MASTER BUILDERS AUSTRALIA

Submission to the Australian Treasury

Business Tax Working Group

Interim Report on Taxation Treatment of Business Losses

February 2012

Master Builders Australia Ltd ABN 68 137 130 182

building australia

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1 INTRODUCTION

1.1 This Position Statement is made by Master Builders Australia Ltd (Master Builders).

1.1 Master Builders is the peak national association for the building and construction sector in Australia.

1.2 Master Builders' primary role is to champion the interests of the building and construction sector, representing residential and commercial building, and engineering construction.

1.3 Master Builders has more than 33,000 member-companies with representation in every state and territory in Australia, the great majority of which, by number, are small to medium sized enterprises.

1.4 Master Builders' membership consists of large national, international, residential and commercial builders and civil contractors through to smaller local subcontracting firms, as well as suppliers and professional industry advisers.

1.4.1 Membership of Master Builders' represents 95 per cent of all sectors of the building and construction sector.

1.5 The building and construction sector accounts for almost 8 per cent of gross domestic product and more than 9 per cent of employment, in Australia.

2 EXECUTIVE SUMMARY

2.1 The Australian building and construction industry needs a competitive and efficient taxation system, typified by:

2.1.1 taxation scales, rates and burdens which are competitive by international standards;

2.1.2 tax administration which is efficient and does not constitute an unreasonable compliance burden on business taxpayers; and,

2.1.3 at least does impede, and preferably, facilitates dynamic change and rewards entrepreneurial endeavour and risk-taking.

2.2 The building and construction industry is one of the most widely taxed sectors in Australia, and bears a direct and indirect tax burden at all levels of government - Federal, State and Territory, and Local.

2.3 This high and onerous tax burden distorts investment decisions, discourages entrepreneurship and innovation, reduces business investment and employment opportunities, and diverts scarce resources into (unproductive and unnecessarily costly) tax compliance, within a key sector of the Australian economy.

2.3.1 These impacts, in turn, lower housing affordability, increase housing stress and add to the fiscal burden on governments for housing assistance.

2.4 The Business Tax Working Group's (BTWG) Interim Report usefully outlines the broader commercial, economic and taxation issues associated with the tax treatment of losses, canvasing a number of possible reform options, both singularly and in a number of combinations.

2.4.1 While the general thrust and the wider tone of the Interim Report suggests the BTWG recognises meaningful action is required on the tax treatment of losses, it does not make any substantive recommendations for reform (although it does exclude one option, on the basis of likely revenue-cost).

2.5 Master Builders' supports ongoing rigorous analysis of the benefits and costs of the various reform options, singularly and in combinations, for the tax treatment of losses.

2.5.1 However, we reserve our final position on the matter until we have seen and considered the BTWG's concluding report, including its recommendations for delivering the 'offsetting' changes to the business tax system required to meet the Federal Government's conditions of revenue-neutrality within that framework.

3 MAIN RECOMMENDATIONS

3.1 Master Builders':

3.1.1 supports ongoing rigorous analysis of the benefits and costs of each of the options, singularly and in combinations, set out in the BTWG's Interim Report for their impact on businesses (especially smaller business which make up the backbone of the building and construction industry), government revenue and Australia's broader economic performance (most notably international competitiveness and productivity growth);

3.1.2 does not, at present, have any fixed preference for any single or combination of approaches to improving the tax treatment of losses,

3.1.2.1 although at the moment leans towards a combination of applying a loss uplift factor based on the Commonwealth bond rate and allowing loss 'carry back' for a period of two years.

3.1.3 reserves its final position on the outcomes of the BTWG's program of work on the tax treatment of losses until we have seen and considered the 'whole package'

3.1.3.1 that is, its proposals for reform on the treatment of tax losses and the 'offsetting' changes to the business tax system required to meet the Federal Government's condition of revenue-neutrality within that framework.

3.1.4 recognises, for reasons of sound fiscal policy, any changes to the tax treatment of losses should be prospective, that is for losses incurred after a specified date; and,

3.1.5 will be expecting to see in the BTWG's final report on tax losses an expansive narrative and detailed quantitative analyses and modelling, of any proposed reform package, both for their recommended changes to the tax treatment of losses and the 'offsetting savings' elements.

4 OVERVIEW

4.1 The Australian building and construction industry needs a competitive and efficient taxation system, typified by:

4.1.1 taxation scales, rates and burdens which are competitive by international standards;

4.1.2 tax administration which is efficient, and does not constitute an unreasonable compliance burden on business taxpayers; and,

4.1.3 at least does impede, and preferably, facilitates dynamic change and rewards entrepreneurial endeavour and risk-taking.

