Improving access to company losses

Discussion Paper
July 2012

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CONSULTATION PROCESS

REQUEST FOR FEEDBACK AND COMMENTS

The Government seeks your feedback and comments on the issues outlined in this discussion paper. The information obtained through this process will inform the Government's approach on the way forward and also assist in meeting the requirements of the Office of Best Practice Regulation.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

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Closing date for submissions: Monday, 6 August 2012

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Table of Contents

FOREWORD v

1. BACKGROUND 2

2. TIMELINE 2

3. OUTLINE OF THE CURRENT LOSS RECOUPMENT RULES 2

4. IMPROVING ACCESS TO COMPANY LOSSES — ANNOUNCED DESIGN FEATURES 3
   - 4.1 Limited carry-back period 3
   - 4.2 A $1 million quantitative cap 3
   - 4.3 Available to companies and entities taxed like companies 3
   - 4.4 Refunds limited to a company's franking account balance 4
   - 4.5 Revenue losses only 5
   - 4.6 Integrity rules 5

5. IMPROVING ACCESS TO COMPANY LOSSES — PROPOSED TAX LAW DESIGN FEATURES 7
   - 5.1 Delivery mechanism 7
   - 5.2 Losses eligible for carry-back 7
   - 5.3 Tax liability in chosen eligible profit years 8
   - 5.4 Net exempt income 8
   - 5.5 Choice to claim loss carry-back 9

6. CALCULATING THE LOSS CARRY-BACK TAX OFFSET 9

7. SUMMARY OF PROCESS (DIAGRAM) 10

8. OTHER RULES 11
   - 8.1 No outstanding tax returns 11
   - 8.2 Interest on overpayments and late payments 11
   - 8.3 Amended assessments 11

9. APPLICATION TO CONSOLIDATED GROUPS 12
   - 9.1 Head company current year loss 12
   - 9.2 Joining entity holds current year loss 12

10. DATE OF EFFECT 12

FOREWORD

I am pleased to release this discussion paper on the Gillard Government's proposed loss carry-back initiative. Loss carry-back will help businesses facing pressures in our patchwork economy, reduce disincentives to sensible risk taking and encourage investment and growth.

While our economic fundamentals are strong, Australia's economy is in transition, creating major challenges for many businesses that aren't in the fast lane of the mining boom. In its first four years, this major tax reform is estimated to provide much-needed assistance to nearly 110,000 companies struggling with these challenges of an economy in transition, helping them ride out difficult times and invest for the future.

This new initiative is part of the Government's reforms designed to boost productivity by helping businesses invest and innovate. Currently, businesses are able to carry forward their tax losses to offset future profits and so reduce future tax liabilities. This new initiative will allow businesses to also 'carry back' their losses, to offset past profits and get a refund of tax previously paid on that profit. In doing so, this reform will mean businesses can use their tax losses now — when they need to — rather than in the future when their businesses are performing better.

The introduction of the loss carry-back tax reform implements another recommendation of Australia's Future Tax System review.

Loss carry-back received strong and widespread support at the Government's Tax Forum last year and was developed further in close consultation with business representatives and tax experts through the Business Tax Working Group, which recommended the measure in its *Final Report on the Tax Treatment of Losses*.

This paper sets out the proposed implementation and design details for the loss carry-back initiative, and I encourage all interested parties to participate in the consultation process.

The Hon David Bradbury MP
Assistant Treasurer, Minister Assisting for Deregulation

1. Background

1. On 6 May 2012, the Australian Government announced its intention to introduce a company loss carry-back initiative. The Deputy Prime Minister and Treasurer, in a joint Media Release with the Hon David Bradbury MP (Assistant Treasurer and Minister Assisting for Deregulation) and the Hon Brendan O'Connor MP (Minister for Small Business), noted that the loss carry-back initiative will encourage companies to adapt to changing economic conditions and take advantage of new opportunities through investment.

