Regulation impact statement: Refundable loss carry-back tax offset

Background

1. The *Income Tax Assessment Act 1997* provides the rules for calculating a taxpayer's assessable income, allowable deductions and offsets to arrive at their taxable income and consequential income tax liability. One of the consequences of the rules is that in an income year a taxpayer may experience a tax loss as a result of their business or investment activities. If allowable deductions are greater than assessable income then the taxpayer will incur a tax loss.

2. The current taxation system treats profits and losses asymmetrically. Profit is taxed in the year in which it is derived, but a loss must be carried forward (indefinitely) at its nominal value and be deducted against future assessable income. A perfectly symmetrical treatment of profits and losses would see the income tax value of the loss (that is, the value of the loss multiplied by the relevant tax rate) refunded to the taxpayer in the year that the loss is incurred.

3. At the present time, individual taxpayers, including businesses operating as sole traders, can offset current year business losses against other income sources such as salary and wages and investment income.

4. For large companies and consolidated groups that conduct a range of business activities, losses in one activity can be offset against profits from other activities, improving their ability to utilise current losses.

5. However, companies that undertake only one business activity do not have other sources of income against which to offset their losses. Companies that make a current year loss are therefore required to carry that loss forward.

6. Australia is not unique in this respect; it is common practice in other jurisdictions to require a loss to be carried forward, although various forms of loss carry-back are available in a number of OECD countries, including Canada, France, Germany, Ireland, Singapore, the United Kingdom and the United States.

7. The rules governing the utilisation of tax losses have evolved considerably over time, generally to allow companies greater access to prior year losses, but with additional integrity rules to prevent 'loss trafficking'.

8. 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.

9. 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. 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'. The COT ensures that, broadly, a company cannot deduct its losses if there has been a change in the identity of 50 per cent or more of its ultimate owners in the period since the loss was incurred.

10. 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.

11. These integrity rules limit the ability of companies to carry forward losses. Thus the benefit (cash flow) of the loss is potentially not realised until a significant period of time has elapsed from the circumstances that caused the loss to occur and in some circumstances, may not be realised at all. As a result, the real value of the loss can be eroded by the time it is utilised.

12. The current treatment of losses restricts companies' cash flow in an economic downturn as they cannot access the value of the loss until they return to profitability. It also acts as a bias against risk taking, by increasing the effective tax rate over the course of the investment if in some years it incurs a loss. The current rules can also limit the companies' ability to utilise past losses if they seek an equity injection or seek to make changes to their business to respond to changes in demand or broader economic circumstances. In summary, the current treatment of losses inhibits companies' ability to meet the challenges and opportunities from the structural changes that the Australian economy is experiencing.

Problem

13. The Australian economy is undergoing structural change in the wake of Mining Boom Mark II and its impact on the terms of trade and the Australian dollar.

Businesses operating in the non-mining sectors of the economy, such as manufacturing, tourism, education, retail and construction, are facing challenging trading conditions.

14. Businesses facing these conditions need to be able to adapt and restructure. It is particularly important that companies that are experiencing losses be able to make changes to their business to return them to profitability. That may mean undertaking investment in plant and equipment or retraining staff. It is important that the tax system does not place impediments in the path of businesses that are seeking to engage in the sensible risk taking and investments that are necessary in order to adapt and restructure.

15. The current taxation treatment of losses can act as an impediment to sensible risk taking.

16. Company profits are taxed in the year in which they are earned but losses must be carried forward and be deducted against future profits.

17. This asymmetric treatment of profits and losses can have the effect of increasing the effective tax rate above the statutory rate for companies that incur losses over the course of the investment. This is because the tax system looks through a single financial year lens at an investment that generates returns over multiple years. For an investment that has less risk of a loss and so generates returns evenly over the investment period, the lens of a single financial year may have little impact. But for a riskier investment that may generate uneven returns, the lens of a single financial year can result in a higher effective tax rate over the period of the investment. This is set out in the tables below that show the effective tax rate on a low risk and high risk investment.

Tax impact on low-risk investment choice

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

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%**

18. Of the approximately 850,000 companies in Australia, nearly 60% were in a tax loss position in 2008-09 (see below for a breakdown by industry).

