on an investment ($)	Investment 1 (less risky)			
	Prob. of return (%)	Before-tax expected return ($)	After-tax expected return ($)	Effective tax rate (%)
40	*50*	20	14	30
20	*50*	10	7	30
Total		$30	$21	30%

Table 2: Tax impact on a higher-risk investment choice

Possible before-tax return on an investment ($)	Investment 2 (more risky)			
	Prob. of return (%)	Before-tax expected return ($)	After-tax expected return ($)	Effective tax rate (%)
120	*10*	12	8.4	30
100	*20*	20	14	30
80	*20*	16	11.2	30
20	*10*	2	1.4	30
-40	*20*	-8	-8	-
-60	*20*	-12	-12	-
Total		$30	$15	50%

Chapter 3: Loss carry back

Key points

- Loss carry back allows companies to offset current period losses against previously paid taxes. It can be viewed as a limited form of loss refundability.
- Loss carry back would support investment by reducing the tax bias against investing in riskier but worthwhile projects, particularly by small and medium sized companies. It would also act as an automatic stabiliser by providing increased cash flows to businesses during an economic downturn.
- Loss carry back should be provided to companies and entities that are taxed like companies. Further consideration of the relative costs and benefits of carry back for other entities (such as sole traders and partnerships) is needed before recommending an extension to these entities.
- A two year carry back period would strike the right balance between limiting the exposure of government revenues and allowing companies to access the tax value of their losses.
- The amount of any carry back refund should be limited to the franking account balance to manage the interaction with the imputation system.
- A quantitative cap should be applied to help manage the exposure of government revenues to economic downturns and would also target the benefits of carry back to smaller businesses.
- Loss carry back could be implemented through a refundable tax offset rather than through amending tax assessments of prior years.
- The greatest benefit from loss carry back would be derived by previously profitable companies that are in a temporary loss position.
- A phased approach to implementation would reduce the costs of loss carry back over the forward estimates.

Loss carry back would support business investment

The Working Group believes that there is a case for introducing loss carry back into the Australian company tax system. This was widely accepted during consultations with stakeholders. By reducing the tax bias against riskier but worthwhile projects, loss carry back could be expected to provide benefits for businesses and the economy by supporting business investment and improving investment decisions in response to changes in the wider economy. Loss carry back has been adopted in a number of OECD countries.

The Working Group has not had sufficient time to fully explore the net benefits of loss carry back and possible offsetting saves relative to other possible reforms. Nonetheless, the Working Group considers that loss carry back is a worthwhile reform in its own right and has identified some design and implementation options that could be adopted.

Loss carry back is a form of loss refundability

Loss carry back would allow companies to use a current year loss against taxable income in previous years, resulting in a refund for all or part of the tax value of that loss to the extent of taxes paid in previous periods.

Loss carry back differs from the benchmark of full loss refundability since refunds are limited to taxes paid prior to the loss year. As such, there would be fewer refunds distributed under loss carry back and those refunds would be smaller on average compared to full refundability.

Loss carry back would reduce the effective marginal tax rate on new risky investments by providing companies with more certainty that they will receive a tax refund for any future losses. This reduces the bias against risky investments that currently exists in the company tax system and supports businesses adapting to changed economic conditions, for example, by innovating to take advantage of new opportunities or making plans for an orderly exit (for example, by settling existing debts and assisting employees to transition to new jobs). Investments would be made with a greater expectation that a business would receive tax refunds if losses are incurred in future years.

Loss carry back has been implemented in a number of OECD countries including Canada, France, Germany, Ireland, Singapore, the United Kingdom and the United States. Box 3.1 outlines the carry back systems in some OECD countries.[13] It is common practice within these systems to limit the carry back period, normally from one to three years, such that businesses can only use current period losses against taxes paid over that period.

Loss carry back acts as an automatic stabiliser

Loss carry back allows businesses to access the tax value of their losses by providing tax refunds for loss periods. This has an automatic stabiliser effect by increasing cash flows for previously profitable companies during economic downturns when they are most needed, without the need for direct government intervention. Businesses that are credit constrained can use these increased cash flows to make new investments and adapt and recover more quickly from a loss position. This increased investment and activity helps to reduce the magnitude and longevity of economic downturns.

This automatic stabiliser effect of loss carry back makes government revenues more volatile. Less revenue would be collected during economic downturns as more companies incur losses, and more tax refunds are provided to those loss making companies. On the other hand, company tax collections would recover more quickly during economic upturns due to the smaller stock of carry forward losses being utilised as companies return to profit.

13 Appendix D contains a more detailed outline of the treatment of losses in OECD countries.

The Working Group considers this automatic stabiliser effect to have some benefits over ad-hoc government interventions in response to changes in economic conditions as the benefits of loss carry back are both timely and broad in scope. However, not all companies will benefit from loss carry back and not all companies will be able to access the full benefit of the tax value of their losses, for example, if the tax value of losses is greater than previous taxes paid. To the extent that loss utilisation is limited in this way, and by other design features that are discussed later in this chapter, the automatic stabiliser effect will not be as strong as under full loss refundability.

Table 3.1 International loss carry back systems

Country	Loss carry back
Australia	No
Austria	No
Canada	3 years (permitted for unincorporated businesses)
Denmark	No
France	1 year (recently reduced from 3 years and subject to a €1 million annual cap)
Germany	1 year (Extends to sole traders and partnerships, capped at €0.5 million per year)
Ireland	1 year (permitted for unincorporated businesses, 3 years if business ceases trading)
Italy	No
Mexico	No
Netherlands	1 year (3 years for 2009, 2010 and 2011 losses, capped at €10 million per year)
New Zealand	No
Norway	No (temporarily introduced for 2 years if business ceases trading or for losses in 2008 and 2009, capped at NOK 20 million per year)
Spain	No
Sweden	No
Switzerland	No (one canton does allow 1 year carry in respect of local taxes)
United Kingdom	1 year (permitted for unincorporated businesses, 3 years if business ceases trading and temporarily extended to 3 years for losses incurred in 2008 and 2009 but subject to a £50,000 cap)
United States	2 years (permitted for unincorporated businesses up to 5 years for 2008-09 losses)

Source: Table adapted from OECD, Corporate Loss Utilisation through Aggressive Tax Planning (2011), p.34.

The Working Group has considered making loss carry back available to all businesses

Most businesses face a risk of making losses from time to time, regardless of their organisational structure. Whilst the Working Group has given serious consideration to how loss carry back might be made available to all business structures, it has focussed its attention initially on companies and entities that are taxed like companies. As mentioned in Chapter 1, company structures tend to be the organisational form preferred for risky investments and typically face more constraints on their ability to realise the value of their tax losses than businesses operating through alternative structures (except for trusts). For other business entities, the additional administrative costs of introducing loss carry back could outweigh the benefits that loss carry back provides.

Companies

Companies already collect the information needed to administer loss carry back. As a result the compliance costs of applying loss carry back to companies would not be expected to be significantly different from current costs. It is not expected that the increase in compliance costs from the introduction of loss carry back would significantly offset the benefits of increased loss utilisation.

Trusts

A number of stakeholders raised the idea that it would be beneficial to extend loss carry back to trusts. However, this would be difficult. The Working Group acknowledges that applying loss carry back rules to trusts that are taxed as companies (public trading trusts and corporate limited partnerships) would be similar to applying loss carry back to companies as they must also lodge a company tax return and collect the appropriate information. For example, loss carry back would be available only in cases where trusts are taxed like a company over the loss year and the carry back period. This is not likely to provide large benefits as there are only a small proportion of trusts that are taxed as companies.

The Working Group believes that extending loss carry back to trusts more broadly would not be feasible. Trusts are generally not subject to tax, which means that tax losses for trusts would need to be offset against taxes paid at the beneficiary level. A trustee is unlikely to be aware of a beneficiary's marginal tax rate (other than in some closely held trust scenarios) and they may not have detailed knowledge of a beneficiary's overall tax profile, including whether the beneficiary actually paid income tax on any trust distributions. Due to other income sources and deductions, some beneficiaries may fall below the tax free threshold and would thus not pay any tax on trust distributions or pay tax at a lower average tax rate than their marginal tax rate.

A further complication arises for discretionary trusts, as there are no strict rules around distributions to beneficiaries. As a result, benefits from loss carry back may not flow through to those beneficiaries that paid the tax on previous distributions without complicated and impractical tracing rules.

Sole traders and partnerships

Loss carry back could potentially be applied to sole traders and partnerships by allowing them to carry back business losses against taxes paid in respect of taxable income earned in carrying on a business. Some stakeholders expressed their support for such an extension to loss carry back.

However, in addition to imposing additional compliance costs, loss carry back would place additional pressure on the boundary issues that currently exist in the tax law between income and deductions associated with business and personal activities. Rules for sole traders would be required to allocate income and expenses between the business and other investments, for example a share portfolio or property. This would be less of an issue for partnerships that must distinguish between partnership and personal income and expenses.

Partnerships are not taxed in their own right — any taxable income or loss flows through to the partners. To the extent that corporate partners receive taxable income or a distribution of a partnership loss in any income year, the rules applying to companies (including the recommendations in this paper) would apply to that corporate taxpayer. Sole traders and individual partners in partnerships arguably have a greater degree of flexibility in utilising losses associated with their business activities than companies. For example, losses incurred by sole traders and individual partners in partnerships can already be offset by income earned through other activities and other available tax offsets. So the case for loss carry back is arguably less compelling in respect of these taxpayers.

An additional challenge of applying loss carry back to sole traders and individual partners in partnerships is that they face a progressive tax rate schedule and multiple marginal tax rates. This would complicate the calculation of available carry back refunds for businesses as well as decisions around when to utilise the loss carry back system.

Given the difficulties involved in applying loss carry back to trusts generally and the limited benefits for sole traders and partnerships with individual partners relative to the additional costs, the Working Group has concluded that loss carry back should initially be limited to companies and trusts that are taxed as companies. Extending loss carry back to other business structures could be considered further in the future.

The Working Group has considered the possible design of loss carry back

A two year carry back period strikes the right balance

As mentioned above, it is common practice internationally to limit the carry back period, generally to between one and three years. This reduces the administrative costs of storing, amending and auditing tax returns from previous periods and also places a limit on the impact of loss carry back on government revenues.

There are trade-offs with choosing the length of the carry back period. A shorter carry back period limits the Government's exposure to the revenue effects of loss utilisation as refunds would not be as large during economic downturns. However, it would also limit the benefits that companies can derive from loss carry back during loss periods, and limit the automatic stabiliser effect. A shorter carry back period means that companies experiencing large losses (relative to taxes paid over the carry back period) or longer periods of loss may not be able to access the full tax value of current period losses. Longer carry back periods would have a larger effect on the taxes paid by some companies and would allow companies greater access to the tax value of their losses. Compared to the carry back periods chosen in international carry back systems (between one and three years), a carry back period of two years strikes a balance between allowing companies to offset current period losses and limiting the exposure of government revenues.

Loss carry back periods can also be amended to reflect the economic environment. For example, after the global financial crisis, in an effort to stimulate business activity the United States and the United Kingdom both extended the allowable time period over which losses could be carried back. This increased access to losses and provided assistance to struggling businesses. In some cases, governments have extended the carry back period for businesses that incur losses in shutting down. This allows companies to access the tax value of more of their losses, particularly when this involves multiple loss periods. Providing a refund to closing companies can be seen as providing a cash flow benefit that will flow on to future consumption or investment in the economy.

The Working Group considered the potential merits of a longer initial carry back period of three years to provide further assistance for businesses affected by the Global Financial Crisis (GFC). However, the Working Group believes that this assistance would not be necessary or useful as affected companies are likely to have already made adjustments in response to the effects of the GFC. For loss carry back to be useful to companies affected by the GFC, it would need to apply retrospectively to losses already incurred or to allow new losses to be carried back to pre-GFC period profits. The Working Group considers it would be more beneficial to the economy to apply loss carry back with the view to improving future investment and business decisions.

Any refunds should be limited to a company's franking account balance

In its interim report the Working Group suggested that any refunds provided under loss carry back might be limited by the franking account balance due to interactions with the imputation system, as restated below. This position was generally endorsed by stakeholders.