2. It will also help companies seeking to adjust to the challenges and opportunities of the patchwork economy by improving cash flows and alleviating disincentives for businesses to take sensible risks.

3. Further details of the measure were announced as part of the 2012-13 Budget on 8 May 2012.

4. The company loss carry-back measure will apply to losses arising in the 2012-13 and later income years.

5. The company loss carry-back measure is based on a model recommended by the Business Tax Working Group (the Working Group). The *Australia's Future Tax System Review* also recommended that a company should be able to carry-back revenue losses.

6. The Working Group, chaired by Mr Chris Jordan AO, was established following the Government's Tax Forum in October 2011 to examine what kind of business tax system would best support Australia's future growth prospects.

7. On 13 April 2012, the Treasurer released the Working Group's *Final Report on the Tax Treatment of Losses* (the report). In the report, the Working Group recommended that loss carry-back would be a worthwhile reform in the near term.

2. TIMELINE

8. Feedback and comments are sought on the issues outlined in this discussion paper by Monday, 6 August 2012.

9. Exposure draft legislation (with explanatory material) will be released as soon as possible after consultation on this discussion paper closes. There will be a four week period for the public to comment on the exposure draft.

10. The bill will then be finalised with a view to being introduced into the House of Representatives in the Spring 2012 sittings.

3. Outline of the current loss recoupment rules

11. The existing tax system only allows taxpayers to access the tax value of an expense by using it to reduce taxable income in the year it was incurred or, to the extent that the expense results

in a loss, by carrying the loss forward and using it to reduce future assessable income. This treatment provides some recognition of the tax value of a loss, but no immediate benefit. Moreover, the loss will ultimately have zero tax benefit if it cannot be used to reduce taxable income, such as where the company never returns to a 'tax profit' position or where the application of integrity rules disqualifies it from using the loss in the future. These factors can adversely affect business decision making, by creating a bias against sensible risk taking and investment, because any losses incurred as a result of undertaking an investment may have their value reduced.

4. Improving access to company losses — Announced design features

12. Access to company losses will be improved by introducing a loss carry-back measure to allow companies that have paid tax in the past, but are now in a tax loss position, to choose to claim a refund of some of the tax they have previously paid. This will allow companies to utilise the losses sooner and reduce the risk of never being able to use them.

4.1 Limited carry-back period

13. A one year carry-back period will be allowed for the 2012-13 income year, followed by a two year carry-back period from the 2013-14 income year onwards.

14. This means that a loss carry-back refund will be able to be claimed for the 2012-13 income year against tax paid for 2011-12.

15. From the 2013-14 income year onwards, a loss carry-back refund will be able to be claimed against tax paid for the two years preceding the claim year.

4.2 A $1 million quantitative cap

16. A cap of $1 million will apply in each claim year to the amount of losses that any company can carry-back against taxes paid in previous income years. This design feature means that loss carry-back will particularly benefit small companies, which are relatively disadvantaged by the existing loss utilisation rules. Larger companies are also more likely to conduct a wider range of business activities, such that losses in one activity could be offset against profits from other activities.

17. The maximum potential refund in any year will be the tax value of the cap. With a $1 million cap and a 30 per cent tax rate, this will be $300,000.

4.3 Available to companies and entities taxed like companies

18. Loss carry-back will only be available for companies and other corporate tax entities (which are taxed as companies). This is consistent with the finding of both the Working Group and the *Australia's Future Tax System Review* that loss carry-back should only be available for companies.

19. Section 960-115 of the *Income Tax Assessment Act 1997* (ITAA 1997) defines a ***corporate tax entity*** as:

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

20. In its report, the Working Group noted that the administrative and compliance costs of extending loss carry-back to trusts, partnerships and sole traders would be significant and outweigh the possible benefits.