4.2 The Business Tax Working Group in its "Interim Report on the Tax Treatment of Losses" (BTWG, 2011: v) was correct to point out:

4.2.1 "Australian businesses will need to be responsive to make the most of the opportunities that are available and be flexible to cope with the volatile economic environment.

This will contribute to the re-shaping of Australia's economy, allowing businesses to break into new niche markets and regions, and build on existing and develop new comparative advantages.

Responsiveness will rest on businesses' ability to take risks and to restructure and grow through accessing innovation, technology and a skilled workforce. It is important that all policy settings, including tax, are designed so as not to hinder such risk taking and innovation."

4.3 Regrettably, according to the World Economic Forum's Global Competitiveness Report for 2011/12, taxation issues constituted two of the top six most problematic factors for doing business in Australia.

4.3.1 'Tax rates' was rated equal second most problematic issue (by 12.3 per cent of survey respondents); and,

4.3.2 'Tax regulation' was rated sixth most problematic issue (by 8.0 per cent of survey respondents).

4.4 In short, the business tax system in Australia, whether in terms of the tax burden and/or the compliance processes, are a disincentive to doing business in Australia.

4.5 Building and construction is one of the most widely taxed sectors in Australia, and bears a direct and indirect tax burden at all levels of government - Federal, State and Territory, and Local.

4.6 This high and onerous tax burden distorts investment decisions, discourages entrepreneurship and innovation, reduces business investment and employment opportunities, and diverts scarce resources into (unproductive and unnecessarily costly) tax compliance, within a key sector of the Australian economy.

4.6.1 These impacts, in turn, lower housing affordability, increase housing stress and add to the fiscal burden on governments for housing assistance.

4.7 The building and construction sector is also one of the most cyclical in the Australian economy.

4.7.1 Analyses by Master Builders' indicates cycles in the building and construction sector are around twice those of the wider business cycle – that is, the amplitude of the peaks/troughs and troughs/peaks for the building and construction sector is double that of the Australian economy as a whole.

4.8 Master Builders' National Survey of Building and Construction for the December Quarter of 2011 found builders are currently experiencing poor trading conditions, with expectations of further declines therein over the coming six months.

4.8.1 Key metrics of business conditions and prospects in the building and construction sector – potential-buyer traffic and enquiries through display centres, as well as sales and profits – are generally headed in a downward direction.

4.8.2 Anecdotal evidence offers no advance signal as to when this deterioration in business conditions and expectations is likely to 'bottom out', suggesting the decline the sectoral activity still has some time to run.

4.9 Against this background, the building and construction sector has a substantial interest in improving the taxation treatment of business losses.

5 TAX TREATMENT OF LOSSES

5.1 While the underlying objective of businesses is to make sustained (and ideally growing) profits, from time-to-time, for a variety of reasons (eg re-orientation or restructuring of the enterprise, or adverse trading conditions), they may make trading losses which can be taken into account for taxation purposes.

5.1.1 In simple terms, a tax loss occurs when the taxpayer's allowable deductions exceed their tax-assessable income for a given year – that is, they have negative taxable income.

5.1.2 In this situation, the taxpayer cannot utilise the allowable deductions as they do not have enough assessable income in that given year to absorb them.

5.1.3 Such losses can either be 'carried forward' into future tax years (when the taxpayer can offset them against taxable profits) or they can become 'trapped' in the enterprise (where it makes ongoing losses) essentially evaporating if the business fails.

5.2 Australian taxation law currently allows for the offsetting of business tax losses against taxable income. However, the taxation treatment of such losses is asymmetric – it does not pay the tax value of losses to taxpayers on an accruals basis:

5.2.1 At present, taxpayers pay tax to the government on their positive taxable income, but the government does not make payments to taxpayers on their negative taxable income;

5.2.2 However, Australian taxation law does permit tax losses to be 'carried forward' to be deducted against assessable income in future years.

5.3 The current arrangements for the 'carry forward' of losses have both benefits and limitations.

5.3.1 The benefits include the capacity of generally profitable business experiencing temporary, adverse trading conditions or undertaking a substantive re-orientation or restructuring of the enterprise to offset such expenses against their taxation liabilities in future years of positive taxable income.

5.3.2 The limitations include the so-called ‘integrity rules’ which are designed to regulate access to losses where there has been a substantial change in company ownership (the ‘change of ownership’ test; COT) or in the type of commercial activity undertaken by the business (the ‘same business’ test; SBT).

5.3.2.1 The ‘continuity of ownership’ test (COT) focuses on whether the economic owners of the business which incurred the losses are the same ones who are able to gain the tax benefit from that loss;

5.3.2.2 The ‘same business test’ (SBT) allows companies which fail the COT to use their tax losses if the business is carrying on the ‘same business’ as that which incurred the losses.