Companies can attach franking credits to dividends for the taxes already paid at the company level. Foreign shareholders can use these credits against withholding taxes on franked dividends. All related transactions (for example, paying taxes, receiving tax refunds and distributing franking credits) are recorded in franking accounts. When a franking account has a negative balance at the end of a period, companies must pay a franking deficit tax (FDT) to bring the account balance to zero.

Because of the FDT, the benefits of loss carry back are automatically limited to the positive balance of the franking account. While this result limits the impact on Government revenue, it also creates administrative costs by creating 'churn' in the tax system, whereby companies are paid refunds and then must pay back taxes to the extent that those refunds result in a negative franking account balance.

The timing of FDT would also be relevant for this interaction effect. A company's liability for FDT is worked out at the end of the income year but refunds paid within three months after the end of the income year are included in the calculation of FDT for that year. So a loss carry back refund paid within three months after the end of the income year may result in a FDT liability. Companies that receive a loss carry back refund more than three months after the start of the income year would have the rest of the current income year to make up their franking account balance (and thereby avoid FDT for that year).

To deal with this issue the Working Group considers that loss carry back refunds should be limited so that they do not result in a negative franking account balance. This would reduce the churn caused by the interaction between loss carry back and the imputation system as well as the potential for inequitable outcomes between taxpayers depending on when they are paid their refund.

The Working Group recognises that this proposal may induce some companies to reduce their dividend pay-out rate to increase the reserve of franking credits to support the carry back of losses.

A quantitative cap provides a flexible approach to targeting

A quantitative cap limits the amount of losses that taxpayers can carry back against taxes paid in previous periods. Quantitative caps have been used, for example, in the carry back systems of Germany and the United Kingdom.[14] A quantitative cap is also easy to adapt when needed to meet policy objectives. For example, the cap might be increased during an economic downturn to stimulate investment, although frequent changes to the cap could create uncertainty.

A quantitative cap can target the benefits of loss carry back to small and medium sized companies struggling with the two speed economy, without relying on legislative definitions around company size and type.

Targeting companies using the existing definition of a small business entity (that is, a taxpayer who carries on a business and has aggregated turnover of less than $2 million per year)[15] would limit loss carry back to the 760,000 small business entities that are incorporated.[16] Moreover, expanding the application of loss carry back using legal definitions of small and medium sized companies would add further complexity to the tax law and would still create incentives for restructuring as companies attempt to benefit from the loss carry back rules. A quantitative cap would allow all companies to claim carry back while still targeting the benefits to smaller and struggling companies.

Applying a quantitative cap would reduce the overall cost of providing loss carry back and reduce the Government's exposure to large losses incurred by individual businesses, while still providing benefits to all eligible companies.

The Working Group notes that limiting the overall cost of loss carry back also limits the effectiveness of loss carry back compared to the economic benchmark of full loss refundability. A larger cap increases the potential refunds that can be paid to companies in respect of loss periods but also increases the exposure of government revenues to economic downturns. Choosing a cap level is a policy choice that will be, in part, dependent on economic and fiscal conditions.

The Working Group envisages that a cap would apply to the tax loss that can be carried back from a particular year, not the amount of taxable income in a previous year that can be offset. For example consider a two year loss carry back with a cap of $1 million and a company that had paid tax on $2 million of taxable income in year one and incurred tax losses in years two and three. The losses in years two and three could be carried back against the tax income in year one, up to $1 million in each of the two years. Any losses that cannot be carried back due to the cap (or other limit) would be carried forward.

14 The United Kingdom only introduced a temporary quantitative cap in respect of the extension of loss carry back during the global financial crisis.

15 Section 328-110 of the ITAA 1997. The AFTS Review recommended that the Government consider increasing the turnover threshold to $5 million.

16 Only 28 per cent of all small business entities are incorporated (760,000 out of 2.7 million).

The Working Group analysed possible reform options in light of a $1 million cap (resulting in a $290,000 maximum carry back refund from 2013-14 onwards, assuming a 29 per cent tax rate) and also discussed this cap during consultations with stakeholders. While there was agreement that this cap was appropriate, there were some calls for a larger cap. With this in mind the Working Group supports a quantitative cap of not less than $1 million but further analysis could be conducted on the benefits of a higher cap, for example the effect of a $5 million cap on both the cost and impact of loss carry back. The higher $5 million cap was particularly supported by stakeholders in the tourism sector, which is currently facing difficult trading conditions due to the impact of the high value of the Australian dollar. For example, companies undertaking investments such as hotel or resort refurbishments may be influenced by carry back with a $5 million cap.

Loss carry back does not need to involve amended assessments

Conceptually, loss carry back could require a taxpayer's previous tax assessments to be amended. When a company claims a tax refund for a current period loss, previous tax assessments may be reopened and altered to reflect the reversal of tax paid in those periods due to carry back. This delivery mechanism could become administratively costly as old tax returns must be maintained and updated as loss carry back is utilised.

Additional compliance costs would arise if amendments are made to previous tax returns. A taxpayer's assessment for the year in which they incurred a loss (and received a carry back refund) may subsequently be amended such that they were not entitled to loss carry back or were entitled to a greater refund than was provided. Correcting this would require reopening and amending the tax return from the loss year as well as the tax returns over the carry back period.

Further problems may also arise if some of the tax returns that need to be amended fall beyond the Commissioner's amendment period. To deal with this problem, additional income tax could be imposed on the taxpayer to claw back incorrect refunds or additional refunds could be provided if taxpayers are found to have been entitled to a greater refund. This would eliminate the need to reopen and amend previous tax returns in light of an audit by the Commissioner, significantly reducing the administrative costs of reversing incorrect refunds.

However, amending previous assessments is not the only delivery mechanism available for providing loss carry back. A similar result could be achieved through the use of a refundable tax offset. For example, a company could become entitled to a refundable tax offset in a year it has negative taxable income and has paid income tax in at least one year over the carry back period. So, in the case where carry back is limited to a company's franking account balance and a quantitative cap, the amount of the refundable tax offset would be the lesser of:

- the tax value of the company's tax loss for the current year;
- the company's franking account balance;
- the tax value of any quantitative cap imposed on loss carry back; and
- the amount of income tax paid over the carry back period.

The relevant proportion of the company's tax loss would then be converted to a refundable tax offset and, subject to any outstanding tax liabilities, paid to the company. To substantiate a claim for the refundable tax offset, a company would need to provide details of previous claims (to ensure there is no double dipping). The refundable tax offsets would be counted as a debit in the franking account.

This delivery mechanism is likely to be administratively easier as it would remove the need to reopen previous tax returns and reduce the risk of complications due to the Commissioner's allowable amendment period. However, previous tax returns would still need to be maintained and accessed to calculate the refundable tax offset that is available to taxpayers. Any review of the company's tax affairs which lead the Commissioner to conclude that the company was not entitled to a refundable tax offset in a previous year could lead to the offset being disallowed.

From a tax administration perspective, we should also note that in the year in which a refund occurred, a franking debit would arise to the extent of the refund provided (this means that the franking credits are not then also available to frank dividends which would give a double-dip on those franking credits).

Loss carry back will benefit businesses experiencing a temporary shock

Loss carry back would be more beneficial to some companies than others. It will not directly assist companies that have not paid tax before (for example, some start-up companies) or those that do not have losses to carry back (for example, constantly profitable companies). However, to the extent that such companies expect to be profitable in general, loss carry back would still be beneficial in relieving the tax bias against investing in riskier projects. Consolidated groups are not expected to be large beneficiaries of loss carry back as they are able to offset losses of one subsidiary with the profits of another subsidiary under the single entity rule.

The worked examples set up earlier can illustrate the situations in which companies will gain the greatest benefit from loss carry back. It should be noted that, for simplicity and illustrative purposes, the examples show carry back refunds being paid in the year that the associated losses are made. In reality, refunds paid in respect of a loss year will be received in the next income year after company tax returns have been filed and processed. The worked examples assume a company tax rate of 29 per cent (30 per cent in 2012-13) and a two year carry back period, limited to a quantitative cap of $1 million and the franking account.

Worked example 1: A start-up company

The start-up company would not benefit from a loss carry back system. Any losses made by the start-up will not be able to be offset against previously paid taxes because the company has not previously paid any taxes. The start-up company would need to rely on the existing carry forward rules to access the tax value of its losses.

Worked example 2: A company facing a temporary shock

Bread Pty Ltd (Bread) would benefit from loss carry back as it has previously paid taxes. Note that Bread has a franking account balance of $1 million at the end of 2015-16.

Because of the impact of the floods, Bread is in its first tax loss position in 2015-16, so that Bread has;

- a loss with the tax value of $174,000 ($600,000 x 29%)
- a franking account balance of $1 million
- paid $928,000 in taxes over the carry back period, and
- a quantitative cap with the tax value of $290,000 ($1 million x 29%)

As the tax value of Bread's loss is lower than the quantitative cap and the franking account balance, Bread will be able to carry back the full $600,000 against previously paid taxes. Bread will receive a refund of $174,000 (the tax value of the $600,000 loss). In 2016-17 Bread is no longer in a loss position and returns to paying taxes.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$2,000,000	$2,000,000	$2,000,000	$1,200,000	$1,800,000	$2,500,000
Expenses — excluding depreciation	($200,000)	($200,000)	($200,000)	($1,000,000)	($500,000)	($200,000)
Deductions — depreciation	($200,000)	($200,000)	($200,000)	($800,000)	($800,000)	($800,000)
Deductions — losses	$0	$0	$0	$0	$0	$0
Taxable income	$1,600,000	$1,600,000	$1,600,000	($600,000)	$500,000	$1,500,000
Tax payable	*$480,000*	*$464,000*	*$464,000*	*$0*	*$145,000*	*$435,000*
Loss carried back	$0	$0	$0	$600,000	$0	$0
Carry back refund	*$0*	*$0*	*$0*	*$174,000*	*$0*	*$0*
Total carry forward losses	$0	$0	$0	$0	$0	$0

Worked example 3: A company facing a sustained shock

Similarly, XYZ Pty Ltd (XYZ) would benefit from the loss carry back, but would not be able to utilise the full value of its tax losses through the carry back system. XYZ has a franking account balance of $1 million at the end of 2015-16.

Due to the strong Australian dollar and technical advancements made by competitors, XYZ is in its first tax loss position in 2015-16 so that XYZ has;

- a loss with the tax value of $145,000 ($500,000 x 29%)
- a franking account balance of $1 million
- paid $580,000 in taxes over the carry back period, and
- a quantitative cap with the tax value of $290,000 ($1 million x 29%)

As the tax value of XYZ's loss is lower than the quantitative cap and the franking account balance, XYZ will be able to carry back the full $500,000 against previously paid taxes. XYZ's loss for 2015-16 will be carried back against tax paid in 2013-14 (the earliest year). As the tax paid in 2013-14 exceeds the tax value of the loss, there is no need to access the tax paid in 2014-15. XYZ will receive a loss carry back refund of $145,000 for its loss in 2015-16. This reduces the franking account balance to $855,000 ($1 million — $145,000).

XYZ then experiences a second year of loss in 2016-17 with a tax value of $580,000 ($2 million x 29%), where the franking account balance is $855,000, the tax paid over the carry back period is $145,000 and the quantitative cap is still $290,000. Here the tax value of the loss is limited by both the quantitative cap and the amount of tax paid in 2014-15 (as no tax was paid in 2015-16). However, the amount of tax paid in 2014-15 is lower than the quantitative cap and as a result XYZ can only claim a refund of $145,000 for its loss in 2016-17. The remaining $1.5 million of the loss in 2016-17 is carried forward to 2017-18.