21. In particular, the report acknowledged that complex and costly compliance arrangements would be required for trusts (other than corporate tax entities) and the trustee would need to be aware of the beneficiary's marginal tax rate and whether the beneficiary had paid tax on the trust distributions. Due to other income sources and deductions, some beneficiaries may fall below the tax free threshold and would therefore pay no tax on trust distributions or pay tax at a lower average rate than their marginal tax rate.

22. A further complication arises for discretionary trusts, as trustees will generally have more discretion about which beneficiaries to distribute to. Therefore, benefits from carry-back may not flow through to the beneficiaries that paid the tax on previous distributions without complex and impractical tracing rules.

23. Businesses operating through a company structure typically face more constraints on their ability to use their tax losses than those operating as sole traders or in partnership, who may offset business losses against other sources of income, such as salary and wages, and are not subject to the continuity of ownership test.

4.4 Refunds limited to a company's franking account balance

24. The maximum amount of the tax value of loss carry-back (currently $300,000) cannot exceed the surplus balance of the company's franking account at the end of the income year for which the loss carry-back is claimed. That is, the tax value of loss carry-back cannot exceed the value of past taxes paid and of franking credits received that have not been distributed to shareholders at that time.

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

26. There will be a debit to the company's franking account balance for the tax value of each loss carry-back, on the day that the refund of tax is applied.

27. Therefore, when claiming loss carry-back, companies should ensure that they will have sufficient franking credits in their account to avoid placing their franking account in deficit and incurring franking deficits tax and penalties.

4.5 Revenue losses only

28. Because taxpayers can time the realisation of capital losses, loss carry-back will be restricted to revenue losses. This is consistent with the recommendation of the Working Group and the *Australia's Future Tax System Review*.

4.6 Integrity rules

29. A company that carries losses forward faces the risk of not passing the loss integrity rules. Loss carry-back helps mitigate this risk because a company can utilise its losses sooner, reducing the risk that it will lose access to its tax losses.

30. Under existing rules, a company's ability to utilise carry-forward losses depends on whether it satisfies the continuity of ownership test or, failing that, the same business test (section 165-10 of the ITAA 1997).

31. In general, the continuity of ownership test is satisfied if the same persons have more than 50 per cent of the company's voting power, rights to dividends and rights to capital distributions at all times during the ownership test period (section 165-12 of the ITAA 1997). The ownership test period is generally the period from the start of the income year in which the loss was incurred (the loss year) to the end of the year in which the loss is sought to be recouped (the utilisation year).

32. The same business test is generally satisfied if the company is carrying on the same business in the loss utilisation year that it carried on immediately before the time it failed the continuity of ownership test (section 165-13 of the ITAA 1997).

33. The key reason for loss integrity rules is to remove an incentive for tax driven activities involving entities with losses. In particular, the continuity of ownership test prevents 'loss trafficking' — that is, purchasing defunct companies or other companies with losses in order to gain a tax advantage.

34. For loss carry-back, the analogous concern is that taxpayers expecting losses for a new venture might seek to gain a tax advantage by conducting the venture through a defunct or other company with both franking credit balances and prior year tax payments.

35. Consequently, integrity rules will be needed to prevent such tax planning arrangements. The Government is interested in your views on what the most appropriate integrity rule would be. Some options are discussed below.

Part IVA

36. One option would be to enact rules in Part IVA (the general anti-avoidance rule in the *Income Tax Assessment Act 1936*) similar to existing sections 177EA and 177EB, which cover schemes involving the sale of shares that are entered into with the dominant purpose of obtaining an imputation benefit.

37. An equivalent rule for the loss carry-back tax offset could say that, if new owners acquire a company for a purpose (other than a merely incidental purpose) of obtaining a loss carry-back tax offset, the Commissioner of Taxation can deny the offset. The provision would not apply

where there was a genuine acquisition of a profitable business. However, in some cases, the purpose of an acquisition might not be clear for some time.