5.4 While Master Builders’ recognises the importance of ensuring the processes for the treatment of tax losses are not subject to abuse, we also underscore the potential for the current arrangements to act as a disincentive to entrepreneurship and innovation, and through them support improvements in productivity and international competitiveness.

5.4.1 As the BTWG (2011: v) correctly observed: *“… the current treatment of losses restricts business cash flow, which in turn reduces the ability for business to invest and can impact on its ability to access debt and equity. These impediments to risk taking, investment and innovation impose a cost on the economy through detracting from productivity growth.”*

5.4.2 And, further (BTWG, 2011: 6): *“It is … increasingly important that the tax system does not impose barriers to businesses adapting and changing in response to the current economic environment or encourage businesses to pursue or maintain sub-optimal strategies.”*

5.5 The BTWG (2011: vi) was also correct to note any changes to the tax treatment of losses will need to balance a number of competing objectives.

5.5.1 The BTWG records these objectives are their impact on government revenue, the nature and incidence of tax-related distortions on business decision-making, and the integrity of the tax base.

5.5.2 Master Builders' would add to this list of objectives their potential to contribute toward improving the post-tax returns for entrepreneurship and innovation (and through them productivity), and the capacity of firms (especially small to medium sized business) to sustain adverse movements in the business and economic cycles.

6 FOUR OPTIONS FOR REFORM

6.1 The BTWG in its Interim Report (BTWG, 2011) presented, and discussed, four potential approaches to improving the tax treatment of trading losses. These were:

6.1.1 amending the current integrity rules which restrict access to losses;

6.1.2 allowing the immediate refundability of losses;

6.1.3 permitting losses to be 'carried back' and offset against previous years' profits; and,

6.1.4 allowing losses carried forward to be 'uplifted' by a pre-determined rate of adjustment.

6.2 The BTWG, however, rejected the option of allowing the immediate refundability of losses, pointing out while this approach would likely overcome the asymmetries in the tax treatment of profits and losses, and the distortions arising therefrom it would likely involve a substantial loss of revenue, and hence would not be considered further.

6.2.1 Master Builders' however notes immediate refundability of (excess tax) is practiced within the Goods and Services Tax (GST) system, under which taxpayers are (reasonably) promptly refunded the amount by which input GST exceeds output GST.

6.2.2 As such, it would appear the Federal Government has accepted the principle of immediate refundability for taxation purposes, but does not accept its practical application in the area of business losses.

6.3 The identification of the preferred approach to reforming the tax treatment of losses is not a one dimensional challenge – that is, just identifying and then implementing the 'best' option. Rather, any reform proposal will need to have three elements, namely:

6.3.1 determining the best approach for improving the tax treatment of losses (most likely a single or some combination of the three remaining options, absent another alternative being presented);

6.3.2 identifying offsetting 'savings' 'from the business tax system to achieve the revenue-neutrality required by the Federal Government; and,

6.3.3 an objective, rigorous and transparent assessment of the costs and benefits of the overall package of reforms, that is the proposed reforms to the tax treatment of losses compared to the 'offsetting' changes to the business tax system.

6.4 Master Builders' notes the BTWG in its Interim Report did not address the (challenging) issue of identifying 'offsetting savings', holding over the matter to its final report.

6.4.1 While this approach is understandable given the interim nature of the first report, the complex issues and the tight-time frames involved

6.4.2 **Master Builders' will be expecting to see in the BTWG's final report on tax losses an expansive narrative and detailed quantitative analyses and modelling, of any proposed reform package, both for preferred changes to the tax treatment of losses and the 'offsetting savings' elements.**

6.5 We now turn our attention to consideration of the three remaining options for reform presented by the BTWG, namely:

6.5.1 amending the current integrity rules which restrict access to losses;

6.5.2 permitting losses to be 'carried back' and offset against previous years' profits; and,

6.5.3 allowing losses carried forward to be 'uplifted' by a pre-determined rate of adjustment.

6.6 <u>Amending the current integrity rules which restrict access to losses</u>

6.6.1 this option would involve the removal of the change of ownership (COT) and the same business (SBT) tests, allowing a company to carry forward its tax losses regardless of a change of ownership or in the nature of the business undertaken;

6.6.2 Such an approach would be particularly beneficial for smaller firms who

6.6.2.1 tend to be more likely than larger firms to experience a change of ownership and/or change the nature and direction of the enterprise, and

6.6.2.2 would likely obtain greater commercial advantage from the resulting liberalisation of capital and cash-flow, which in turn could be used more productively to assist in the structural adjustment, or sustainability, of the enterprise.

6.6.3 However, the BTWG (2011: 17) cautions such an approach could be vulnerable to abuse by globally mobile businesses, and could involve a substantial risk to revenue.