Loss carry back provides an income injection to XYZ Pty Ltd when it is feeling the impact of the strong Australian dollar and the technical advancements made by competitors. However, the longer XYZ stays in a loss position the less benefit loss carry back would provide.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$3,000,000	$3,000,000	$2,000,000	$1,000,000	$500,000	$1,000,000
Expenses — excluding depreciation	($500,000)	($500,000)	($500,000)	($500,000)	($2,500,000)	($500,000)
Deductions — depreciation	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)	$0	($100,000)
Deduction for carry forward losses	$0	$0	$0	$0	$0	($400,000)
Taxable income	$1,500,000	$1,500,000	$500,000	($500,000)	($2,000,000)	$0
Tax payable	*$450,000*	*$435,000*	*$145,000*	*$0*	*$0*	*$0*
Loss carried back	$0	$0	$0	$500,000	$500,000	$0
Carry back refund	*$0*	*$0*	*$0*	*$145,000*	*$145,000*	*$0*
Total carry forward losses	$0	$0	$0	$0	$1,500,000	$1,100,000

Worked example 4: A company investing to upgrade its product line

Especial Pty Ltd (Especial) would benefit from the loss carry back due to the losses made during its refurbishments, but would not be able to utilise the full value of its tax losses. Note that Especial has a franking account balance of $5 million at the end of 2014-15.

Due to the reduced income and increased deductions involved with refurbishments, Especial is in its first tax loss position in 2014-15 so that Especial has;

- a loss with the tax value of $1.45 million ($5 million x 29%)
- a franking account balance of $5 million
- paid $3,397,500 in taxes over the carry back period, and
- a quantitative cap with the tax value of $290,000 ($1 million x 29%)

As the tax value of Especial's loss is higher than the quantitative cap, Especial will only be able to carry back $1 million against previously paid taxes. Especial's loss for 2014-15 will be carried back against tax paid in 2012-13 (the earliest year) because this exceeds the tax value of the cap so there is no need to access the tax paid in 2014-15. Especial will receive a loss carry back refund of $290,000 for its loss in 2014-15. This reduces the franking account balance to $4.71 million ($5 million — $290,000). The remaining loss of $4 million is carried forward to 2015-16.

Especial then experiences another loss in 2015-16 with a tax value of $1.15 million, where the franking account balance is $4.71 million, the tax paid over the carry back period is $1.52 million and the quantitative cap is still $290,000. Again, the carry back refund is limited by the quantitative cap so Especial can only claim a refund of $290,000 for its loss in 2015-16. The remaining $6.95 million of the loss in 2015-16 is added to the loss carry forward stock and carried forward to 2016-17.

Especial suffers a third year of loss in 2016-17 but cannot carry the tax value back as there were no taxes paid over the previous two years. The full value of the loss is added to the loss stock and carried forward to 2017-18.

In 2017-18 Especial returns to profit and is able to use its carry forward stock to reduce its taxable income.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$25,000,000	$25,000,000	$12,000,000	$15,000,000	$20,000,000	$30,000,000
Expenses — excluding depreciation	($18,000,000)	($19,000,000)	($16,100,000)	($18,000,000)	($19,000,000)	($18,000,000)
Deductions — depreciation	($750,000)	($750,000)	($900,000)	($950,000)	($1,800,000)	($1,800,000)
Deductions — losses	$0	$0	$0	$0	$0	($7,750,000)
Taxable income	$6,250,000	$5,250,000	($5,000,000)	($3,950,000)	($800,000)	$2,450,000
Tax payable	*$1,875,000*	*$1,522,500*	*$0*	*$0*	*$0*	*$710,500*
Loss carried back	$0	$0	$1,000,000	$1,000,000	$0	$0
Carry back refund	*$0*	*$0*	*$290,000*	*$290,000*	*$0*	*$0*
Total carry forward losses	$0	$0	$4,000,000	$6,950,000	$7,750,000	$0

Worked example 4 ($5 million cap): A company investing to upgrade its product line

Under a $5 million cap (which has a tax value of $1.45 million), Especial would be able to claim larger refunds during its loss periods but these would still limited by the quantitative cap in some periods.

In 2014-15, Especial suffers a loss with a tax value of $1.45 million ($5 million x 29%). The refund in this period is not limited by the cap and as a result Especial can claim a carry back refund of $1.45 million for its loss in 2014-15.

Especial makes another loss in 2015-16 with a tax value of $1.15 million. As this is lower than the cap and the taxes paid in 2013-14 (no taxes were paid in 2014-15), Especial is able to claim a carry back refund for the full amount. As under the $1 million cap, Especial cannot claim a carry back refund for its loss in 2016-17 because it did not pay any taxes over the carry back period. The full value of the loss is added to the loss stock and carried forward to 2016-17.

In 2017-18 Especial returns to profit and is able to utilise its carry forward losses to reduce its taxable income. Here we see that, due to the increased quantitative cap, Especial has increased cash-flows as it undertakes refurbishments (through larger carry back refunds) but also pays more tax when it returns to profit as a smaller stock of losses is carried forward.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$25,000,000	$25,000,000	$12,000,000	$15,000,000	$20,000,000	$30,000,000
Expenses — excluding depreciation	($18,000,000)	($19,000,000)	($16,100,000)	($18,000,000)	($19,000,000)	($18,000,000)
Deductions — depreciation	($750,000)	($750,000)	($900,000)	($950,000)	($1,800,000)	($1,800,000)
Deductions — losses	$0	$0	$0	$0	$0	($800,000)
Taxable income	$6,250,000	$5,250,000	($5,000,000)	($3,950,000)	($800,000)	$9,400,000
Tax payable	*$1,875,000*	*$1,522,500*	*$0*	*$0*	*$0*	*$2,726,000*
Loss carried back	$0	$0	$5,000,000	$3,950,000	$0	$0
Carry back refund	*$0*	*$0*	*$1,450,000*	*$1,145,500*	*$0*	*$0*
Total carry forward losses	$0	$0	$0	$0	$800,000	$0

Worked example 5: A terminal company

Similar to the start-up company, the terminal company would not benefit from loss carry back because it has not previously paid taxes.

Worked example 6: A consolidated group

Head Co would not benefit from loss carry back because Consol is not in an overall tax loss position. The losses from Hardware Co can already be deducted from the positive assessable income of Grocery Co and Mining Co. As such Head Co has no need to utilise loss carry back.

The worked examples show that otherwise profitable companies that experience a short term loss will benefit the most from loss carry back. This benefit will decrease the longer the company stays in a loss position.

Based on historical data, the industries (as defined by the Australian Tax Office's (ATO) industry codes) that would be expected to be the largest beneficiaries of a two year carry back, limited to company franking account balances and subject to a $1 million cap, include: construction (15 per cent of the total benefit), finance and insurance (15 per cent), manufacturing (15 per cent), professional scientific and technical services (10 per cent) and wholesale trade (10 per cent) and 35 per cent distributed among the remaining 16 main industry categories.

In terms of company size (according to the entity size definitions used by the ATO)[17], the distribution of benefits would be expected to accrue mostly to micro companies (40 per cent), then small companies (25 per cent), medium companies (25 per cent), large companies (five per cent) and then very large companies (five per cent).

Treasury's analysis of loss carry back is based on historical company tax return data from 2003-04 to 2009-10. The distributional analysis represents the industries that would have benefited if loss carry back had been in place from 2003-04 but is nonetheless indicative of which industries are the most likely to benefit if carry back were introduced in the future.

Prospective implementation would reduce the costs

It would be preferable to introduce loss carry back as soon as possible to assist businesses that experience losses as a result of changes in the economic environment. The Working Group is also mindful that the Government may be attracted to announcing reforms to the tax treatment of losses in the 2012-13 Budget, with a 1 July 2012 start date, to boost business confidence in sectors not favoured by current economic conditions.

The Working Group considered the introduction of a two-year loss carry back from 2012-13 (that is, in respect to tax losses incurred for that year). The cost of loss carry back over the forward estimates on this basis would be around $800 million (see table 3.2 below).

The Working Group also considered phasing in loss carry back from the 2013-14 year with an initial carry back period of one year. That is, any loss incurred in 2013-14 could be carried back against taxable income from 2012-13. From that point onwards, the carry back period would be two years. This approach substantially cuts the cost of introducing loss carry back over the forward estimates and hence the quantum of savings that need to be found. This completely prospective approach to loss carry back is also arguably more consistent with our mandate to relieve the tax burden on only new investment.

Regardless of the introduction date, Treasury's costing of the annual cost of loss carry back (as recommended by the Working Group) indicates that the cost at maturity would be in the order of $300 million per annum.

17 Micro entities have annual turnover of $1 or more but less than $2 million. Small entities have annual turnover of $2 million or more but less than $10 million. Medium entities have annual turnover of $10 million or more but less than $100 million. Large entities have turnover of $100 million or more but less than $250 million. Very large entities have annual turnover of $250 million or more.

The Working Group has been informed that it may be feasible to have legislation in place by the end of the 2012-13 income year (including consultation on draft legislation), but understands that this would be subject to the Government's legislative drafting priorities. Introducing a prospective loss carry back would ease the pressure on completing other drafting by the end of 2012-13.

Table 3.2: Estimated cost of loss carry back

	Estimated costs ($ millions)					
	2011-12	2012-13	2013-14	2014-15	2015-16	Total
Phase in of loss carry back from 2013-14 with an initial carry back period of one year, an ongoing carry back period of two years and a $1 million cap	0	0	0	150	300	450
Loss carry back commencing in 2012-13 with two year carry back period with a $1 million cap	0	0	250	250	300	800

Conclusion

The Working Group considers it worthwhile for the Government to pursue loss carry back as a form of increased loss utilisation that provides many of the benefits of full loss refundability.

To manage the trade-off between targeting reforms to small and medium sized businesses and identifying required offsetting savings while still decreasing the bias against risk taking by companies, a two year carry back could be provided, limited by a quantitative cap of not less than $1 million and the franking account balance.

Consideration should be given to implementing loss carry back through a refundable tax offset to reduce the legislative, administrative and monitoring costs of the reforms.

Recommendation

Recommendation 2: The Working Group considers that loss carry back would be a worthwhile reform in the near term and could be implemented consistent with a model that:

- is limited to companies;
- provides a two-year loss carry back period on an ongoing basis;
- limits the amount of losses that can be carried back by applying a cap of not less than $1 million;
- limits the amount of refunds to a company's franking account balance; and
- is phased in from 2013-14 with an initial one year carry back period.

CHAPTER 4: LOSS CARRY FORWARD

Key points

- Loss carry forward departs from the benchmark of refundability:
  - The utilisation of carry forward losses is subject to 'continuity of ownership' and 'same business' rules.
  - The delay in accessing carry forward losses diminishes their value.

Loss integrity rules

- The continuity of ownership test (COT) disallows the use of carry forward losses when a company undergoes a substantial change in underlying ownership and the same business test (SBT) is applied when a company does not satisfy the COT.
- The COT and the SBT should operate together to balance two policy objectives: preventing tax driven trading in companies and ensuring the continued use of losses if a change of ownership occurred for commercial reasons.
- The COT performs a valuable function as a safeguard against loss trafficking. However, the SBT is not effective as a means for determining whether a change to a company's ownership was motivated by commercial considerations.
- Creating a more effective SBT would be expected to result in benefits to commercial behaviour and positive risk taking. The Working Group considers that identification of appropriate amendments to the SBT should be a priority for the Government.

Loss uplift

- The tax law allows losses to be carried forward indefinitely but only at their nominal amount. This deprives businesses of the time value of their losses.
- Allowing losses to be 'uplifted' so that they maintain their value would go some way to achieving symmetry in the treatment of taxable gains and losses.
- The case for uplifting revenue losses is stronger than the case for uplifting capital losses.
- Loss uplift would move the tax system closer to the benchmark of refundability and would be valued by some sections of the business community, particularly start-up businesses. Loss uplift should represent a lesser priority for Government than other reforms that would improve loss recoupment.

The treatment of carry forward losses departs from the benchmark of refundability

The Working Group has, in this report, considered the current tax treatment of losses against a benchmark of full refundability. Loss carry back is one means of moving closer to that benchmark. Targeted carry back could encourage risk taking and innovation and provide timely cash flow to businesses during economic downturns, acting as an automatic stabiliser.