19. Options to assist loss making companies will vary in terms of the number of companies affected. For example to benefit from loss carry-back, companies must have paid tax in the carry-back period and have a positive franking accounting balance. Once these factors have been taken into account, only around 110,000 (12%) companies are expected to benefit from loss carry-back over the first four years of operation – the majority of which will be small businesses.

Non-taxable companies[1], by industry[2], 2008-09 income year[3]

	Number of non-taxable companies	Percentage of total companies
Industry	**No.**	**%**
Agriculture, forestry and fishing	11,565	68.6
Mining	2,973	71.1
Manufacturing	22,740	59.4
Electricity, gas, water and waste services	1,305	60.8
Construction	57,239	61
Wholesale trade	23,758	59.6
Retail trade	26,821	61.9
Accommodation and food services	14,728	69.9
Transport, postal and warehousing	21,568	64.5
Information media and telecommunications	6,025	69.2
Financial and insurance services	52,737	56.4
Rental, hiring and real estate services	50,676	48.8
Professional, scientific and technical services	62,483	60.8
Administrative and support services	14,571	60.5
Public administration and safety	1,951	60.9
Education and training	4,873	66
Health care and social assistance	15,535	58
Arts and recreation services	4,685	68.6
Other services	15,944	61.1
Other[4]	39,960	60.2
Total	**452,137**	**59.3**

Source: Taxation Statistics 2008-09, Table 3.13

Notes:

1. Non-taxable companies are defined as companies with net tax less than or equal to $0.
2. The industry groups are classified based on the Australian and New Zealand Standard Industrial Classification (ANZSIC) 2006 codes on the Australian Business Register.
3. Data for the 2008–09 income year includes data processed up to 31 October 2010.
4. Includes companies lodging under the 'nil company returns' code, which includes non-taxable companies or companies with nil company returns – no income, expense or balance sheet data present; companies that did not state their industry; and/or companies registered under the government administration and defence industry code.

20. Reducing the tax system's bias against sensible risk taking could be expected to increase both the quantity and quality of investment and improve cash flow for companies that have experienced a tax loss, 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. Importantly, reducing the bias can also encourage businesses under pressure to adapt and restructure to make the necessary changes to their business.

21. The tax system's bias against sensible risk taking 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.

22. Companies are also required to meet integrity tests that impact on their ability deduct the current year loss against future years' assessable income. The company must satisfy the COT to utilise a prior year loss. 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. Therefore, if there is a change in ownership or a capital injection, the taxpayer will not pass the COT and will not be able to carry forward any losses.

23. In the event the COT is not satisfied, the company can still utilise the loss if it can satisfy the SBT. That is, the company must carry on the same business in the year they claim the loss as it carried on immediately before it failed the continuity of ownership test. That can mean that, faced with the need to restructure their business in the face of incurring losses, a business may face restrictions on how it can change its products or services if it is to deduct its losses against future profits.

24. Where a business passes the integrity tests, they can deduct their tax losses but at their nominal value. The real value of the loss can therefore be reduced by the time it can be claimed as a deduction against income.

25. The asymmetric treatment of profits and losses can also impact on a businesses' cash flow – they are required to remit tax in the year they earn the profit but have to wait until they return to profitability in order to benefit from deducting the loss. 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.

26. This cash flow impact can be detrimental to a business's 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.

Objectives of Government action

27. The objectives of introducing loss carry-back are:

   – to reduce the bias in the tax system against innovation and sensible risk-taking;

   – to assist businesses in the current economic climate; and

   – to manage the impact of assistance measures on the Budget.

Options that may achieve objectives

Full loss refundability

28. The asymmetry in the treatment of profits and losses could be directly addressed by providing a tax refund, equal to the value of the loss multiplied by the statutory tax rate, to companies in the year in which they incur a loss.

29. This would assist businesses in the current economic climate by providing them with immediate cash flow benefits and removing the bias against sensible risk taking.

30. However, this would raise integrity concerns that some taxpayers may engage in tax planning to achieve a loss in order to access the refund. If the business subsequently ceased operating there would be little recourse for the Commissioner of Taxation to take action against the taxpayer to recover the refund.

31. Providing an immediate refund of tax losses would also only provide symmetry to the extent that business income is being measured consistently. For example, where losses are derived from access to accelerated depreciation, business income and deductions are not being consistently measured.

