The Institute of
Chartered Accountants
in Australia

3 February 2012

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

email: BTWG@treasury.gov.au

Dear Patrick,

INTERIM REPORT ON THE TAX TREATMENT OF LOSSES

The Institute of Chartered Accountants in Australia (the Institute) welcomes the opportunity to comment upon the issues and ideas canvassed in the Business Tax Working Group's (BTWG) interim report on the tax treatment of losses which was issued on 11 December 2011.

As Australia prepares to fully embrace what is widely regarded as the dawn of the 'Asian Century', and stakes its claim as a major economy in the developed world, it will become increasingly more important that our tax system is calibrated to the globalised marketplace in which we now operate. The tax system can be used as a highly effective lever to assist businesses to make the necessary transition to a high technology environment where competitive advantages play a major role in determining success.

Alternative proposals to improve productivity

The proposals regarding the tax treatment of losses alter a significant part of the tax system, and may improve Australia's productivity. However, there are also alternative mechanisms that can be used to improve Australia's productivity through the tax system. These alternative mechanisms may be able to be implemented across a broader range of taxpayers and at a reduced cost to government revenue. The Institute believes that the following options are deserving of further consideration by the BTWG as mechanisms to encourage the development of businesses:

- Reducing the corporate tax rate which could be funded by the reduction in the number of business tax concessions; and/or
- Allowing small businesses the ability to have an entity flow through tax regime – this would substantially simplify the tax system and provide benefits to those organisations that most need assistance with restructuring their businesses to meet the challenges and opportunities of an Asian century.

More details and consultation required

Given the magnitude of the issues contained in this interim report relating to tax losses and the treatment of expenditures, the Institute is concerned that vital information regarding the proposals has not been released and that the consultation process has been constrained by occurring during the Christmas/New Year break when many people are on holidays. The Institute is also concerned that in just over a month, the BTWG is required to consider all submissions, conduct and analyse costing scenarios and devise final recommendations without any further consultation.

GPO Box 9985
in your capital city

Customer Service Centre
1300 137 322

NSW
33 Erskine Street
Sydney NSW 2000
Phone 61 2 9290 1344
Fax 61 2 9262 1512

ACT
L10, 60 Marcus Clarke Street
Canberra ACT 2601
Phone 61 2 6122 6100
Fax 61 2 6122 6122

Qld
L32, 345 Queen Street
Brisbane Qld 4000
Phone 61 7 3233 6500
Fax 61 7 3233 6555

SA / NT
L11, 1 King William Street
Adelaide SA 5000
Phone 61 8 8113 5500
Fax 61 8 8231 1982

Vic / Tas
L3, 600 Bourke Street
Melbourne Vic 3000
Phone 61 3 9641 7400
Fax 61 3 9670 3143

WA
Ground, 28 The Esplanade
Perth WA 6000
Phone 61 8 9420 0400
Fax 61 8 9321 5141

In particular, the Institute is concerned about the potential for the BTWG report to be used as a basis for formulation of 2012 Federal Budget, the risk that policy decision may be made without properly weighing the implications of the potential policy options, and the risk of such accelerated policy options leading to decisions about other revenue replacement policy changes to the business tax system.

The importance of maintaining a revenue neutral package is recognised by the Institute. However, in the absence of details regarding the magnitude of the costing associated with each of the tax loss proposals and the lack of detail regarding possible revenue raising measures to counter potential revenue losses, it is difficult to provide a definitive view regarding the direction and priorities that the tax loss proposals should take. To enable more meaningful consultation, we encourage the BTWG to release and allow consultation to occur regarding:

- details of how tax losses are currently allocated between years, types of losses, business sizes and industries;
- the costing of each tax loss proposal (along with an explanation of how they were compiled and their assumptions – for example, does the costing take into account possible offsetting revenue from the economic efficiencies of the proposal), and
- details regarding possible revenue raising measures that are being considered to offset the cost of the tax loss proposals.

The Institute would be pleased to participate in any further analysis.

Views on the tax loss proposals

Given the lack of information concerning the cost of the proposals and the possible methods of offsetting the cost, the Institute cannot provide a firm view regarding the desirability of the loss proposals. Subject to being provided with greater information concerning the cost and impact of the loss proposal and the associated revenue raising measures, the Institute does have the following comments regarding the tax loss proposals:

- Loss refundability – The Institute agrees that this option should not be pursued due to its expected high cost to revenue.

- Removal of the existing continuity of ownership test (COT) and the existing same business test (SBT) and replacing them with an alternative integrity test – This is worth exploring further provided that there are also simplifications made to the existing tax loss rules for existing tax losses.