In this chapter, we turn our attention to losses that are carried forward. There are two ways in which the treatment of carry forward losses departs from the benchmark of immediate refundability. First, losses carried forward can only be deducted against future taxable income if certain integrity rules are satisfied. Secondly, as losses can only be carried forward at their nominal amount, the value of losses to taxpayers erodes over time.

Overlaying both of these considerations is the fact that losses that are carried forward are often never able to be used. Even businesses that satisfy the integrity rules face the very real possibility of never generating sufficient future income to fully absorb the losses.

Facilitating adaptation and innovation should be paramount

There is no single, coherent policy that governs the tax treatment of carry forward losses. Our current system attempts to negotiate various competing policy considerations, not least of which is the impact the treatment of losses has on government revenues.

A key justification for loss integrity rules is that they remove incentives for 'tax driven' activities involving entities with losses. The challenge is how to frame these rules to discourage tax driven practices without impacting adversely on legitimate commercial activities.

The Working Group considers that the tax treatment of losses should reflect the broader policy that the tax system should not impede businesses from innovating or from adapting to changes in economic circumstances. Maintaining integrity in the tax system must be carefully balanced against the risk of stifling innovation.

The remainder of this chapter evaluates the current tax treatment of carry forward losses and suggests possible models for reform that reflect this broader policy consideration.

The loss integrity provisions have evolved over time

The rules governing the utilisation of tax losses have evolved considerably over time. Although tax losses can now be carried forward indefinitely, that is a relatively recent development. It was extended to primary producers in 1966 and was given general application in 1990. Before that time, most companies were only entitled to a deduction for losses from the preceding seven years. In the early decades of the federal income tax, losses could only be carried forward for four years.

Prior to 1944, the time limitations were the only restrictions that were imposed on the ability of companies to carry forward their tax losses to offset against future income. In 1944, the continuity of ownership test (COT) was established for private companies to address 'loss trafficking', that is, purchasing companies in order to gain a tax advantage from the carry forward losses.[18] Loss trafficking was described by the Treasurer at the time as the practice 'of buying up shares in practically defunct companies and then operating those companies for purposes other than those for which they were originally registered'.[19] The COT ensures that, broadly, a company cannot deduct its losses if there has been change in the identity of 50 per cent or more of its ultimate owners in the period since the loss was incurred.

The same business test (SBT) was first introduced in 1965 at a time when the COT requirements were being strengthened. It was intended to serve as a concession to the COT, aimed at ensuring that the COT did not interfere with bona fide attempts to take over, and rehabilitate, ailing businesses.[20]

For consolidated groups, even where the COT and SBT are satisfied, the available fraction rule generally applies to spread the use of the losses transferred into the consolidated group over time, referable to the asset base of the acquired entity. This recognises the potentially more diverse nature of businesses within a consolidated group and applies a formulaic base for utilising new losses coming into the consolidated group for integrity purposes.

Other integrity rules operate alongside the COT and SBT to target specific behaviour that could lead to loss duplication, whereby multiple losses stem from one economic loss. Overlaying all of these rules is the general anti-avoidance rule contained in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) and other rules to target behaviour aimed at reducing tax liabilities.[21]

A timeline of the changes to the loss integrity rules is set out at Appendix E.

The continuity of ownership test

The COT is satisfied if the same persons have more than 50 per cent of the voting power, rights to dividends and rights to capital distributions at all times during the ownership period.[22]

The ownership test period is generally the period between the start of the year in which the loss was incurred (the loss year) to the end of the income year in which the loss is sought to be recouped (the claim year). The point in time just before the COT is failed within the ownership test period is then used to compare the business to the SBT test period. A number of additional rules affect the application of the COT.

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18 Asprey, K. W, 1975, Taxation Review Committee: Full report, Australian Government Publishing Service, Canberra, pp. 249 – 250 ('Asprey Review').

19 Asprey Review, p. 249.

20 See Treasurer's Second Reading Speech to Income Tax Assessment Bill 1965 (Cwth), cited in *Lilyvale Hotel Pty Ltd v Federal Commissioner of Taxation* 2009 ATC 9452.

21 Division 165 and 175 also include specific anti-avoidance provisions to protect the effectiveness of the COT by preventing share ownership being manipulated by arrangements aimed at reducing a tax liability (for example, by manipulating the ownership of shares to gain access to carried forward losses or injecting income into a business to utilise losses).

22 This is the 'primary' COT test. If one or more other companies beneficially owned shares, or interests in shares, in the company at any time during the ownership test period, then an alternative COT test which also examines voting, dividend and capital distribution rights to assess whether there has been a majority change in ownership where one or more companies beneficially owned shares or interest in shares in the company at any time during the ownership test period (subsection 165-12(6), 165-150(2), 165-155(2) and 165-160(2) of the ITAA 1997). A modified COT containing concessionary tracing rules that simplify the tracing of ownership interests is available for widely held companies and other types of companies (Division 166 of the ITAA 1997).

The same business test

A company satisfies the SBT if it carries on the same business in the claim year as it carried on immediately before it failed the COT. The SBT is intended to ensure continuity of the *whole of the business activities* carried on by the taxpayer just before it failed the COT and the *whole of the business activities* carried on by the taxpayer during the period of recoupment.[23]

However, a company will not satisfy the SBT if it:

- derives assessable income from a type of business of a kind that it did not carry on before the test time (new business test); or
- derives assessable income from a transaction of a kind that it had not previously entered into in the course of its business before the test time (new transaction test).

The new business test and new transaction test are described as 'negative tests' that look to see whether the *component* undertakings or enterprises and the transactions of the overall business are of the same kind as previously undertaken.[24]

Removing COT and SBT provides de facto loss refundability

The removal of the COT and SBT would move the treatment of losses closer to the benchmark of refundability. By removing the key restrictions on loss utilisation, the removal of the COT would increase the overall amount of losses that companies are able to put to use. Under the current system, losses incurred by a company that subsequently fails the COT and SBT are effectively trapped or wasted. The removal of the COT would also enhance the ability of company shareholders to be compensated for a company's tax losses by selling the shares at a price that reflects the value of the losses. This is illustrated in the following example.

Box 4.1 Example of loss trading

Anne injects equity of $100 in Company A (assume she is the only shareholder). During income year 1, the company makes a (revenue) loss of $100. Assume the company has poor prospects of earning future revenue against which it might use its loss. However, the loss potentially has a theoretical tax value of $30 to someone who could immediately use the loss against other income.

At the start of income year 2, Boris purchases Anne's shareholding for $20. Boris is willing to pay $20 for the shares because he is confident he can use the tax loss against other income in year 2. Anne will have made a capital loss on her shares of $80. Assuming she has other capital gains for the year, Anne will have realised some of the tax value of the revenue loss incurred by the company plus the value of the capital loss on her equity in Company A. Boris shields $100 of income from his other business in year 2 by using the carried-forward loss and terminates the business activities of company A.

As the example demonstrates, removing or relaxing the COT would, in theory, facilitate transactions to allow losses and profits in different businesses to be offset.

23 Australian Taxation Office, Taxation Ruling TR 1999/9, *Income tax: the operation of sections 165-13 and 165-210, paragraph 165-35(b), section 165-126 and section 165-132*, para 25. ('TR1999/9').

24 TR 1999/9, para 27.

The Working Group considered such an approach but concluded that it had disadvantages relative to other options for improving loss recoupment. The Working Group has ruled out recommending refundability of losses as a viable option for the foreseeable future because of its revenue impact. Creating a tolerance for de facto refundability through the trading in loss entities is also therefore ruled out by the Working Group.

Most comparable tax jurisdictions have a COT

The removal of COT would theoretically enable the trading in loss entities in cases where there may be no other legitimate commercial motivation for a share sale transaction. This issue is particularly significant when the treatment of losses in Australia is compared with comparable tax regimes.

The Working Group notes that OECD countries typically use a similar provision to the COT as one component of their loss integrity rules. In a recent OECD report, a COT was a feature of 16 of the 17 countries surveyed, with the required rate of continuity ranging from 30 to 75 per cent.[25]

The Working Group considers that introducing substantially less restrictive rules could create an incentive for multinational companies to bring their tax losses into Australia, putting greater pressure on transfer pricing rules and the thin capitalisation regime as revenue protection measures. This concern is shared by the OECD which noted that the opportunities for taxpayers to exploit differences among country rules are a source of tax risk.[26]

The key features of the loss integrity rules of the surveyed OECD member countries are summarised in the table below.

25 OECD, 2011, Corporate Loss Utilisation through Aggressive Tax Planning, Paris, pp. 34-6 ('Corporate Loss Utilisation through Aggressive Tax Planning').

26 Corporate Loss Utilisation Through Aggressive Tax Planning, p. 30.

Table 4.1 Restrictions on loss utilisation within OECD countries

Country	Restrictions	Exceptions
Australia	Change of ownership and activity	Ownership tracing concessions apply to widely held companies
Austria	Change of ownership and activity	Other (non-tax) considerations
Canada	Change of ownership and activity	Acquisition of corporations business activities
Denmark	Change of ownership and other criteria	Internal reorganisations
France	Change of activity	No
Germany	Change of ownership	Other (non-tax) considerations
Ireland	Change of ownership and activity	Internal reorganisations
Italy	Change of ownership and activity, mergers	Other (non-tax) considerations
Mexico	Change of ownership and activity, mergers	Inheritance, donation, internal reorganisation, merger and split off that are not considered alienations for tax purposes
Netherlands	Change of ownership and activity	Lack of tax avoidance motive
New Zealand	Change of ownership	Ownership tracing concessions internal reorganisations
Norway	Change of ownership and other criteria	Lack of tax avoidance motive
Spain	Change of ownership	Internal reorganisations
Sweden	Change of ownership	Internal reorganisations
Switzerland	Change of ownership and restart of activity	Financial restructurings
United Kingdom	Change of ownership and activity	Internal reorganisations
United States	Change of ownership	No

Source: Table adapted from OECD, Corporate Loss Utilisation through Aggressive Tax Planning (2011), p.34.

Changes to the SBT need to be considered

The SBT too narrowly prescribes the types of activities that a company can undertake without forfeiting its tax losses. In particular, the new business test and new transaction test (the negative tests) may create incentives for companies that have undergone a substantial ownership change to remain 'locked in' to an inefficient business model in order to avoid the risk of forfeiting those tax losses.

The Working Group considered three models for addressing deficiencies in the SBT:

- replacing it with a dominant purpose test;
- retaining the SBT but modifying it so that it better aligns with the modern business environment; and
- introducing a statutory drip-feed as a replacement, or alternative to, the same business test.

Each of these options is considered in detail below.

A dominant purpose test would be uncertain in its application

Under a dominant purpose test, carry forward tax losses would not be utilised where the tax losses were obtained through a transaction undertaken for the dominant purpose of obtaining a tax loss.

A dominant purpose test would require an assessment of the purpose of a transaction and companies may be uncertain about its application. Even where a dominant purpose test is established using objective criteria, it would require the development of new interpretative guidance on its operation. Also, the current SBT performs (or is intended to perform) a similar function to a dominant purpose test. Like a dominant purpose test, the SBT is essentially a mechanism for distinguishing between commercial and tax-driven transactions. As taxpayers, tax practitioners and administrators are familiar with the current regime, modifying the SBT to accord with the current economic environment is likely to involve lower transitional costs than the establishment of a new dominant purpose test.

Carrying on the same business is an appropriate measure of commerciality

Although there are deficiencies in the SBT in its current form, it is effective in reducing the risks to the revenue including from inappropriate trading in losses. There is value in retaining a same business test as a means of determining whether carry forward loss can be used. However, the SBT should be modified so that it better reflects the types of changes that are commonly made to businesses to restore or enhance profitability.

The Working Group considers that there is scope to achieve substantial improvements to the loss integrity provisions by recasting the language of the SBT. The key design consideration in developing indicators of similarity is that the rule should tolerate difference to the extent that it is consistent with genuine attempts to rehabilitate an ailing business. It should also have regard to the current dynamic business environment which requires businesses to change and adapt.