32. No tax system in the world provides full loss refundability (and the cost to revenue would be extremely high). Providing a refund for tax losses would have a significant impact on the budget. The aggregate carried forward loss balance

for all companies was estimated to be around $170 billion in 2009-10. It therefore does not meet the objective of managing the impact on the budget.

33. However, full refundability does operate as an automatic stabiliser. It increases cash flows for previously profitable companies during economic downturns when they are needed. It also means that revenue would recover more quickly as the economy recovered as companies would not lower their taxable income during the recovery period by deducting prior year losses as currently occurs.

Loss carry-back

34. A second option is to provide a more limited form of refundability by allowing companies to carry-back losses incurred in one year against taxes paid in earlier years. This means that rather than applying a single financial year lens, the tax system would look at the returns to investment across a number of years, allowing profits and losses to be offset across the period.

35. If loss carry-back were unlimited it could raise similar integrity concerns to that raised by full refundability and result in significant costs to the budget.

36. However, a number of restrictions can be placed on loss carry-back to mitigate these risks.

37. Carry-back would allow losses to be offset against prior years' tax paid. Australia's imputation system credits company income tax against the personal tax of the shareholders. Under the imputation system, companies must keep a franking account. A credit arises in the franking account when a company pays income tax. A debit arises when the company receives a refund of the tax paid or when it attaches franking credits to dividends paid to shareholders. If a company has a negative franking account balance at the end of an income year then they must pay a franking deficit tax to bring the account balance to zero. This means, if a company was to receive a carry-back refund for losses incurred then they would have to pay the franking deficit tax to the extent the carry-back refund leads to a negative franking account balance. To avoid this, the benefits of loss carry-back are limited to the positive balance of the franking account. That is, the carry-back can never exceed the value of past taxes paid that have not been distributed to shareholders. This reduces the risk of fraudulent activity.

38. The number of years that taxpayers can carry-back a loss can be limited to limit the impact on the budget. However, a shorter carry-back period means that companies experiencing large losses or longer periods of loss may not be able to fully realise the value of their loss. Other jurisdictions that have adopted loss carry-back have opted for between one and three years.

39. The amount of loss that can be carried back can be limited. Placing a cap on the amount of the loss reduces integrity concerns by reducing the value of the deduction that is available and so reducing the incentive to engage in tax planning.

40. A cap on the amount of the losses that can be carried back also targets the option to small and medium businesses. For example, for a cap of $1 million, around 90 per cent of the 'cash' benefit will flow to medium, small and micro businesses (see impact analysis section for more detail).

Loss uplift

41. A third option is to uplift the value of the losses that are carried forward. This would maintain or partially maintain the value of the loss, depending upon the uplift factor chosen. The impact on the budget would also depend upon the uplift factor. The impact on the budget would also ramp up over time as more losses were carried forward.

42. This option would not assist companies to as great an extent as loss carry-back as it would not provide a cash flow benefit at the time that the company incurred a loss, but would provide a benefit only when the company was once again profitable.

43. Uplifted losses would also not provide assistance to companies that could not access their losses because of the application of the integrity tests – the COT and the SBT.

Relax the loss integrity rules

44. A fourth option is to amend the integrity rules. The current rules limit companies' ability to seek new equity or to alter the goods or services or business model.

45. This option would assist companies in the current economic climate by removing an impediment to adaptation and restructuring. However, any relaxation of the integrity rules would move the tax system towards full loss refundability (that is, refunding losses at the company tax rate in the year in which they are incurred). However, this would need to be weighed against the risk of significant costs to the budget from potentially undermining the integrity of the tax treatment of losses through encouraging loss trafficking.

Refundable loss carry-back tax offset – design options

46. Treasury proposes a refundable loss carry-back tax offset that:
    - is only available to companies, or entities that are taxed like companies;
    - is subject to the loss integrity rules (that is, the continuity of ownership and/or same business tests);
    - is restricted to revenue losses only;
    - has a limited carry-back period;
    - limits the amount of current year losses that can be carried back; and
    - is limited to the amount of credit in the company's franking account.