  The existing COT and SBT are overly complex and, in the opinion of the Institute, could be substantially simplified without a significant cost to revenue. If this proposal is implemented without changes to the treatment of existing tax losses, then taxpayers will bear substantial compliance costs due to the need to comply with multiple tax rules for losses.

- Loss carry back – In the medium term, further analysis of the merits of a limited loss carry back regime for small business should be carried out.

- Loss uplift – subject to obtaining further details of the costing, it is the Institute's view that it is unlikely that, for most taxpayers, the benefits of providing loss uplift will substantially exceed the associated compliance costs. Accordingly the Institute does not recommend proceeding with this approach.

- The only combination of measures that may be worth pursuing is the removal of COT and SBT and the allowance of a loss carry back.

- The BTWG should consider closer alignment of the rules for the treatment of revenue and capital losses.

- Type of entity **-** The interim report is concerned only with company tax losses. Ideally the type of entity in which business is conducted should not affect the treatment of losses. Accordingly the Institute recommends that the BTWG takes into account the current reviews of trusts and small business taxation with a view to ensuring that there is not a significant dichotomy of treatment based on entity alone.

- Black hole provisions – the Institute encourages the BTWG to further explore the possibility of writing off black hole expenditure (other than expenditure related to shut down) over a shorter period of time.

These issues are discussed further in the attached submission.

We would be pleased to discuss any aspect of this submission with you. If you have any queries please contact me on 02 9290 5623.

Yours sincerely

Yasser El-Ansary
Tax Counsel
The Institute of Chartered Accountants in Australia

Submission

1. Strategic overview

Whilst the asymmetrical treatment of tax losses may create a bias against risk taking in the economy and restricts business cash flow which in turn reduces the ability to invest and can impact on its ability to access debt and equity; removing the asymmetrical treatment could come at a great cost to the Australian government. Not only could it reduce the amount of revenue available to the government, it could make the revenue supply more volatile and encourage multinational companies to shift loss making activities into Australia.

The Institute recommends that the BTWG consider the following proposals to improve the productivity of Australia which may have a broader impact on taxpayers at a smaller financial cost to government:

- Reducing the corporate tax rate (which is the next BTWG project); and
- Allowing small businesses to use an entity flow through tax regime.

Reducing the corporate tax rate

There have been numerous studies indicating that capital is far more responsive than labour supply to tax cuts. Economic theory suggests this is true for all economies over long periods of time, but is particularly (and increasingly) true as capital becomes increasingly mobile in the global economy. The Institute is attracted to what we understand is the next project for the BTWG, to reduce marginal tax rates for companies. Many features of our current tax system have their genesis in market failures or specific government policies that either no longer exist or are no longer consistent with our desire to be a modern open market economy. A review of the current tax concessions that are embodied in the tax legislation, with a view to eliminating those tax concessions which are no longer appropriate or which unduly bias investment, could identify substantial revenue savings and also simultaneously improve the economic efficiency of the tax system. The revenue savings from this review could fund a reduction in the corporate tax rate.

Entity flow through tax regime for small business

The Australian economy is in the midst of a major structural shift. The small business market is the cornerstone of this transformation; given the significant role the sector plays in the engine-room of numerous industry sectors, and as the leading employer of workers across the economy.
The tax system that applies to the small business market should therefore facilitate, not hold back, business activity that precipitates the economic transition. This ideal can be realised by ensuring:

- The tax system does not divert resources and capital away from their most economically-desirable use through inefficient tax concessions
- A reduction of transaction taxes which impede the remobilisation of assets, such as stamp duty
- There is sufficient flexibility built into the tax system to facilitate the structural adjustment that needs to be made by small businesses through re-skilling and re-training of labour resources.

In addition, allowing micro small businesses (generally, entities that consist of five or fewer members) to access an entity flow-through taxation system would help to ensure that individuals who have suffered an economic loss are not required to pay tax simply because of the choice of legal structure adopted in respect of their business activities. This approach more closely aligns the individual business owners with the business entity itself.

Aside from being more equitable, this system would effectively arrest the increase in compliance costs faced by countless micro small businesses. The introduction of an entity flow-through regime would render complex provisions dealing with discretionary trusts, dividend imputation, loss recoupment and Division 7A all redundant for relevant businesses. This flow-through concept was discussed in greater detail in the April 2008 thought leadership paper prepared by the Institute and Deloitte (Entity flow through submission) which is attached as Appendix A.