Removing the negative tests will better allow companies to adapt and change

One component of reforms to the SBT would be to remove the two negative tests. Where a company can meet the positive same business test, which signifies that the overarching business is the same, the company would be able to deduct previous tax losses from assessable income, despite a new transaction or new businesses generating assessable income. It would be expected that if the magnitude of the impact of the new business or new transaction was increased, then there would be a subsequent failure of the same business test.

The two negative tests are intended to prevent the injection of income into a company (moving a profitable arm of a business into the loss making company and shielding profits). However, the two negative tests do not depend on the existence of a purpose of tax avoidance for their operation and are overly restrictive.

It follows that, as a first step, recasting the SBT to more closely reflect modern business realities should involve removing the two restrictive negative tests, the new business test and new transaction test.

The positive limb of the SBT allows for organic growth and adaptation

In the context of the SBT, the word 'same' is interpreted to mean 'identical' and not merely 'similar'.[27] It is this aspect of the SBT that is the subject of most criticism. The Working Group considers that a better model for a modified SBT[28] is that it should facilitate, and not hinder, genuine and creative attempts to enhance profitability.

The Working Group notes that the test has generally been applied by the courts and the Tax Office with some regard to business reality. The identity requirement was first advanced by Gibbs J in *Avondale Motors (Parts) Pty Ltd v FC of T.*[29] In that judgment, it was stressed that a business could be the same notwithstanding that there are changes in the way it is carried on. It was contemplated that organic changes in a business were permissible.

The Working Group has also noted that statements by the Commissioner of Taxation show a similar tolerance for 'organic' changes:

> *The organic growth of a business through the adoption of new compatible operations will not ordinarily cause it to fail the same business test provided the business retains its identity; nor would discarding, in the ordinary way, portions of its old operations. But if, through a process of evolution a business changes its essential character, or there is a sudden and dramatic change in the business brought about by the either the acquisition or the loss of activities on a considerable scale a company may fail the test.*[30]

Instead of being replaced, the positive limb of the SBT could be retained as the primary test of whether a company that has failed COT should be able to use its losses. This test could ensure the appropriate treatment in most cases where the changes to the business came about because of genuine attempts to restore or enhance its profitability or to adapt to changes (or anticipated changes) to the business environment.

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27 Australian Taxation Office, *Taxation Ruling TR 1999/9 Income Tax: the operation of section 165-13 and 165-210, paragraph 165-35(b), section 165-126 and section 165-132* ('TR 1999/9'), para. 13.

28 The term 'modified SBT' is used in a different sense here than in certain provisions of the ITAA 1997 relating to consolidated groups.

29 (1971) 124 CLR 97

30 TR 1999/9, para. 13.

A further advantage of retaining the positive limb of the SBT as part of any amended test is that the existing body of case law and ATO opinion would continue to be a valuable source of guidance to companies seeking certainty as to the continued availability of their losses.

The positive limb does not produce the appropriate outcome in all cases

In its consultation with the stakeholders, the Working Group has identified a range of situations where a company would fail the positive limb of the SBT even though the 'trigger' for the COT failure (such as a takeover) was motivated by genuine commercial considerations.

Having regard to these considerations, the Working Group consulted with stakeholders on a model for improving the same business test. Under this model, a company which fails the positive limb of the SBT would nevertheless pass the SBT if it carries on 'predominantly' or 'substantially' the same business having regard to a range of factors or indicators that would be set out in the law. These factors would reflect changes that are made to businesses for valid commercial reasons which might otherwise trigger a failure in the positive limb of the SBT. The factors would operate as alternatives, not cumulative requirements, and no particular weighting would be applied to one factor over another.

The Working Group considers the following factors could be incorporated into the modified test or be the basis for determining the meaning of 'predominantly' or 'substantially':

- the extent to which the same physical and intangible assets — including goodwill — are used for the purposes of producing assessable income;
- whether changes to the business are of a kind that might reasonably be expected to be adopted by a similarly placed business (for example, changes to the business to take advantage of unforeseen business opportunities); or
- the extent to which the company continues to generate a specified proportion of the total assessable income for the year from the same source.

The following examples illustrates how (and why), a modified SBT could lead to different outcomes than that provided for under the current law. The examples are extracted from the ATO's Taxation Ruling, TR 1999/9.

Box 4.2 Example of modified SBT in operation — Mammon Pty Ltd

'Mammon' (a company) carries on a gold mining operation on a tenement from which copper could also be produced. Copper prices are depressed so Mammon does not extract any copper. Mammon incurs large losses and changes hands, failing COT. Copper prices recover and Mammon invests in new plant, equipment and specialist staff to commence an operation of concentrating and selling copper concentrate to its gold mine.

Treatment under the current SBT	Treatment under the modified SBT
Under the current law, Mammon may pass SBT if it can demonstrate that the new copper concentrate business is comparatively insignificant in the extent of its overall business.	Under the modified SBT, significant weight would be attached to the fact the changes to Mammon's business are consistent with what might be expected of a similarly placed business in the circumstances.

Box 4.3 Example of modified SBT in operation — Restaurant Pty Ltd

Restaurant Pty Ltd (RPL) owns a high-end Japanese restaurant, catering to a wealthy clientele. The restaurant makes losses and changes hands, failing COT. RPL buys an Italian restaurant, which serves food that is 'notably cheap'. RPL continues to operate the Japanese restaurant but now also operates the Italian restaurant. No significant changes are made to the operations of either restaurant.

Treatment under the current SBT	Treatment under the modified SBT
Under the current law, RPL would fail the SBT because of the qualitative differences between a Japanese restaurant business and an Italian restaurant business.	Under the proposed test, RPL is able to demonstrate that it satisfies the test by having regard to other factors. In particular, although its operations have expanded, RPL is able to show continuity in the use of its physical and intangible assets that it owned immediately before its ownership changed.

Reforming the SBT for new losses only may increase complexity

In developing this report, the Working Group's focus has been on reform options that relieve the taxation burden on new investments. This emphasis suggests that reforms should be given prospective application. While this may be the case for other reforms discussed in this report, the situation with the proposal to modify the SBT may prove to be more complex.

Adopting a prospective application date for changes to the SBT would mean that a company that has existing losses as at the start date and then subsequently incurs further losses would be subject to two concurrent loss integrity regimes. This would lead to added complexity and compliance costs. The Working Group encourages the Government, in the event that it pursues reforms to the SBT, to give careful consideration to the appropriate application date. One option would be to apply the modified SBT to all losses of companies that would pass the existing SBT at the commencement of the new rules. Another option would be apply the modified SBT to companies that pass the COT as at that date.

A statutory drip-feed may complement a modified SBT

The interim report suggested that a drip-feed mechanism akin to the available fraction rule used for consolidation could replace the COT and SBT. The Working Group has concluded that the COT should be preserved as the primary safeguard against loss trafficking and does not consider a general drip-feed approach to be a viable option. However, an alternative reform to the loss integrity measures might be to retain the COT in its current form and adopt a drip-feed mechanism in place of the current SBT.

A drip-feed mechanism lacks a clear rationale other than that it would provide certainty that companies would eventually be able to utilise their tax losses and may provide a means of reducing the incentive for loss trading if a sufficiently low rate of utilisation was enforced.

The replacement of SBT with a drip-feed mechanism may result in some companies utilising tax losses more slowly than they would have under the current integrity rules. This may be considered inequitable and undesirable, especially by affected companies.

The adoption of a drip-feed mechanism raises a number of issues in terms of design and practical administration. One issue relates to the choice of an appropriate rate of utilisation. A single statutory rate applicable to all taxpayers would have the advantage of reducing complexity and being easier to administer. However, such a provision would be arbitrary and would not have proper regard to the taxpayer's individual circumstances. On the other hand, a rate that has regard to individual

circumstances is likely to involve high compliance and administration costs. For example, it may require costly valuations to be undertaken.

A more pressing challenge in the design of a drip-feed mechanism is the need to ensure that it minimises the incentive for tax-motivated trading in companies with tax losses. The need to address 'loss trafficking' suggests that the rate of utilisation under a drip-feed should be relatively low. However, setting a low rate would increase the disadvantage to a company that would have passed the SBT.

In light of its concerns, the Working Group considers that SBT should not be replaced with a drip-feed mechanism. However, there may be merit in making a drip-feed available to companies on an 'opt-in' basis in conjunction with a simple 'continuity of business' rule. That is, a company which has failed COT could be allowed to make a binding election either to deduct losses at a statutory drip-feed rate (subject to there being a continuity of business) or to continue to be subject to the SBT. A company that so elected would enjoy more certainty as to its ability to utilise its losses and avoid the compliance costs associated with the same business test.

For ease of compliance and administration, a drip-feed mechanism offered as an alternative to the SBT could be calculated on single statutory rate applicable to all companies. A recovery rate of ten per cent per annum over ten years may be reasonable.

A modified SBT would assist start-up companies and companies facing a temporary shock

The worked examples described earlier illustrate the situations in which companies may benefit from a modified SBT.

Worked example 1: A start-up company

AAA will benefit from the changes to the SBT. AAA will gain more benefits the longer the period is between when it failed the COT and when it uses the loss, as there is a higher probability that AAA will change and not meet the current SBT.

In 2014-15, when AAA Pty Ltd is doing well but still has unrecouped tax losses, it receives an injection of equity from an additional shareholder (this results in a majority change in ownership). While AAA will fail COT, it is still carrying on the same business.

In 2015-16, in addition to producing algae plastic for plastic retailers the company also provides plastic direct to customers. There has also been a finding that algae can help in the teeth whitening process, and AAA starts exporting some of its stock of algae to overseas dentists. AAA has failed the COT but will pass the modified SBT because it has carried on predominantly the same business as it carried on immediately before the test time because:

- it uses the same physical and intangible assets (including goodwill) for the purposes of producing assessable income;
- it is reasonable to expect that a similarly placed business would take advantage of the increased demand for algae and sell off some of its excess supplies; or
- the company continues to generate a majority of its total assessable income for the year from selling the algae plastic.

Worked example 2: A company facing a temporary shock

Bread Pty Ltd will not benefit from the modifications to the SBT because it no longer has a tax loss. Bread Pty Ltd was able to access loss carry back and was provided a refund of $30,000 (the tax value of the loss).

Worked example 3: A company facing a sustained shock

XYZ Pty Ltd will not benefit from the modification of SBT because it is never able to use its losses.

Worked example 4: A company investing to upgrade its product line

Especial will not benefit in the short term from changes to the SBT as it would pass the existing integrity rules. The changes to the SBT would give Especial more flexibility to make changes to its business in the future.

Worked example 5: A terminal company

CCC Pty Ltd will not benefit from the modification of SBT because it is never able to use its losses.

Worked example 6: A consolidated group

The consolidated group will not benefit from the modification of SBT because the group is not in a tax loss position.

The Working Group has considered uplifting losses

The Business Tax Working Group's interim report identified that where losses are carried forward to be deducted against future income, the value of the tax loss carried forward erodes over time. As a result, the taxpayer will be deprived of the full value of the loss if it takes a number of years to generate sufficient income to offset the loss (assuming the integrity tests are met). This is a departure from the benchmark of refundability of tax losses.

A possible reform for the tax treatment of losses would therefore be to apply an uplift factor to tax losses as they are carried forward. The Working Group made it clear in its interim report that this would only apply to 'new' losses and not to the existing stock of losses. This is to ensure that reforms properly target removing the distortions on future decision making.[31]

Uplifting losses would move the treatment of losses closer to the immediate refundability benchmark. The uplift would preserve the value of the loss which is able to be used (deducted against future assessable income). It would therefore be of greatest benefit to those companies that make a tax loss but expect to generate taxable income in future years and are able to satisfy the relevant integrity tests.

31 Interim Report, paras 143-7.

An uplift would be of most benefit to a company that incurs significant expenditure while only generating limited income in its early years of operation, but subsequently becomes profitable. An uplift would allow such a company to shield a greater proportion of its future income against tax. Companies likely to fit this scenario may include start-ups[32], explorers and companies undertaking infrastructure projects.[33] For these companies, a loss uplift would increase the projected after-tax returns on the investment.