Available to companies and entities taxed like companies

47. Businesses can operate as sole traders, partnerships, companies or trusts. The administrative and compliance costs of extending loss carry-back to trusts, partnerships and sole traders is significant and outweighs the possible benefits.

48. Sole traders have broader options for utilising losses, such as offsetting the business loss against salary and wage income, which are not available to companies and entities taxed like companies.

49. Trusts are flow through vehicles for tax purposes – the point of taxation is the beneficiary not generally the trust. In order to apply loss carry-back the trustee would need to be aware of the beneficiary's marginal tax rate and whether the beneficiary paid tax on the trust distributions. This would require potentially complex and costly compliance arrangements. For discretionary trusts, the benefits of loss carry-back may flow to beneficiaries other than those that paid the tax on the profits.

50. The advantages of restricting the measure to company losses are that it will be administratively simple, and have a negligible compliance impact.

Loss integrity rules apply

51. The loss integrity rules serve a crucial role in preventing loss trading. 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 SBT 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. The consolidation regime modifies the loss utilisation rules, recognising the potentially more diverse nature of businesses within a consolidated group.

52. The COT and SBT will continue to apply to carry-back losses, to ensure that the new measure does not encourage the creation of arrangements that lead to loss trading.

53. The advantages of applying the loss integrity rules to loss carry-back are consistency with the current company loss recoupment rules and protecting the revenue.

Revenue losses only

54. Providing loss carry-back for capital losses would effectively provide an opportunity for companies to circumvent the integrity rules (in Part 3-1 of the *Income Tax Assessment Act 1997*) which quarantine the use of capital losses to capital gains. Currently, capital losses may only be applied against capital gains. Allowing capital losses to be applied against taxable income, which is revenue in nature, would permit capital losses to be converted into revenue losses – with significant potential cost to revenue.

55. Accordingly, loss carry-back would only be available in respect of revenue losses.

Limited carry-back period

56. Shorter carry-back periods have the advantage of reducing administrative and compliance costs, as well as limiting the impact on revenue. However, its primary disadvantage is that it limits the benefits that companies can receive during a loss period, especially where those losses are large or protracted.

57. Longer carry-back periods have the advantage of providing companies with greater access to the tax value and benefit of their losses. However, they increase administrative and compliance costs, as well as increasing the potential impact on revenue.

Reduces the pool of losses

58. As a matter of clarification, any loss (or part of a loss) that is carried back will not be able to be carried forward.

Cap on amount of losses that can be carried back

59. Small and medium sized incorporated businesses don't have the same access to losses as diversified businesses and corporate groups. Large companies and consolidated groups have profits from other activities that they can use to absorb losses. Carry-back of losses could be targeted to small business by using the definition of small business or through imposing a quantitative cap (the amount of losses that could be carried back). A quantitative cap has the advantage of ease of administration and reduced compliance burden. The cap also reduces the exposure of the Government to very large losses incurred by individual businesses. A quantitative cap can also be easily adjusted to meet the economic circumstances.

Limited to the balance of the company's franking account

60. Loss carry-back would be limited to the balance of the company's franking account. This means that the benefit of the loss carry-back is limited by the amount of tax that has been paid in the past. This operates as an integrity measure and, together with the quantitative cap, minimises the impact on the budget.

Start date

61. The advantages of providing loss carry-back for losses incurred from the 2012-13 income year include allowing companies experiencing a downturn to benefit as promptly as possible. In addition, it provides impetus for companies considering innovation and investment to do so in 2012-13.

62. The advantages of a later start date are that the Australian Taxation Office would have significant lead-in time to update systems and income tax returns. However, the Australian Taxation Office, in its consultation with the Treasury, has indicated that the changes required are not extensive. In addition, the legislation could be achieved within current priority lists, although there will be pressure due to other legislative priorities, and potential 'tight' spots experienced by the Australian Taxation Office in updating its systems and documents.

Delivery Method

63. There are the two methods for delivering loss carry-back:

    – Amending prior year returns; and

    – A refundable loss carry-back tax offset for the current income year.

64. There are significant disadvantages to amending prior year returns. The disadvantages of a refundable tax offset are relatively minor when compared to

the disadvantages of amending prior year returns. In view of this analysis, Treasury support the implementation of loss carry-back via the mechanism of a refundable tax offset.