6.7 <u>Permitting losses to be 'carried back' and offset against previous years' profits</u>

6.7.1 This option would permit companies to 'carry back' current year tax losses for offset against previous year's profit, thus producing a refund of tax previously paid. This arrangement would effectively cap the maximum refund for any particular year to the taxes paid in the previous/past income year/s.

6.7.2 Such an approach would be beneficial to companies looking to undertake a sizeable capital investment, which may result in a short term trading loss for taxation purposes, and for those experiencing trading difficulties due to a downturn in the business and/or economic cycle.

6.7.3 It would also likely facilitate an improvement in tax compliance, given tax losses could only be offset against tax previously paid (that is, for whom the previous income year's tax assessment has been finalised).

6.7.4 The duration of 'carry back' period could, theoretically, be open ended, but the BTWG (2011: 21) observes a two or three year 'carry back' period would improve its utility for companies and have a 'smoothing' impact on the tax treatment of business.

6.7.5 A longer carry back period would also benefit companies undertaking large capital investments (relative to their past growth strategies) and/or experiencing longer-than-expected downturns in trading conditions.

6.8 Allowing losses carried forward to be 'uplifted' by a pre-determined rate of adjustment

6.8.1 While the current 'carry forward' arrangement allows current tax losses to be offset against future income, the value of such losses are not indexed for inflation and so their real value erodes with time.

6.8.2 An uplift factor (either the rate of inflation, or the long-term (ten year) Commonwealth bond interest rate) could be applied to the value of the tax losses to at least maintain their real value.

6.8.3 Such an approach would lower the effective tax rate on investments which have the potential to result in tax losses in the short-term but which are likely to generate longer-term returns – that is, have long lead times between up-front capital costs and resulting taxable revenue streams.

6.8.4 It would also benefit, in particular, 'start up' businesses, and those engaged in larger and/or higher risk capital investments, as well as providing additional incentives for government to economic policies more consistent with price stability (eg labour market reform and higher productivity growth).

6.9 The BTWG Interim Report also recognises these approaches are not necessarily mutually exclusive, and could be pursued in one or more possible combinations. Options explored by the BTWG include:

6.9.1 removing the 'change of ownership' and the 'same business' tests, and allowing loss carry back;

6.9.2 removing the 'change of ownership' and 'same business' tests, and applying loss uplift factor; and,

6.9.3 removing the 'change of ownership' and 'same business' tests, applying loss uplift factor, and allowing loss 'carry back'.

6.10 Another combination could be added to this list, namely applying a loss uplift factor and allowing loss 'carry back'.

6.11 Against this background, **Master Builders':**

6.11.1 supports ongoing rigorous analysis of the benefits and costs of each of the options, singularly and in combinations, set out in the BTWG's Interim Report for their impact on businesses (especially smaller business which make up the backbone of the building and construction industry), government revenue and Australia's broader economic performance (most notably international competitiveness and productivity growth);

6.11.2 does not, at present, have any fixed preference for any single or combination of approaches to improving the tax treatment of losses,

6.11.2.1 although at the moment leans towards a combination of applying a loss uplift factor based on the Commonwealth bond rate and allowing loss 'carry back' for a period of two years.

6.11.3 reserves its final position on the outcomes of the BTWG's program of work on the tax treatment of losses until we have seen and considered the 'whole package'

6.11.3.1 that is, its proposals for reform on the treatment of tax losses and the 'offsetting' changes to the business tax system required to meet the Federal Government's condition of revenue-neutrality within that framework.

6.12 The BTWG also usefully discussed the scope of the tax losses to which any new arrangements could apply. The most important issue in this regard was whether the new arrangements should apply to:

6.12.1 accumulated tax losses (that is, those pre-existing before a specified date); or,

6.12.2 only to those tax losses incurred after a specified date.

6.13 The BTWG (2011: 26) favoured the second option, applying any new arrangements to tax losses incurred after a specified date (that is, not altering the tax treatment of existing, accumulated losses), pointing out:

6.13.1 *"…any reforms to the tax treatment of losses should only apply prospectively, given that the primary aim of the reforms to the tax treatment of losses is to improve productivity by improving decision making in the economy and delivering tax relief to struggling businesses (without distorting existing business decisions based on current tax law). That is, reforms would only apply to new losses, as the reforms are targeted at removing distortions on future decision making …"*

"Given that there is currently $170 billion worth of accumulated tax losses in the tax system, any retrospective application of the reforms would also come at a substantial cost to Government revenue and represent a substantial cost for the Government."

6.14 Master Builders' recognises, for reasons of sound fiscal policy, any changes to the tax treatment of losses should be prospective, that is for losses incurred after a specified date.

7 BIBLIOGRAPHY

Business Tax Working Group (2011), *"Interim Report on the Tax Treatment of Losses",* Australian Treasury, Canberra