An uplift would also benefit a company which suffers a temporary shock as it would ensure that the value of tax losses is maintained in the period leading up to its return to profitability. This would also be relevant for those medium to large businesses with limited access to loss carry back because they have run down their franking account balances or their loss exceeds a quantitative cap.

Uplift would not provide a cash flow benefit to struggling businesses at the time they are incurring losses.

Loss uplift should be targeted and sustainable

Based on the benchmark of refundability, there is justification for a loss uplift that continues indefinitely at a rate that preserves the value of losses whilst having regard to each company's particular circumstances.

However, the Working Group considered that any uplift should be relatively simple to administer and sustainable in the long term.

The Working Group has consulted on a number of key factors in the design of a loss uplift. They are:

- the choice of the uplift rate;
- the scope of the uplift or the types of losses to which it would be available;
- the duration of the uplift; and
- simplicity of administration and compliance.

An uplift factor of the long term bond rate is appropriate

The interim report suggested that the long term (ten-year) government bond rate may be appropriate as the uplift rate. In the course of its consultation with stakeholders, the Working Group also considered alternative uplift rates. One view that emerged in consultation was that the most appropriate rate of uplift would be one which reflects each company's cost of capital. Another view is that the consumer price index (CPI) would most accurately ensure that the value of a loss is maintained.

Having considered the various options, the Working Group considers that the long-term government bond rate should be preferred. Alternatives which reflect the company's individual circumstances such as its cost of capital would be uncertain in their application and difficult to calculate. The CPI, while having the advantage of ease of calculation, does not accurately capture the time value of money. By contrast, the long-term bond rate can be viewed as the cost of the Government retaining

32 Noting that any eligible research and development (R&D) expenditure undertaken up such a company would already be refundable under the R&D tax incentive (provided the company has a turnover of less than $20 million). Such expenditure would therefore not form part of any tax loss the company carries forward.

33 In the 2011-12 Budget the Government announced that tax losses associated with designated infrastructure projects would be uplifted as they are carried forward and would not be subject to the COT and SBT rules.

the value of a loss as it is carried forward rather than immediately refunding it in the year it is incurred. That is, it treats the value of the tax loss like a government security, and offers the same return the taxpayer would earn on an alternative government security.

The Working Group acknowledges that a disadvantage of an uplift rate equal to the government bond rate is that it does not recognise the remaining risk that the losses may not ever able to be accessed (for example, in the event the business defaults or fails the COT or SBT). However, the Working Group believes that this rate achieves the appropriate balance between moving closer to the immediate refundability benchmark while maintaining simplicity and sustainability.

The long term government bond rate also has certain practical advantages. As it is a single rate applicable to all companies, it would impose a low cost of compliance and administration. It would also align with the Government's announcement in the 2011-12 Budget that tax losses from designated infrastructure projects can be uplifted at the long term Government bond rate.

Uplifting revenue losses is a higher priority

In light of its broader objectives and the need to ensure revenue neutrality, the Working Group does not regard the uplifting of capital losses as a priority. The approach that is adopted should be designed to assist businesses that, after a period of making losses, start (or resume) generating positive revenue flows rather than irregular capital profits. Companies in this position would not benefit from the uplifting of capital losses which will, in any event, be quarantined. This approach would align with business priorities because companies (particularly those in a net loss position) are less often in a position to realise capital gains against which to offset capital losses.

While there is some theoretical justification for applying uplift to capital losses, it is also arguable that it is inappropriate considering the nature of the capital gains tax (CGT) regime. A particular concern with uplifting capital losses is its consistency with 'quarantining', that is, the requirement that capital losses can only be offset against capital gains. The quarantining of capital gains and losses reflects the concessional nature of CGT, particularly the fact that CGT is levied on a realisation basis and can therefore be deferred indefinitely.

The Working Group understands that providing an uplift for capital losses may render quarantining ineffective in some cases where capital losses can be realised and uplifted. It would remove the disincentive to realise capital losses early where there are no realised capital gains against which they can be offset.

It is also noted that while the quarantining rules only allow capital losses to be offset against capital gains, it would not prevent uplifted revenue losses from being deducted from net capital gains. This would give companies some scope to shelter capital gains from tax by using uplifted revenue losses.

A time limited uplift is the most sustainable alternative

The Working Group considers, in the absence of a time limitation, that the impact of uplift to government revenue would be unsustainable in the medium to long term. The Working Group considered two alternatives for maintaining revenue neutrality while ensuring that it targets those businesses which would benefit most from the uplift.

One alternative for limiting the impact of loss uplift is to allow uplift for a fixed period, with the condition that losses would become unusable at the expiry of that period.

After consulting with stakeholders, the Working Group has concluded that an uplift that involves forfeiture of losses would not be welcomed by the business community and should not be adopted.

The Working Group considers that the forfeiture of losses would worsen the effects on investment of the existing asymmetric treatment of gains and losses.

The Working Group's preferred model is that tax losses should be able to be uplifted for a period of three to five years and then carried forward indefinitely without further uplift. A three to five year period would be of assistance to start-ups and other businesses that carry forward losses over a longer period. It would also assist those companies that are affected by the proposed quantitative cap or franking account limit on loss carry back.

Loss uplift is most suitable for incorporated businesses

In Chapter 3 of this report, the Working Group considered the arguments for and against extending loss carry back to unincorporated businesses, that is, sole traders, partnerships and trusts. It was concluded that, in light of administrative difficulties associated with extending carry back to non-corporate entities, and its limited benefits for partnerships and sole traders, it should initially be extended only to companies.

A proposal to implement loss uplift would require a similar examination of whether it should be extended to unincorporated business entities. This analysis gives rise to issues that largely mirror those that arise in relation to loss carry back.

Sole traders and partnerships allow for business losses to be offset against other income, so those entities may attach less value to uplift. Allowing loss uplift to trusts may present significant challenges in terms of design and implementation.

Loss uplift is a lesser priority for many businesses

The principal advantage of loss uplift is that it moves the treatment of losses closer to the benchmark of refundability. However, it would not improve loss recoupment or provide cash flow benefits to businesses at the time losses are incurred. In the context of the Government's broader objectives and the need to ensure revenue neutrality, loss uplift should represent a lower priority than other reforms outlined in this report.

As a result of consultation with stakeholders, the Working Group has concluded that, in general, businesses attach relatively less value to the ability to uplift losses. A number of stakeholders advised that uplift would not be a significant factor in determining whether to proceed with an investment. It was also noted that loss uplift would not provide additional cash flow to businesses undergoing a temporary downturn.

While it generally appears that businesses regard loss uplift as a lesser priority, this view is not universally shared. Loss uplift would be highly valued by businesses that endure lengthy periods of losses before achieving (or returning to) profitability. Businesses in this category include, notably, start-ups, explorers and stand-alone infrastructure projects.

Loss uplift would be of most benefit to start-up companies

The following examples illustrate the effects of loss uplift on each of the companies, with particular emphasis on the start-up company. The examples have been drafted to follow on from a loss carry back. An uplift rate of 5.75 per cent has been used in the calculations.

Worked example 1: A start-up company

If AAA Pty Ltd passes the loss recoupment rules, it would benefit from loss uplift as the uplift ensures that the tax value of the losses does not erode as it is carried forward. This is particularly beneficial for the start up as there may be considerable time between when the loss is made and when it is able to use the loss.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$0	$1,000,000	$5,000,000	$7,000,000	$8,000,000	$10,000,000
Expenses — excluding depreciation	($2,000,000)	($2,000,000)	($2,000,000)	($2,000,000)	($2,000,000)	($2,000,000)
Deductions — depreciation	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)
Deductions — losses	$0	$0	($2,000,000)	($3,669,439)	$0	$0
Taxable income	($3,000,000)	($2,000,000)	$0	$330,561	$5,000,000	$7,000,000
Tax payable	*$0*	*$0*	*$0*	*$95,863*	*$1,450,000*	*$2,030,000*
Loss carried back	$0	$0	$0	$0	$0	$0
Carry back refund	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*
Total value of carry forward losses	$3,000,000	$5,172,500	$3,469,919	$0	$0	$0
Uplifted carry forward amount	$3,172,500	$5,469,919	$3,669,439	$0	$0	$0

Worked example 2: A company facing a temporary shock

Bread Pty Ltd would not benefit from loss uplift because it no longer has a tax loss. Bread Pty Ltd was able to access loss carry back and was provided a refund of $174,000 (the tax value of the loss).

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$2,000,000	$2,000,000	$2,000,000	$1,200,000	$1,800,000	$2,500,000
Expenses — excluding depreciation	($200,000)	($200,000)	($200,000)	($1,000,000)	($500,000)	($200,000)
Deductions — depreciation	($200,000)	($200,000)	($200,000)	($800,000)	($800,000)	($800,000)
Deductions — losses	$0	$0	$0	$0	$0	$0
Taxable income	$1,600,000	$1,600,000	$1,600,000	($600,000)	$500,000	$1,500,000
Tax payable	*$480,000*	*$464,000*	*$464,000*	*$0*	*$145,000*	*$435,000*
Loss carried back	$0	$0	$0	$600,000	$0	$0
Carry back refund	*$0*	*$0*	*$0*	*$174,000*	*$0*	*$0*
Total carry forward losses	$0	$0	$0	$0	$0	$0
Uplifted carry forward amount	$0	$0	$0	$0	$0	$0

Worked example 3: A company facing a sustained shock

XYZ Pty Ltd would benefit from loss uplift in the timeframe because it is able to uplift the $1.5 million loss that it is required to carry forward because it has reached the maximum carry back.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$3,000,000	$3,000,000	$2,000,000	$1,000,000	$500,000	$1,000,000
Expenses — excluding depreciation	($500,000)	($500,000)	($500,000)	($500,000)	($2,500,000)	($500,000)
Deductions — depreciation	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)	$0	($100,000)
Deductions — losses	$0	$0	$0	$0	$0	($400,000)
Taxable income	$1,500,000	$1,500,000	$500,000	($500,000)	($2,000,000)	$0
Tax payable	*$450,000*	*$435,000*	*$145,000*	*$0*	*$0*	*$0*
Loss carried back	$0	$0	$0	$500,000	$500,000	$0
Carry back refund	*$0*	*$0*	*$0*	*$145,000*	*$145,000*	*$0*
Total carry forward loss	$0	$0	$0	$0	$1,500,000	$1,186,250
Uplifted carry forward amount	$0	$0	$0	$0	$1,586,250	$1,254,459

Worked example 4: A company investing to upgrade its product line

Especial would benefit from loss uplift to the extent that it cannot access carry back the full tax value of its losses in any one period and must carry forward remaining losses. The amounts that can be uplifted are:

- $4 million in 2014-15.
- $2.95 million in 2015-16.
- $800,000 in 2016-17.

In 2017-18 Especial returns to profit and is able to utilise its entire uplifted loss stock to reduce its taxable income.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$25,000,000	$25,000,000	$12,000,000	$15,000,000	$20,000,000	$30,000,000
Expenses — excluding depreciation	($18,000,000)	($19,000,000)	($16,100,000)	($18,000,000)	($19,000,000)	($18,000,000)
Deductions — depreciation	($750,000)	($750,000)	($900,000)	($950,000)	($1,800,000)	($1,800,000)
Deductions — losses	$0	$0	$0	$0	$0	($8,875,439)
Taxable income	$6,250,000	$5,250,000	($5,000,000)	($3,950,000)	($800,000)	$1,324,561
Tax payable	*$1,875,000*	*$1,522,500*	*$0*	*$0*	*$0*	*$384,123*
Loss carried back	$0	$0	$1,000,000	$1,000,000	$0	$0
Carry back refund	*$0*	*$0*	*$290,000*	*$290,000*	*$0*	*$0*
Total carry forward losses	$0	$0	$4,000,000	$7,180,000	$8,392,850	$0
Uplifted carry forward amount	$0	$0	$4,230,000	$7,592,850	$8,875,439	$0

Worked example 5: A terminal company

CCC Pty Ltd would not substantially benefit from loss uplift because it has enough losses to use in 2013-14 without the uplift and it is never able to use its final stock of losses at the end of 2014-15, even though the stock is larger under uplift.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$500,000	$5,000,000	$1,000,000	$0	$0	$0
Expenses — excluding depreciation	($3,000,000)	($2,000,000)	($500,000)	$0	$0	$0
Deductions — depreciation	($1,000,000)	($1,000,000)	($1,000,000)	$0	$0	$0
Deductions — losses	$0	($2,000,000)	$0	$0	$0	$0
Taxable income	($3,500,000)	$0	($500,000)	$0	$0	$0
Tax payable	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*
Loss carried back	$0	$0	$0	$0	$0	$0
Carry back refund	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*
Total carry forward loss	$3,500,000	$5,701,250	$6,529,072	$0	$0	$0
Uplifted carry forward amount	$3,701,250	$6,029,072	$6,904,494	$0	$0	$0

Worked example 6: A consolidated group

The consolidated group would not benefit from loss uplift because the group is not in a tax loss position.