65. Providing loss carry-back through amending earlier tax returns would mean that previous tax assessments would be reopened and altered to reflect the reversal of tax paid in those periods due to carry-back. This delivery mechanism could be administratively costly as old tax returns would need to be maintained and updated as losses are utilised.

66. Additional compliance costs would arise if unrelated 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.

67. Further problems may also arise if some of the tax returns that need to be amended fall beyond the Commissioner's amendment period (currently four years for companies). 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.

68. Alternatively, loss carry-back 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.

69. 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.

70. This delivery mechanism is administratively easier than amending tax returns, as it removes the need to reopen previous tax returns and reduces 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.

Impact analysis

71. This measure is not expected to impact on the economy in the broader sense; that is, there will be no measurable impact on Gross Domestic Product.

72. An aggregate macroeconomic analysis would be a blunt tool to use because the policy doesn't affect all firms or most firms or even most firms within an industry. It is more of a microeconomic issue than a macroeconomic issue and the limited scope of the measure and data limitations mean that an aggregate macroeconomic analysis would not be helpful.

73. Nonetheless, there will be positive economic impacts at the microeconomic level:

   – The measure provides assistance to companies that are struggling from the impact of the mining boom. This assists the economy to make the necessary structural adjustments.

   – Eligible companies that incur a loss in 2012-13 would receive a cash flow benefit in 2013-14. This will facilitate further investment and other business decisions that are necessary to return the company to profit.

   – There will be less risk averse investment as the measure supports investment aimed at innovation and adapting to changing economic circumstances.

   – The measure will support businesses, particularly small and medium businesses that are not able to take advantage of the consolidation regime's loss utilisation rules (current year losses incurred by one member of the group can be offset against income earned by other members of the same group).

   – Carrying back losses will flatten taxable income peaks and troughs. Consequently, the upswing/downswing cycle will be flatter, allowing for faster recovery of government revenue on the upswing.

74. Loss carry-back will predominantly benefit existing businesses that have been profitable in the past and are considering what changes they need to make in order to remain competitive. As highlighted earlier, it will do this because such

decisions involve uncertainty and risk for companies and loss carry-back will lower the risk adjusted after-tax return on a range of potential new investments.

75. The measure will be of potential benefit to the 26 per cent of small businesses (around 700,000) that are incorporated, but not to the 74 per cent (around 2.0 million) that are not incorporated.

76. A worked example is provided below:

Worked Example: A company investing to upgrade its product line

Seven Beaches Resorts Pty Ltd (Seven Beaches) would benefit under a loss carry-back arrangement with a $1 million cap, a one year carry-back period, limited by franking account balance. Seven Beaches operates seven beach resorts in different states around Australia.

To attract greater numbers of international and domestic clients, Seven Beaches decides to undertake a substantial refurbishment of all its resorts. This will involve upgrading all resort bars, replacing all beds and other furniture, upgrading all in-room televisions and fridges and installing a new range of light fittings and lamps.

Seven Beaches 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, by becoming qualified recreational activity instructors).

This plan is developed over the course of 2012-13 and 2013-14 where Seven Beaches has taxable income of $8.00 million and $7.00 million respectively. At the end of 2014-15 Seven Beaches has a franking account balance of $3 million.

The refurbishment is planned to commence in 2014-15 with the eastern states beach resorts and involves closing parts of the resort during the refurbishment. In April 2016, Seven Beaches plans to launch an advertising campaign promoting its revamped facilities.

Seven Beaches plans to refurbish its other beach resorts in 2015-16. A further advertising campaign would be rolled out once the refurbishment of all beach resorts is completed early in 2016.

As a result of the refurbishment Seven Beaches would have substantially less assessable income and larger deductions than in previous years. As a result, it would make a tax loss of $6.00 million in 2014-15 and $4.00 million in 2015-16.

Under the current income tax law, Seven Beaches 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 Seven Beaches’ taxable income in future years.