2. Tax loss proposals

Subject to being provided with greater information concerning the cost and impact of the loss proposal and the associated revenue raising measures, the Institute makes the following comments regarding the tax loss proposals:

Loss refundability

> *"While the potential benefits of immediate refundability would be significant, so would the potential costs. The working group also notes that no other jurisdiction offers immediate refundability of tax losses....[As a consequence,] the working group does not propose immediate refundability as a viable option for the foreseeable future." (paragraphs 101-102 of the BTWG Interim report on the tax treatment of losses)*

The Institute shares the concerns of the BTWG regarding loss refundability and agrees with the BTWG's conclusion that this option should not be pursued further at this point in time due to its expected impact on Government revenues.

Remove COT and SBT

> *"Removing the COT and SBT would increase the potential for a company to use its carry forward losses to reduce its current year taxable income, regardless of whether it experiences a change in ownership or a change in the nature of the business it conducts. This means that, for example, companies that seek new equity partners, restructure their ownership arrangements, embark on new commercial ventures and cease unviable or unprofitable components of their business, would not be denied access to past tax losses." (paragraph 75 BTWG interim report on the tax treatment of losses)*

Subject to understanding the cost associated with this proposal and the associated revenue raising measurers, the Institute supports the BTWG exploring this option further. It has the potential to stimulate productivity through enabling companies to introduce new technology and methods without threatening the utilisation of their losses as well as removing barriers to M&A activity and restructuring.

Before considering alternative loss tests, the Institute is of the opinion that a review of the existing integrity tests is warranted as it may be found that the existing integrity tests are sufficient – particularly if a dominant purpose test is being considered.

If it is considered that an additional integrity test is required, then the available fraction rule may be worth pursuing. A disadvantage of the available fraction rule is that the costs and ambiguities associated with obtaining market valuations (which can result in lengthy tax disputes) can be substantial. To reduce such costs, it is recommended that consideration also be given to allowing use over a straight line basis, say three to five years. Such an approach is similar to that used for certain COT losses on consolidation in the transitional period.

The Institute notes that the US has, for acquired companies where there is not a significant continuity of ownership, an alternative drip feed rule utilising the losses up to an annual limit calculated by applying a statutory rate to the market value of the loss company, contained in the US 'section 382' rules. However, this US rule has similar issues to using the available fraction method as it also requires potential extensive costs of compliance from obtaining market valuations.

Application to current losses

Currently, the BTWG propose that any changes to the tax loss rules will only apply to prospective tax losses. This is based on the view that the reforms aim to affect future not past decision making. However, this does not recognise that some businesses are locked into inefficient business structures due to the restrictive nature of the existing SBT and that future business decisions can be affected by accumulated losses.

It is understood that with $170 billion worth of accumulated losses in the tax system (paragraph 143 of the BTWG interim report on the tax treatment of losses) that applying the reform proposals to existing tax losses could be prohibitively expensive from a government revenue perspective. However, not to simplify the existing tax system for the utilisation of losses will dramatically increase complexity for taxpayers who will be required to apply two different sets of rules for a period of 20 years or more.

It is recommended that due to the complexity that can be generated by two taxation systems operating simultaneously and the recognition that future decisions can be affected by existing losses, that the BTWG allocate substantial resources to the consideration of how the existing tax system can be simplified and how existing tax losses could be 'drip feed' into the new system. In particular consideration should be given to ensuring the multiple share class provisions operate appropriately and to relaxing the SBT.

Loss carry back

> *"Loss carry back would allow companies to carry current year tax losses back to be offset against previous year's profits, resulting in a refund of tax previously paid. As such, loss carry back is limited to the taxes paid in previous income years. That is, the maximum refund under a one-year loss carry back would be the taxes paid in the previous income year." (paragraph 102 BTWG interim report on the tax treatment of losses)*

A reconsideration of our existing tax loss rules has merit across all taxpayer segments. However, small businesses in particular can be disproportionately impacted, relative to larger businesses by periods of stagnate and negative economic growth where cash flows can be difficult to manage as part of the process of 'smoothing' the effects of economic cycles. The ability of small businesses to claim back a portion of tax payments previously remitted to the ATO would play a major role in assisting business owners in periods of financial hardship.

A limited form of loss carry-back for small businesses would seemingly represent a positive policy initiative that is not likely to carry prohibitive costs to government revenues and therefore further analysis of the merits of this policy should be undertaken in the short-term.

We recommend a period of two years carry back. This will provide taxpayers with better smoothing than only a 1 year period but would still reduce volatility in tax collections compared to a longer period.
We agree that the loss carry-back could be limited to the franking account balance of the company. However mechanical issues including with the timing of tax payments, impact of prior year amendments and the operation of the franking account rules (including the potential application of integrity measures and other potential adjustments) will need to be addressed.