38. Furthermore, Part IVA does not currently cover schemes undertaken with the sole or dominant purpose of obtaining a tax benefit by a loss carry-back tax offset. Therefore, amendments may need to be made to ensure that it applies to loss carry-back tax offsets in the same way as it applies to deductions for carry-forward losses.

39. However, this type of anti-avoidance approach might not be sufficient as a stand-alone integrity rule. In particular, the anti-avoidance rules in Part IVA only apply to a particular arrangement when the Commissioner determines that they should apply to it. Where there are known and identifiable integrity risks, an anti-avoidance approach can prove costly to administer and comply with.

40. However, an anti-avoidance rule could be combined with a stand-alone integrity rule. Any integrity rule that addresses the potential abuse of the loss carry-back arrangements would have to be effective, not overly complex and involve neither taxpayers nor the Commissioner of Taxation facing excessive compliance or administrative costs.

Modified/simplified continuity of ownership and same business tests?

41. Another option for an integrity rule would be to have a modified or simplified continuity of ownership test for loss carry-back similar to the current test used for deducting carry-forward losses. This would provide a symmetrical approach to loss carry-back and carry-forward and would be based on law that companies are already familiar with.

42. Generally under the continuity of ownership test, the test period starts at the beginning of the income year the tax loss arises in and runs to the end of the (profit) year in which the loss is utilised. However, in the loss carry-back scenario, the tax profit year *precedes* the loss year.

43. Accordingly, for loss carry-back purposes, the continuity of ownership test would have to be modified so that the test period runs from the profit year to the claim year. The rules for widely held companies and certain other companies ('eligible Division 166 companies') could be adapted in a consistent way.

44. However, the continuity of ownership test and the same business test are complex pieces of tax law. The *Australia's Future Tax System* review noted that there may be merit in reviewing the continuity of ownership and same business tests to give greater weight to simplicity and certainty objectives.

45. Furthermore, the Business Tax Working Group recommended that Government should consider options for improving the same business test to allow greater scope for businesses to adapt and change in the current dynamic business environment.

46. Given the intention of loss carry-back is to provide greater access to tax losses when companies need it most, simplified integrity rules might be appropriate.

Would an integrity rule based on the continuity of ownership and same business tests be practical?

- *If so, how could the rules be simplified and adapted to loss carry-back?*

– *Should the test period run from the beginning of the profit year to the end of the claim year (modified as appropriate for widely held companies)?*

Are there alternative approaches that would prevent tax driven activities but allow and encourage businesses to reinvest, retrain and retool?

– *How would such a rule rely on something different from the change of ownership and change of business events used in the continuity of ownership and same business tests?*

5. Improving access to company losses — Proposed tax law design features

5.1 Delivery mechanism

47. A loss carry-back measure could be implemented by carrying a tax loss back and using it to reduce the taxable income — and hence reduce the tax liability — for an earlier year, resulting in an amended assessment and a refund of tax.

48. However, as noted by the Working Group, there would be disadvantages with this approach. In particular, additional complexity and compliance costs will arise if unrelated amendments are made to previous assessments. A taxpayer's assessment for the year in which they incurred a loss (the loss year) and claimed loss carry-back might subsequently be amended such that they were not entitled to loss carry-back or were entitled to a larger loss carry-back claim. Correcting this would require re-amending the earlier assessment that had previously been amended in order to claim loss carry-back.

49. Accordingly, it is proposed that loss carry-back be achieved through the use of a refundable tax offset in the claim year. The relevant proportion of the company's tax loss would be converted to a refundable tax offset and paid to the company (subject to satisfying any outstanding tax liabilities).

5.2 Losses eligible for carry-back

50. In simple cases, the 'eligible loss' for loss carry-back purposes will be the 'current year loss' of the claim year.

– A current year loss is a tax loss calculated under ITAA 1997 section 36-10, and basically refers to the amount by which deductions exceed assessable income in a particular income year. This will be the figure returned as a loss at the 'Taxable income or Loss' label of the company tax return.