Current tax system						
Year	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**
Assessable income	$30,000,000	$30,000,000	$14,000,000	$19,000,000	$25,000,000	$35,000,000
Expenses — excluding depreciation	($21,000,000)	($22,000,000)	($18,800,000)	($21,700,000)	($23,900,000)	($20,900,000)
Deductions — depreciation	($1,000,000)	($1,000,000)	($1,200,000)	($1,300,000)	($2,100,000)	($2,100,000)
Deductions — losses	$0	$0	$0	$0	$0	($11,000,000)
Taxable income	$8,000,000	$7,000,000	($6,000,000)	($4,000,000)	($1,000,000)	$1,000,000
Tax payable	***$2,400,000***	***$2,100,000***	***$0***	***$0***	***$0***	***$300,000***
Total carry forward losses	$0	$0	$6,000,000	$10,000,000	$11,000,000	$0

Seven Beaches 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 Seven Beaches has a franking account balance of $3 million at the end of 2014-15.

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

- a loss with the tax value of $1.8 million ($6 million x 30%)

- a franking account balance of $3 million

- paid $2,100,000 in taxes over the carry-back period, and

- a quantitative cap with the tax value of $300,000 ($1 million x 30%)

As the tax value of Seven Beaches' loss is higher than the quantitative cap, Seven Beaches will only be able to carry-back $1 million against previously paid taxes. Seven Beaches' loss for 2014-15 will be carried back against tax paid in 2013-14 (the prior year). Seven Beaches will receive a loss carry-back refund of $300,000 for its loss in 2014-15. This reduces the franking account balance to $2.70 million ($3 million — $300,000). The remaining loss of $5 million is carried forward to 2015-16.

Seven Beaches then experiences a second year of loss in 2015-16 but cannot carry the tax value back as there were no taxes paid in the previous year. The full value of the loss is added to loss stock and carried forward to 2016-17.

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

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

Loss carry-back						
Year	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**
Assessable income	$30,000,000	$30,000,000	$14,000,000	$19,000,000	$25,000,000	$35,000,000
Expenses — excluding depreciation	($21,000,000)	($22,000,000)	($18,800,000)	($21,700,000)	($23,900,000)	($20,900,000)
Deductions — depreciation	($1,000,000)	($1,000,000)	($1,200,000)	($1,300,000)	($2,100,000)	($2,100,000)
Deductions — losses	$0	$0	$0	$0	$0	($10,000,000)
Taxable income	$8,000,000	$7,000,000	($6,000,000)	($4,000,000)	($1,000,000)	$2,000,000
Tax payable	***$2,400,000***	***$2,100,000***	***$0***	***$0***	***$0***	***$600,000***
Loss carried back	$0	$0	$1,000,000	$0	$0	$0
Carry-back refund	***$0***	***$0***	***300,000***	***$0***	***$0***	***$0***
Total carry forward losses	$0	$0	$5,000,000	$9,000,000	$10,000,000	$0

77. A range of variables for a refundable loss carry-back tax offsets were considered by Treasury. The costings are provided below.

	2011-12 ($m)	**2012-13 ($m)**	**2013-14 ($m)**	**2014-15 ($m)**	**2015-16 ($m)**	**Total ($m)**
Option A: Working Group Proposal Option Phase in Loss Carry-back (applied to losses incurred in 2013-14, $1 million cap, with a 1 year carry-back phase-in for 1 year, then 2 year carry-back going forward, limited by franking account balance.)	0	0	0	-150	-300	**-450**
B. Variation: Phase in Loss Carry-back, (applied to losses incurred in 2012-13, $1 million cap, with an initial 1 year carry-back phase-in for one year, then 2 year carry-back going forward, limited by franking account balance.)	0	0	-150	-250	-300	**-700**
C. Variation: Phase in Loss Carry-back, (applied to losses incurred in 2012-13, $1 million cap, with an initial 1 year carry-back phase-in for 2 years, then 2 year carry-back going forward, limited by franking account balance.)	0	-0	-150	-150	-300	**-600**
D. Variation: Loss Carry-back (applied to losses incurred in 2012-13, $1 million cap, with a 1 year carry-back, limited by franking account balance.)	0	0	-150	-150	-150	**-450**
E. Variation: Loss Carry-back, (applied to losses incurred in 2012-13, $10 million cap, with a 1 year carry-back, limited by franking account balance.)	0	0	-200	-200	-250	**-650**

78. 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. Across all the options with a cap around $1 million 90 per cent of the 'cash' benefit will flow to medium, small and micro businesses.