Conclusion

There is significant scope for improvements in the way the tax treatment of carry forward losses impacts on business decision making. Losses have real value to businesses and are taken into account in investment decision making.

The effect of the same business test is that the advantages of making improvements to a business must be weighed against the disadvantage of its losses becoming unusable. The need for integrity in the treatment of tax losses must be tempered by consideration of the costs of locking businesses into inefficient structures. Subject to an evaluation of the costs and benefits of savings options, the integrity rules should, as a matter of priority, be changed to reflect modern business realities.

There is scope to improve incentives for businesses to innovate and adapt to change by reforming the SBT. The Working Group has considered a range of possible alternative approaches to reforming SBT that would better reflect the modern commercial environment. However, in the time available, we have not been able to settle on a preferred approach. We consider that the Government should undertake further work on possible reforms as a matter of priority.

Loss uplift is another potentially useful reform to the tax treatment of losses. Loss uplift is likely to have a positive impact on business risk taking and innovation but is a lower priority for Government in the short to medium term.

Recommendation

Recommendation 3: The Working Group recommends that the Government, as a matter of priority, undertake further analysis with a view to developing a model for reforming the same business test. One model for improving the existing loss integrity rules could involve a combination of:

- modifying the existing SBT so that it better aligns with the modern business environment; and
- introducing an alternative statutory drip-feed mechanism calculated on a straight line basis.

Appendix A: Business Tax Working Group — Terms of Reference

Objectives

1. The Working Group will make recommendations on how the Australian business tax system can be improved to make the most of the challenges and opportunities arising from transformations in the broader economic environment, including the patchwork economy.

2. The revenue neutral reforms to the business tax system will aim to increase productivity, while delivering tax relief to struggling businesses.

Scope

3. The Working Group will focus on reform options that relieve the taxation of new investment:

   3.1. in the near term, by reforming the tax treatment of business losses; and

   3.2. in the longer term, by reducing the corporate tax rate further or moving to a business expenditure tax system, particularly an allowance for corporate equity.

4. For its final reports, the Working Group will provide specific analysis of these business tax reform options, including:

   4.1. description of how these reforms options operate overseas and evidence on their effectiveness;

   4.2. potential priorities for reform, including transitional paths;

   4.3. worked examples of how these options would affect business taxpayers, including their financial and tax accounts;

   4.4. revenue integrity provisions, such as measures necessary to limit: the inappropriate claiming of tax losses; the equity allowance to new equity; and small and closely held businesses converting labour into business income;

   4.5. how the reform options integrate with the rest of the tax system now and in the future;

   4.6. impacts on national income and macroeconomic risks; and

   4.7. costings.

5. The working group will also identify a range of off-setting budget savings from existing Commonwealth business taxation (or spending) measures. Changes to the GST should not be considered.

   5.1. The savings to be generated by the particular options will be costed by the Treasury in accordance with the budget rules.

6. In developing its recommendations, the Working Group should have regard to the report of the Australia's Future Tax System Review and relevant international experience and expertise.

Timing

7. The Working Group is required to provide the Treasurer with:

   7.1. an initial report on the proposed directions for improving the tax treatment of losses and offsetting savings in mid-November 2011;

   7.2. a final report on the treatment of losses and the offsetting savings in March 2012; and

   7.3. a further report on longer-term business tax reform options and offsetting savings by the end of 2012.

Consultation

8. For its final reports, the Working Group should consult widely with industry and the broader community.

9. The Working Group may establish technical sub-groups to consider specific issues or seek input from other sources of expert advice.

Support

10. The Working Group will be supported by a Secretariat within Treasury.

APPENDIX B: POSSIBLE BUSINESS TAX SAVINGS

Treasury provided the Working Group with information on possible business tax savings largely drawn from the Tax Expenditures Statement. In the time available the Working Group has not had the opportunity to fully consider the benefits and risks of one or more or a combination of savings options and the Working Group has not been able to consult widely on the extent of any adverse impacts.

Statutory effective life caps

A substantial expenditure in the business tax system is the provision of statutory effective life caps[34] for certain depreciating assets used in certain industries. In particular, statutory caps are available in the oil and gas, petroleum, agricultural and transport industries. The application of the statutory cap on the effective life of depreciating assets means that the effective tax rate applying to each of these industries is kept below the statutory rate. Assets with statutory effective life caps generally have very long effective lives such that even a statutory effective life cap of 15-20 years is a concession in some cases.

Accelerated depreciation arrangements for all other assets were removed as part of the reforms following the Review of Business Taxation.[35] Statutory effective life caps were introduced in 2002 to maintain accelerated depreciation for certain depreciating assets amid concerns that the extension of effective lives would have wide-ranging effects on investment decisions.

In consultation sessions the Working Group has discussed the application of statutory caps in the oil and gas industry. Possible savings generated from the removal of statutory caps would be influenced by how the removal was applied. For example, the level of savings would be influenced by the start date and whether the changes applied to assets installed ready for use after the start date or whether the current statutory caps would still be used where contracts for assets had been entered into before the start date despite assets not being installed ready for use.

Immediate deduction for exploration and prospecting

The current tax law allows an immediate deduction for certain expenditure on exploration or prospecting for minerals which allows the expenditure to be deductible outright in the year in which it is incurred.[36] Examples of deductible expenditure include transport, materials, labour and administrative costs incurred in carrying out exploration or prospecting activities. The tax law also allows an immediate deduction for the cost of depreciating assets that are first used in exploration or prospecting.[37]

Treasury has costed the removal of the immediate deduction for exploration and prospecting expenditure, with effect from the announcement of the 2012-13 Budget, as achieving savings of $1200 million over the forward estimates period. Alternatively, the removal of the immediate deduction for the cost of depreciating assets first used in exploration or prospecting from the announcement of the 2012-13 Budget would achieve savings of $900 million over the forward estimates period.

34 That is, the life of the asset for tax depreciation purposes is shorter than the actual economic depreciation of the asset.
35 Review of Business Taxation, 1999, *Review of Business Taxation: A tax system redesigned*, Canberra.
36 Under section 40-730 of the ITAA 1997.
37 Under subsection 40-80(1) of the ITAA 1997.

Possible savings generated from the removal of the immediate deductions represent the upper bound for potential savings under those options. Phasing in the removal of either of the immediate deductions would reduce the potential savings achieved. It is also important to note that savings achieved would be influenced by the start date.

The R&D non-refundable tax incentive

The R&D tax incentive replaced the R&D tax concession from 1 July 2011 to provide a targeted tax offset to encourage certain companies to conduct R&D activities that benefit Australia. The R&D tax incentive provides a 40 per cent non-refundable tax offset for eligible entities with a turnover of $20 million or more.

Treasury costings indicate that a reduction in the rate of the non-refundable tax offset from 40 per cent to 37.5 per cent, with effect from 1 July 2013, would achieve savings of $500 million over the forward estimates period.

A second approach could leave the rate unchanged but impose a cut-off turnover threshold. Treasury costings indicate that imposing an upper turnover threshold at a relatively high level of $30 billion would provide savings of around $150 million per year. Introducing such a threshold would be expected to affect a small number of very large companies with very large R&D spends.

A third approach would be to impose a substantial annual cap (for example, at least $100 million) on the amount of R&D expenditure that would attract the 40 per cent non-refundable tax offset. The size of the cap needed to achieve a particular savings target is yet to be costed by Treasury.

Thin capitalisation rules

The current thin capitalisation regime is designed to ensure that multinationals do not allocate an excessive amount of debt to their Australian operations. The regime operates by disallowing a proportion of otherwise deductible borrowing expenses where the debt allocated to Australian operations exceeds certain limits. Without robust thin capitalisation rules, improved loss recoupment arrangements could increase the incentives of multinationals to shift debt and their related deductions to Australia providing them with a competitive advantage over purely domestic firms (or firms with truly independent financing arrangements).

The current thin capitalisation regime consists of a number of debt tests or limits. These limits require Australian entities under the regime to calculate the maximum debt deductions allowed to be claimed on their Australian operations, based on the underlying Australian assets involved. If the Australian operations have debt deductions above the maximum allowed (the debt limit that the entity elects to use for its operations), the excess deductions will be denied. Conversely, where the debt deductions of the entity's Australian operations do not exceed the maximum allowed, none of these deductions will be denied.

The following possible changes to the thin capitalisation rules were used as the basis for consultation:

- removing the arm's length debt test (for general entities and non-bank financial entities) and the arm's length minimum capital amount (for banks) from the domestic law;
- reducing the safe harbour maximum debt limit for general entities from 75 per cent to 60 per cent on a debt-to-total assets basis (or from 3:1 to a 1.5:1 debt to equity basis);
- reducing the worldwide gearing ratio for general entities and non-bank financial entities from 120 per cent to 100 per cent; and

- increasing the worldwide capital ratio for banks from 80 per cent to 100 per cent.

Treasury's costing of the savings that might be realised through these changes (approximately $300 million per year) was criticised as being too low by stakeholders.

Appendix C: Consultation summary

In accordance with the terms of reference, in arriving at this final report the Working Group has provided the Treasurer an interim report and conducted a mix of public and confidential consultation.

Public submissions made in response to the interim report

The Working Group's interim report on the tax treatment of losses was publicly released on 11 December 2011. The interim report explored the tax treatment of losses in Australia, in particular how this treatment affects Australian businesses' ability to respond to changes in the local economy and developments abroad.

The Working Group invited written submissions from businesses and the wider community on the issues and ideas discussed in the interim report. To assist interested parties in making submissions, some framing questions were provided in a separate consultation guide.

Submissions were requested by 3 February 2012. The Working Group received a total of 24 submissions in response to the interim report including two confidential submissions. Public submissions were received from the following organisations and individuals:

Association of Mining and Exploration Companies
Australand Property Group
Australian Chamber of Commerce and Industry
Australian Financial Markets Association
Associate Professor Dale Boccabella
BDO
BusinessSA
Corporate Tax Association
CPA Australia
Ernst and Young
Grant Thornton
Institute of Chartered Accountants in Australia
Institute of Public Accountants
Master Builders Australia
National Tourism Alliance
Penam Partners
Property Council of Australia
Real Estate Institute of Australia
The Tax Institute
Tourism and Transport Forum
Tourism Accommodation Australia
Yarrawa Management Pty Ltd

The Working Group's interim report on the tax treatment of losses was intended to elicit stakeholder views on reform priorities in this area and help us gain a better understanding of how the current system affects business decision making.

Confidential consultation on possible reforms and savings options

In light of the feedback we received in response to the interim report, the Working Group started to develop more specific reform proposals that could be costed by Treasury. Only in light of this information was the Working Group able to focus on the potential savings task.

Over the course of March 2012, representatives of the Working Group conducted meetings with stakeholders in Melbourne, Sydney, Brisbane and Perth.

The stakeholders consulted were a mix of representative bodies and individual businesses. In light of the Working Group's focus on the corporate tax loss rules, in each location there was an opportunity for members of the Corporate Tax Association to meet with representatives of the Working Group.

The Working Group asked for these meetings to be conducted on a confidential basis to allow discussions between the Working Group and participants to be as open as possible. Given the confidential nature of the meetings, the Working Group does not propose to name all of those involved in the process.

