Submission to the Business Tax Working Group into Review of Treatment of Tax Losses

Submission by:

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Business Tax Working Group,

This submission has been lodged one day late. Please accept the submission even though it is lodged after the due date (by 3 February 2012).

There are no restictions on the distribution of this submission to the public.

1. Introduction

This submission is brief and only deals with selected areas. I am happy to expand on the content at a later time if required.

2. Broad Guiding Principle

Businesses that generate losses and passive property investments that generate losses can be held or operated through: (a) the sole trader "structure" (b) partnership structure (c) a trust or (d) a company. The tax rules re losses should, as far as practically possible, seek to minimise the differences of treatment of these "entities" in regard to their losses.

3. Trusts are also Significant Makers of Tax Losses

Given that many businesses operate through trust structures, this review should also deal with tax losses (revenue losses (tax losses) and net capital losses (CGT losses)) housed in trusts. In this regard, there are a number of anomalies in the tax treatmemt of losses of trusts or departures in the treatment from that given to companies. Two headline ones are:

(a) There are no restrictive tests for trusts with net capital losses; and
(b) Most trusts do not have access to the continuity of business test (same business test) as a means of preserving access to losses on failure of a qualifying test (e.g. continuity of ownership (stake)).

There are many more anomalies in the trust loss rules, and there are many within the company loss rules: see the tables at the back of Dale Boccabella, Continuity of Business Tests Facilitate the Transfer of Tax Attributes Under Australia's Income Tax: Technical Issues and Policy Justification

(1999/2000) 15 *Australian Tax Forum* 243 at 347-355 for a summary of the restrictive tests for each type of entity, and the loss savers for each type of test that is breached.

4. Abolition of All Restrictive Rules or Qualifying Rules for Use of Losses housed in Entities

There are a number of concerns here. Those dealt with below are only a selected list of concerns.

First, the removal of loss use restrictions on entities (e.g. continuity of ownership tests, continuity of control tests) effectively means that tax losses can be freely traded between natural person equity owners through an increased sale price of the investment in the entity. While achieved somewhat differently, the same freely traded point can be made in a discretionary trust situation that is not a family trust. A family trust effectively already achieves loss transfers within the "family". The key question is whether the same transferability is going to be available to sole traders (or partners in a partnership)? It is hard to see how it cannot be if unlimited loss transfers housed in entities is permitted. (On this point, it is worth noting that the current rules permit no transfer of the loss of a sole trader; not even 1% of the loss. A natural person holding a loss through an entity can transfer a fairly significant portion of their loss; just under 50%).

Secondly, if unlimited transferability of tax losses housed in entities is to be the rule, the question becomes whether the transferability will extend to other tax attributes of entities. Given that all tax attributes get back to one thing, namely, ultimate tax payable, the case for differential treatment does not appear strong. In addition, the same point can be made in regard to sole traders.

Thirdly, the unlimited transfer scenario must create some [immeasurable] distortionary behaviour in the buying and selling of entities. The presence of tax losses, and the guarantee that the entity will be able to use the losses, must create a buying incentive to potential purchasers, and a selling incentive to potential sellers. If losses are to stay within the entity, distortions may also arise in terms of housing quite distinct businesses in one legal entity.

Fourthly, and probably one of the bigger concerns, is the damage to the integrity of the income tax caused by unlimited transfers of tax losses housed in entities. Obviously, the damage that will be caused is hard to predict. And, it may be that the specialised nature of the tax system and the tax loss regime could limit the damage of the public's perception. However, one cannot avoid the fact that Australia has a history where unlimited transfers was the position and that those "loss trafficking days" generated considerable negative perceptions of the tax system. In the end, and no matter how it is dressed up, purchasing one's way out of an income tax liability (or reduction in liability) must do some significant damage to the public's perception of the integrity of tax system.

Fifthly, unlimited transfers of losses will lead to faster use of losses. The loss to public revenue is obvious.

5. No Convincing Policy Basis for the Loss Saving Effect of the Continuity of Business Test (Same Business Test)

In short, on the premise that a continuity of ownership requirement of around 50% or more is maintained, no persuasive policy basis appears to exist to support the loss saving effect of the continuity of business test. See Dale Boccabella, Continuity of Business Tests Facilitate the

Transfer of Tax Attributes Under Australia's Income Tax: Technical Issues and Policy Justification (1999/2000) 15 *Australian Tax Forum* 243 at 319-344 for an analysis.

6. Loss Carry-Back Regime

On this issue, I incorporate the comments in my article from late last year into this submision: Dale Boccabella, A loss carry-back rule for business losess in Australia: Some initial thoughts, *Weekly Tax Bulletin*, Thomson Reuters, No 47, 11 November 2011 at paragraph 1770.

7. Is there a need for a Substantiation Type Regime for Tax Losses?

It is very clear that many of the tax losses in the system (claimed by taxpayers) are not losses within the law (i.e. they are made up). It is also clear that considerable ATO resources are used in monitoring this issue. Currently, the only relevant rule is the normal onus of proof rule that applies generally throughout the Tax Act to all transactions.

A strong case can be made that tax losses are so considerable and so important to the integrity of the tax system, and so amenable to overclaim or disputation, that a higher "onus of proof" legislative standard ought to be placed on them. The substantiation provisions for work related expenses provides a general precedent.

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