Distributional Analysis of Loss Carry-back by Industry					
	Option A	**Option B**	**Option C**	**Option D**	**Option E**
Construction	15%	15%	15%	15%	10%
Manufacturing	15%	15%	15%	15%	15%
Finance and Insurance	15%	15%	15%	15%	25%
Prof and Tech Services	10%	10%	10%	10%	10%
Wholesale Trade	10%	10%	10%	10%	10%
All Other Industries	35%	35%	35%	35%	30%

Distributional Analysis of Loss Carry-back by Company Size					
	Option A	**Option B**	**Option C**	**Option D**	**Option E**
Micro	40%	40%	40%	40%	25%
Small	25%	25%	25%	25%	15%
Medium	25%	25%	25%	25%	25%
Large	5%	5%	5%	5%	10%
Very Large	5%	5%	5%	5%	25%

Business cost calculations

79. A nil to insignificant compliance cost for taxpayers will arise from making the choice to obtain a refundable loss carry-back tax offset. As the process of making a claim will involve the lodgement of the current year return, no additional compliance costs are expected to arise. Taxpayers are already required to keep records concerning their losses.

80. The ATO advises that its existing account management system is sufficient to manage the refunds (it already has the capacity to automatically generate refunds). Some minor work on the income tax calculators will be required to allow for the new tax offset, and minor changes may be required to the company income tax return form to allow for the choice to be made.

Consultation

81. The Business Tax Working Group has conducted consultation on loss carry-back. In addition, Treasury and the Business Tax Working Group Secretariat have consulted with the Australian Taxation Office on matters concerning the implementation of the measure, such as compliance and administration issues.

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

83. 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.

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

85. The stakeholders consulted were a mix of representative bodies and individual companies.

86. The Working Group conducted these meetings on a confidential basis to allow discussions between the Working Group and participants to be as open as possible.

87. The following views have been offered in response to the Business Tax Working Group's interim report – generally supportive of loss carry-back:

- **Association of Mining and Exploration Companies:** supports loss reform, however wants a targeted exploration credit instead of loss carry-back.

- **Australian Chamber of Commerce and Industry:** supports loss carry-back but want it extended to all businesses, not just companies.

- **Australian Financial Markets Association:** broadly supports loss carry-back.

- **Australian Property Group:** supports loss carry-back with a three year carry-back period because it isn't likely that a business will have one year in loss followed by a year in profit and so on. Cap on loss carry-back is not mentioned.

- **BDO:** rank loss reform as its highest priority. It prefers a carry-back period of three years, with limit to carry-back determined by franking account balances.

- **Associate Professor Dale Boccabella:** refers to his article, "A loss carry-back rule for business losses in Australia: Some initial thoughts", *Weekly Tax Bulletin*, Thomson Reuters, No 47, 11 November 2011 at paragraph 1770.

- **BusinessSA:** supports loss carry-back with a three year carry-back period.

- **Corporate Tax Association:** support a one year loss carry-back, with exceptions for certain circumstances (eg, GFC) and supports a cap on the losses carried back as in the European model.

- **CPA Australia:** supports loss carry-back for a two year period, with a modest cap as businesses are not prepared to give up much to fund loss carry-back.

- **Ernst & Young:** support a loss carry-back limited to two years, but do not support a cap other than the franking account balance.

- **Grant Thornton:** supports loss carry-back with a two year carry-back period.

- **Institute of Public Accountants:** supports loss carry-back with a one to three year carry-back period. It supports a restriction to small businesses for the measure.

- **Master Builders Association:** support loss carry-back with a longer carry-back period to support large capital investments.

- **National Tourism Alliance:** supports loss carry-back with a carry-back period of more than one year.

- **Pennam Partners:** notes that loss carry-back will not benefit start-up companies.

- **Property Council of Australia:** strongly prefers a loss carry-back to other loss reforms, with a three year carry-back period and be available to all businesses.

- **Real Estate Institute of Australia:** supports loss carry-back with a carry-back period of three years.

- **The Institute of Chartered Accountants Australia:** supports loss carry-back, with a carry-back period of two years, as a measure to support smaller businesses in better accessing their losses and supporting them during downturns.

- **The Tax Institute:** support a limited loss carry-back as outlined in the *Australia's Future Tax System* report.