Appendix D: International loss treatment

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
Australia	No	Not applicable.	Indefinite	Change of ownership and activity. • Change of ownership considered as more than a 50 per cent change in voting power, dividend or capital rights. • Ownership tracing concessions apply to widely held companies. • Carve out for companies with a change of ownership that have maintained the same business activity. *Unincorporated businesses.* Loss carry forward permitted for unincorporated businesses. • Losses must be utilised at first opportunity. • Losses may offset non-business income, subject to various restrictions.
Austria	No	Not applicable.	Indefinite	Change of ownership and activity. • Losses can only be carried forward against 75 per cent of current annual income. • Losses will not be transferable if there is a change in the economic identity of the company combined with a modification of the organisational structure, unless the intentions of such modifications are to preserve employment. • Losses will be forfeited in the case of a merger, if the assets through which the losses were originated are not included in the arrangement. *Unincorporated businesses.* Loss carry forward permitted for unincorporated businesses and may be deducted against non-business income.

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
Canada	3 years	*Unincorporated businesses.* Loss carry back permitted for unincorporated businesses.	20 years	Change of ownership and activity. • A change of ownership takes place if there is more than a 50 per cent change in share capital or voting power. • Continuation of 'similar' business activities is generally interpreted as 'of the same general nature or character', and considers factors such as the location of the business carried on before and after the ownership change, nature of the business, nature of the income-producing assets, name of the business, existence of period/s of dormancy, extent to which the original business activities now constitute the income-producing activities of the successor company. • No explicit rules to allow the transfer of losses within a consolidated group. *Unincorporated businesses.* Loss carry forward permitted for unincorporated businesses and may generally be deducted against other forms of taxable income.
Denmark	No	Not applicable.	Indefinite	Change of ownership. • A change of ownership takes place if there is a more than 50 per cent change in share capital or voting power. • Change of ownership rules do not apply to financial enterprises, including banks. • Restrictions on carry forward of losses do not apply for group internal restructurings. *Unincorporated businesses.* Carry-forward of losses permitted for unincorporated businesses and may be deducted against personal income.
France	1 year	Loss carry back period recently reduced from 3 years to 1 year. Loss carry back amount capped at €1 million. Net operating losses that exceed this €1 million cap may offset taxable income in a subsequent year, but will be limited to 60 per cent of that year's taxable income.	Indefinite	Change of activity. • Only 60 per cent of profits in excess of €1million may be offset against losses carried forward. • Losses will be forfeited if there is a "thorough" change in the business or activity of the loss company, regardless of its ownership.

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
Germany	1 year	Loss carry back amount capped at €0.5 million. *Unincorporated businesses.* Extends to sole traders and partnerships.	Indefinite	Change of ownership. • Only €1million plus 60 per cent of the current year profits in excess of this amount will be offset against tax loss carry forward. • Losses will be forfeited in cases where the loss-incurring entity owns less than 50 per cent of shares within five years of the change of ownership and also if predominantly new business assets are injected into such an entity. • A partial forfeiture of losses will result from a 25-50 per cent of shares in a corporation are acquired. • Exceptions exist for other (non-tax) considerations, including allowances for companies that restructured in order to rescue a loss-making company. *Unincorporated businesses.* Loss carry forward permitted for unincorporated businesses and may be deducted from other forms of taxable income, subject to special restrictions.
Ireland	1 year	Business losses incurred in the year of trade being permanently discontinued may be carried-back against profits of the same trade for the previous 3 years. *Unincorporated businesses.* Loss carry back permitted for unincorporated businesses.	Indefinite	Change of ownership and activity. • Change of ownership requires that the same persons that controlled trade in the 1 year before the change in ownership continue to hold a minimum 75 per cent share in trade within the two years after the transfer of ownership. • Restrictions on loss carry forward do not apply for group internal restructurings. • Activity test requires continuation in the nature of the original company's trade including the type of goods, services or facilities provided and the customers, outlets or markets. *Unincorporated businesses.* Loss carry forward permitted for unincorporated businesses, however may only offset profits from the same trade.

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
Italy	No	Not applicable.	Indefinite	Change of ownership and activity. • Change of ownership takes place if there is more than a 50 per cent change in the ownership of the loss entity. Ownership is calculated by multiplying the acquired corporation's stock by the long-term exempt bond rate. • An equity test[38] and vitality test[39] must be passed to be able to use pre-existing losses in the case of a merger. • All ordinary losses incurred after the first three years of business activity are only permitted to offset 80 per cent of subsequent taxable income. • Loss carry forward is forfeited if a change in the main business activity of the company occurs within two years following or preceding the change of ownership. *Unincorporated businesses.* Loss carry forward permitted for unincorporated businesses, however ring-fencing rules deny offsetting against non-business income.

38 Net equity test: allows carry-forward of losses within the limit of the amount of net equity resulting from the balance sheet for the financial year preceding the shareholder resolution approving the merger.

39 Vitality test: the transferring entity's profit and loss account for the financial year prior to the resolution of the merger must show that revenues and labour costs are higher than 40 per cent of the average of the two prior financial years.

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
Mexico	No	Not applicable.	10 years	Change of ownership and activity. • A change of ownership occurs when 50 per cent of the voting shares of a company changes. • Change of ownership rules may not apply in circumstances of inheritance, donation, internal reorganisation, merger and split off that are not considered alienations for tax purposes. • Where a merger is carried out, only the merging company can carry forward the losses it has at that moment, and only for purposes of using them against profits derived from the same trade that originated the losses. • After a change of ownership and activity, a loss carry-forward can only offset profits from the same type of activity that generated the losses if the sum of the receipts derived during the last three years is less than the accumulated losses of the company. *Unincorporated businesses.* Loss carry-forward permitted for unincorporated businesses, however ring-fencing rules deny their offsetting against non-business income.
Netherlands	1 year	Optional 3 year loss carry back for losses from 2009, 2010 and 2011, for remaining losses a loss carry-forward of 6 years (as opposed to 9 years) is allowed. Loss carry back amount capped at €1 million.	9 years	Change of ownership and activity. • Carry forward is denied if more than 30 per cent of original shareholders have disposed of their shares. Broadly, this rule does not apply if the new shareholders already held one third of the shares. • Exceptions permitted in cases where a lack of tax avoidance motive is demonstrated. • Additional restrictions are applicable in the case of holding and group financing companies.
New Zealand	No	Not applicable.	Indefinite	Change of ownership. • A change of ownership occurs if more than 50 per cent of voting rights changes in one year. Ownership tracing concessions may apply. • Losses can be carried forward after an internal group restructuring if continuity and commonality requirements are met. • Loss carry-forward permitted for

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
				unincorporated businesses and may be deducted against other forms of taxable income.
Norway	No	In the case of liquidation a two-year loss carry back is allowed. In addition, a temporary 2 year loss carry back has been introduced for losses from 2008 and 2009. Loss carry back for these years is capped at NOK 20 million per annum.	Indefinite	Change of ownership. • Pre-existing losses will not be recognised in mergers if one of the merging firms already possesses losses, and the merging arrangement is therefore likely to be underpinned by tax-avoidance motives. • Special rules apply to the petroleum sector: carry forward of losses with interest; tax value of losses refundable on cessation of activity; tax value of losses due to exploration refundable annually. *Unincorporated businesses.* Loss carry-forward permitted for unincorporated businesses.
Spain	No	Not applicable.	15 years	Change of ownership. • As of August 2011, temporary changes were enacted for loss carry-forward utilisation. • For the years 2011, 2012 and 2012, a company with a turnover (that is, sales) between €20-60 million is only allowed to offset up to 75 per cent of its taxable income with net operating losses being carried forward • A company with a turnover in excess of €60 million may only offset 50 per cent of its taxable income. • The original 15 year carry-forward period was extended to 18 years. • For newly established companies, the carry-forward period commences as from the first tax year in which profits are made. • Restrictions exist mainly in cases of change of control of dormant companies. • Restrictions on carry-forward of losses do not apply for group internal restructurings. *Unincorporated businesses.* Unincorporated businesses may carry-forward losses against other sources of income under Personal Income Tax regulations.

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
Sweden	No	Not applicable.	Indefinite	Change of ownership. • A change of ownership occurs if there is a change of controlling interest of more than 50 per cent. • After an acquisition of control of a company, the loss carry-forward is deductable only up to 200 per cent of the acquisition price and it is not possible to use the loss carry-forward of the acquired company through group contributions during the first five years after the change of ownership. • Restrictions on carry-forward of losses do not apply for group internal restructurings. *Unincorporated businesses.* Loss carry-forward permitted for unincorporated businesses.
Switzerland	No	One canton (Thurgau) allows a 1 year loss carry back for local taxes.	7 years	Change of ownership and restart of activity. • No restrictions following change of ownership with the exception of special cases, such as the transfer of shares in a non-active company. • Financial restructurings may overcome change of ownership restrictions. *Unincorporated businesses.* Loss carry-forward permitted for unincorporated businesses.
United Kingdom	1 year	Generally one year, however 3 years was permitted for 2008-09 losses. If a trade is permanently discontinued certain losses may be carried back against profits of the same trade for the previous 3 years. Carry back only allowed if the organisation was carrying on the same trade at some point in the preceding 12 months. *Unincorporated businesses.* Loss carry back is permitted for unincorporated businesses.	Indefinite	Change of ownership and activity. • There is a change in ownership if more than 50 per cent of a company's ordinary share capital changes hands. • Losses may only be carried forward against profits of the same trade. • Internal reorganisations may overcome change of ownership restrictions. *Unincorporated businesses.* Loss carry-forward permitted for unincorporated businesses.

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
United States	2 years	Generally 2 years, however due to the global financial crisis, an extension of 5 years permitted for 2008-09 losses. *Unincorporated businesses.* Loss carry back permitted for unincorporated businesses.	20 years	Change of ownership and activity. • Change in ownership occurs if, as a result of changes in the stock of ownership by '5 per cent shareholders' or other reorganisations, the percentage of the corporation's stock owned by those 5 per cent shareholders increases by more than 50 percentage points over the lowest percentage of stock owned by those shareholders at any time during the prior three-year testing period. • Some losses can be utilised if some of the old corporation's historic business is continued. *Unincorporated businesses.* Loss carry-forward permitted for unincorporated businesses.

Source: Table adapted from OECD, Corporate Loss Utilisation through Aggressive Tax Planning (2011), p.34.

Appendix E: Timeline of the changes to the loss integrity provisions

1922-1934	Preceding 4 years of losses can be deducted against income (including exempt income) in the order they occurred.
1944	COT introduced for private companies, no loss will be an allowable deduction unless 25 per cent of the shares were held by the same person at both the time the loss was made and the time of deduction.
1947	Carry forward period of 7 years introduced for primary producers.
1950	7 year carry forward rule extended to all private companies.
1964	COT rules extended to public companies. COT threshold increased to not less than 40 per cent beneficial ownership based on voting power, rights to dividends and rights to capital and applied to ALL companies.
1965	SBT introduced as a concession where there is a COT failure.
1966	The limit of seven years on the carry-forward period for deductions of prior year losses is removed for primary producers.
1973	COT threshold increased to more than 50 per cent beneficial ownership.
1973	A control test and income injection test introduced to add integrity to COT. The COT and SBT are extended to apply to the utilisation of bad debts.
1984	Group loss transfers introduced. Advent of consolidation saw the scope of these provisions greatly reduced.
1985	CGT introduced. COT and SBT must be satisfied to apply prior year capital losses.
1986	Foreign losses no longer offsettable against Australian income, domestic losses no longer offsettable against foreign income.
1990	Unlimited carry-forward losses introduced.
1995	Trust loss rules take effect. Trust loss rules do not apply to the recoupment of net capital losses.
1997	Modifications made to COT to make it easier for certain public companies to recoup losses — Division 166.
1999	As a precursor to consolidation, 'Business Tax Reform' introduces a series of integrity rules to strengthen COT and reduce the opportunity for capital loss creation.
2002	Consolidation introduced. Measures included loss transfer rules, modifications to COT and SBT and recoupment restrictions, and available fraction test. Normal COT and SBT apply following transfer of the loss into consolidated group.