The alternative to limit the carry-back to a percentage or other portion of the loss should not be adopted as this would increase compliance costs and would potentially create inequities between taxpayers.

Any limitation of the carry-back to small business taxpayers will require further consideration of how eligibility is defined. The current Division 328 of the ITAA 1997 small business entity rules (assets less than $6 million, turnover less than $2 million) would not be appropriate. The use of other broader current measures or the development of a more representative definition for small to medium taxpayers, including entrepreneurs and innovators, should be explored.

Loss uplift

> *"The uplifting of tax losses in the absence of other reform options would not increase tax loss utilisation. However, it would increase the value of the tax loss that is utilised to reduce taxable income in the income year in which the tax loss is utilised and therefore impact on the ultimate amount of tax payable." (paragraph 125 of the BTWG interim report on the tax treatment of losses)*

This option may initially appear appealing as from a government perspective it is relatively easy to implement at a relatively small cost and it gives the impression that action is being taken to improve Australia's productivity. From a business perspective, this measure adds to the complexity of the tax system and compliance costs without substantially providing any benefit. Subject to the provision of further information about costing, the Institute's initial view is that this option should not be pursued any further.

It is acknowledged that businesses with long lead times between up-front capital costs and revenue could benefit from this proposal. However there are already a number of tax concessions for businesses within this category. For example, benefits would flow to projects such as infrastructure projects with a long construction and shake-down period until revenue arises. However this sector is being addressed in the current Treasury examination of exempting certain infrastructure projects from COT and SBT and indexing their losses. It is also acknowledged that major projects such as mining projects in new corporations (without other revenue sources in the same company) would benefit; but the financing and structuring of mining projects is usually planned to accommodate these tax issues, where investors have their own taxable incomes.

Should the BTWG, contrary to our recommendation, continue to progress this issue we strongly recommend that detailed consideration be given to which industries are most likely to benefit from this proposal and what tax concessions can already be accessed by these industries to ensure that the tax system is not inadvertently introducing an investment bias or operating in a manner that is inconsistent with other government policies.

Interaction with dividend imputation

The Institute notes the interaction of losses reform proposals with dividend imputation is relevant in the costing of the proposals.

To the extent that utilisation of tax losses is improved, then lower corporate tax revenues will mean that companies will have less franking credits relative to accounting profit and will therefore be more likely to pay unfranked dividends to their domestic shareholders. It also means that companies are likely to generate greater permanent differences in their deferred tax balances.

This means that increased use of losses in domestically-owned companies will be offset eventually by higher taxes paid at the shareholder level. This issue is relevant for the costing of any reforms and the development of offsetting tax revenue measures.

Possible combinations of loss reforms

The report posits three possible combinations of tax loss reform, namely:

- Remove COT and SBT and allow carry back
- Remove COT and SBT and apply loss uplift
- Remove COT and SBT and apply both carry back and loss uplift.

The Institute does not support further work on the loss uplift proposal at this time. As a consequence, the only combination that may be worth pursuing from an Institute perspective is the removal of COT and SBT and the allowance of carry back.

Black hole expenditure

> *"The black hole provisions provide taxation relief for the costs incurred by businesses considering changes to the way they do business; for example, firms undergoing structural adjustment process may incur expenses in order to explore new business opportunities, put in place new business strategies or shutdown parts of the business." (paragraph 150 BTWG interim report on the tax treatment of losses)*

Allowing black hole expenditure (other than shut down costs) to be recouped in a shorter period of time than the current five years under section 40-880 of the ITAA 1997 is supported by the Institute. Such an approach would assist businesses in making the strategic and structural adjustments that are required in Australia's changing economy.

There are also other opportunities for the current black hole expenditure rules to be improved. These include:

- Reviewing the tax treatment of some types of expenditure to ensure that it is appropriate. For instance, whether the amount should be able to be written off under section 40-880 rather than being added to the cost base of a CGT asset.
- Having an express statutory clarification to ensure that section 40-880 acts as a provision of last resort for business-related capital expenditure not otherwise recognised for income tax purposes.

Type of entity

The interim report is concerned only with company tax losses. Ideally the type of entity in which business is conducted should not affect the treatment of losses.

Many businesses (and, in particular, small businesses) often operate through a combination of company and trust structures; accordingly, making it easier for businesses to access/use tax losses in companies without also enabling easier access/use by businesses of tax losses in trusts will only address part of the tax loss problems currently faced by businesses

Accordingly the Institute recommends that the BTWG takes into account the current reviews of trusts and small business taxation with a view to ensuring that there is not a significant dichotomy of treatment based on entity alone.