– A current year loss will therefore exclude amounts treated as losses because of the company having excess franking offsets for that year.

51. In more complex cases, the loss being carried back will be a loss from the year *before* the claim year (it could include a loss from the claim year as well). In this scenario, the loss from the year before the claim year can only be used for loss carry-back to the extent that it has not

been used previously for loss carry-back and is not used as a carry-forward loss to reduce the taxable income of the claim year.

- That is, any part of a current year loss not carried-back in a claim year will be potentially available for loss carry-back again in the following year.
- Allowing unutilised eligible losses to be accessed in this way benefits companies that have a large tax loss in one year only.

52. Loss carry-back will not be available for losses transferred to an entity under Division 170 of the ITAA 1997. This is to ensure that loss carry-back has consistent application between consolidated groups and non-consolidated groups where the loss or income company is an Australian branch of a foreign bank, or a non-bank foreign financial entity.

53. Eligible losses not used for loss carry-back in a claim year will be available to reduce any taxable income in that year or a future year, according to the usual rules for carry forward losses.

5.3 TAX LIABILITY IN CHOSEN ELIGIBLE PROFIT YEARS

54. The company must have had an income tax liability (in terms of subsection 4-10(3) of ITAA 1997) in the 'target' year or years to which the loss is being 'carried back'. That is, the company must have owed income tax for a target year (that is, after the application of any tax offsets against the year's basic tax liability).

55. It is not necessary for that tax liability to have been paid. However, any loss carry-back tax offset will be applied in the usual way to reduce any outstanding tax liability the taxpayer has before a refund would be paid.

56. As noted above, a target year must be either (or both) of the two years that immediately precede the claim year. The exception is where the claim year is 2012-13, in which case the target year can only be 2011-12.

57. If the assessed tax liability is sufficient, two years' worth of carried back losses may be applied against the same target year. This could potentially result in two consecutive claim years each receiving a $300,000 loss carry-back tax offset, where the immediately prior year had a tax liability of at least $600,000.

5.4 NET EXEMPT INCOME

58. Where a loss arises in the claim year, that loss will have been reduced by the amount of the claim year's net exempt income (if any) in the course of determining the amount of the loss (see subsection 36-10(3) of ITAA 1997). Net exempt income is the exempt income of a taxpayer less the extra amounts that would be deductible if the exempt income had been assessable income (see section 36-20). The loss carry-back measure does not alter this normal treatment.

59. Where there is net exempt income in the claim year and there is an unutilised loss in the previous income year, the company will need to apply that unutilised loss against the net

exempt income of the claim year. This reduces the amount of unutilised loss from the previous year available for loss carry-back in the current year.

60. Where a company chooses, in a particular claim year, to apply loss carry-back against a profit year in which the company had net exempt income, the carry-back losses amount for that claim year will be reduced by an amount equal to the net exempt income of that target year before being converted into an offset. The losses so reduced will be treated as utilised and so be unavailable for further loss carry-back or as carry forward losses.

5.5 Choice to claim loss carry-back

61. Claiming loss carry-back will be optional.

62. For any potential claim year, a company will have the option to claim loss carry-back for any current year loss of that year and/or any unutilised current year loss of the previous year. The company can choose to only claim loss carry-back for a portion of a loss.

63. Where both of the immediately preceding income years were profit years, the company will be able to choose to apply a particular eligible loss, or portion thereof, to either or both profit years.

5.6 Applicable company tax rate

64. Where losses are carried forward and used to reduce future taxable income, the tax benefit received at that future date would equal the carry-forward loss utilised times the company tax rate applicable in the utilisation year. That company tax rate could potentially differ from the company tax rate in the year when the loss was originally incurred.

65. For loss carry-back, one possible approach would be to also use the company tax rate for the utilisation year (the claim year) when calculating the tax offset available in the claim year. This would have the advantage of being simpler to apply, as the company would only need to refer to the prevailing company tax rate.

66. Another approach would be to use the company tax rate that applied in the year the loss was originally incurred. This approach would provide a tax benefit equivalent to what would have been enjoyed had the company had sufficient taxable income in the loss year to prevent a loss arising. The option to claim loss carry-back for unutilised losses of the previous year means that the loss carry-back tax offset for the claim year could, under this approach, be calculated using the prevailing company tax rate, the company tax rate of the previous year or a mixture of both.

67. A third approach would be to use the company tax rate that applied in the target year. This approach would provide a tax benefit equivalent to what would be enjoyed under an 'amended assessment' approach. The option to claim loss carry-back against tax paid in either of the two preceding years means that the loss carry-back tax offset for the claim year could, under this approach, be calculated using the company tax rate of either of those two preceding years, or a mixture of both.

Which company tax rate(s) should be used to calculate the loss carry-back tax offset in the claim year?

6. CALCULATING THE LOSS CARRY-BACK TAX OFFSET

68. The loss carry-back tax offset for a claim year will be determined as follows:

1 Identify potentially eligible losses.

2 Eliminate any that do not pass integrity rules (see discussion in section 4.6).

3 Apply the $1 million cap.

4 Reduce the amount by any net exempt income in a target year, to arrive at the 'carry-back losses amount'.

5 Multiply the carry-back losses amount by the applicable company tax rate, to arrive at the figure for the 'carry-back amount'.

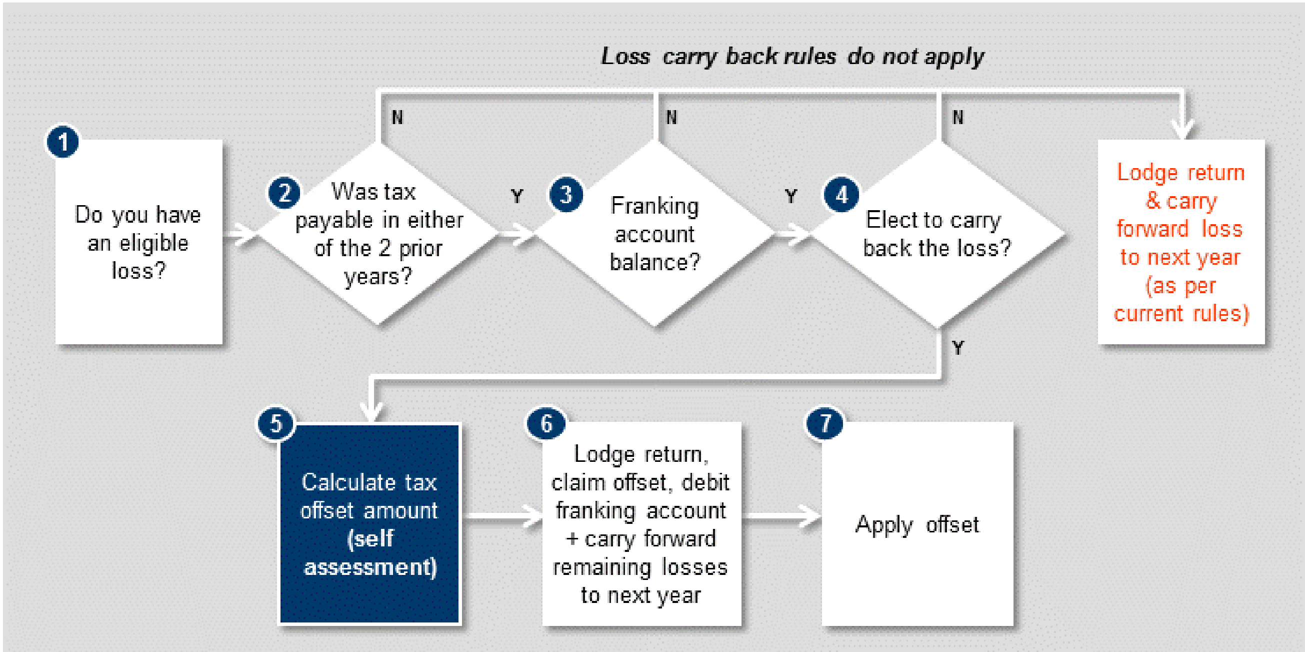
6 The loss carry-back tax offset will be the lowest of:

– the carry-back amount;

– the franking account balance at the end of the claim year; and

– the sum of unutilised tax liabilities in the target years.

7. SUMMARY OF PROCESS (DIAGRAM)



8. Other rules

8.1 No outstanding tax returns

69. To access loss carry-back, tax assessments must have been made for all of a company's prior income years.

8.2 Interest on overpayments and late payments

70. A loss carry-back tax offset will form part of the tax assessment of the claim year. Loss carry-back will neither alter the tax liability of the profit year to which the eligible loss is 'carried back', nor the consequences of a failure to have paid that liability by the due date. It follows then that claiming loss carry-back against a particular profit year cannot:

    – give rise to 'interest on overpayments' in relation to the tax liability assessed for that profit year;

    – reduce any general interest charge arising from a failure to pay the original (or any subsequent amended) assessed liability of the profit year; or

    – reduce any shortfall interest charge in relation to an amended assessment for the profit year.

8.3 Amended assessments

71. A loss carry-back tax offset will be recoverable where a review of a company's tax affairs leads the Commissioner to conclude that the company was not entitled to it.

72. If a company's assessment for a claim year is amended, then:

    – If the amendment results in the company having a reduced loss or no loss (because it increases assessable income or reduces deductions) in the loss year, the amount of the loss carry-back tax offset that the company is entitled to may be reduced (potentially to nil).

    – If the amendment results in the company having an increased loss, the company may qualify for an additional loss carry-back tax offset.

73. If a company's assessment for a target year is amended, then:

    – If the amendment results in the company's tax liability being reduced, this could affect the loss carry-back amount for the claim year and so may require the assessment for the claim year to be amended to provide a lower loss carry-back tax offset.

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

74. If a company did not claim loss carry-back for a year in which it could have, or claimed a smaller amount than it was potentially entitled to, it can seek an amendment of its assessment for that claim year (or potential claim year) accordingly, subject to the usual amendment periods. This includes where an entitlement to loss carry-back arises from or is altered by an amended assessment for the claim year or the target year.

75. In all cases, the company's carried-forward losses pool will be adjusted to reflect the increase or decrease in the amount of loss carry-back used in recalculating the loss carry-back refundable tax offset. Changes to the amount of tax offset will alter the company's franking account at the date on which the amendment is made.

9. Application to consolidated groups

9.1 Head company current year loss

76. Loss carry-back will be available to the head company of a consolidated group or multiple entry consolidated group (MEC group).

77. Where the head company of the consolidated group or MEC group returns an eligible loss, it will be able to choose to carry back such a loss against tax previously paid by the group.

9.2 Joining entity holds current year loss

78. It is not proposed to allow consolidated groups or MEC groups to access loss carry-back in relation to losses brought to the group by a joining entity. To do so would add considerable complexity to the loss carry-back measure. Moreover, to do so would be at odds with the overall principles of the tax consolidation regime.

79. Accordingly, when an entity holding a current year loss joins a consolidated group or MEC group, the group will not be able to carry back the loss against tax previously paid either by the group or by the joining entity.

80. The franking account balance of the joining entity will, under the normal rules, accrue to the head company immediately upon joining. No special restrictions will apply to the group then using those franking credits for loss carry-back purposes.

10. Date of effect

81. The measure will apply from the 2012-13 income year. For companies with substituted accounting periods, this income year will commence either before or after 1 July 2012.