- **Tourism and Transport Forum:** strongly support loss carry-back, with a three year carry-back period, as it will provide a cushion against the shocks regularly experienced by this industry (weather and other natural events, transport shocks, etc).

- **Tourism Accommodation Australia:** support loss carry-back in some form as it will support capital investment in their industry.

- **Yarrawa Management Pty Ltd:** Broadly support a loss carry-back, with a three year carry-back period, as the horticultural industry have longer peaks and troughs.

88. Treasury also intends to consult extensively on the implementation of the measure, and is preparing a Discussion paper to begin its consultation. This will be followed by consultation on exposure drafts as well as separate consultation with the Australian Taxation Office on its administration of the measure.

Conclusion and recommended option

89. All the loss carry-back options identified will reduce the bias in the tax system against innovation and investment and will assist businesses in the current economic climate.

90. The various options involve trade-offs between the timing and size of the incentive to business, and cost to budget and the administrative feasibility of delivering the measure.

Timing

91. Options that start later will reduce the cost, but also delay the benefits to companies considering new innovations and/or investments.

92. Treasury expect that the pressures on business from the high terms of trade and multispeed economy will continue and this will result in ongoing calls for assistance from government.

93. Sector or firm specific assistance can, depending on the policy design, be counter-productive. While support to a particular sector or firm may save jobs in the short term, in the longer term it can condemn those workers to lower wages and business owners to lower profits. It can also become increasingly costly to government and difficult to quarantine to preferred firms or sectors.

94. In contrast economy-wide measures, such as loss carry-back, that address impediments to businesses adapting and changing through supporting sensible investment and risk taking will enhance productivity growth in all sectors of the economy, particularly those currently under pressure.

95. Therefore, Treasury supports the design of loss carry-back suggested by the Working Group, but recommends that it commence sooner to maximise the impact on prospective investment.

96. For example, under a loss carry-back arrangement that starts from 2012-13 with a $1 million cap, businesses that are currently profitable and paying tax, will know that if they undertake investments in 2012-13 that initially result in a loss, they will get a refund of up to $300,000 of tax they previously paid when they lodge their 2012-13 return.

97. A commencement date of 2012-13 will involve challenging legislative and administrative timeframes. However, on the basis that this measure is a high priority, passage of legislation in the winter sittings of 2013 (to enable companies to start claiming loss carry-back after the conclusion of the 2012-13 income year) is possible.

Carry-back Period

98. Different carry-back periods will increase or decrease the cost to revenue, but also reduce or increase the benefits to companies.

99. Countries that have a loss carry-back arrangement generally limit the carry-back period, often to between one and three years. This reduces the administrative costs and also places a limit on the impact of loss carry-back on government revenues.

100. 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 also limits the benefits that companies can derive from loss carry-back during loss periods, and limits the automatic stabiliser effect.

101. Treasury supports an initial carry-back period of one year, moving to a two year period after that. Treasury also notes that once loss carry-back is in place, the carry-back period can be fairly easily amended in response to 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.

Cap

102. Different caps will increase or decrease the cost to revenue, but also reduce or increase the benefits to companies. 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.

103. A quantitative cap can also be used to target the benefits of loss carry-back to small and medium sized companies. The lower the cap, the greater the relative benefit of the measure to small and medium sized companies.

104. As highlighted in the section on the impact of the various loss carry-back options, under a $1 million cap around 90 per cent of the 'cash' benefit will flow to medium, small and micro businesses. This falls to 65 per cent under a $10 million cap.

Implementation and review

105. Amendments to the current tax law will be required to implement this proposal.

106. An initial consultation paper will be issued following the 2012-13 Budget. A period of between four and six weeks will be provided for interested members

of the public to make a submission on the consultation paper. Meetings with key stakeholders may also occur during the consultation period.

107. Responses to the consultation paper will inform any further policy decisions by the Government and the preparation of draft legislation. Subject to Government's overall drafting priorities, the draft legislation could be exposed for public comment by the end of 2012.

108. As with the consultation paper, interested members of the public would have between four and six weeks to make a submission on the exposure draft legislation. Meetings with key stakeholders may occur during the consultation period.

109. Responses to the draft legislation will determine how quickly the legislation could then be finalised for introduction in the Parliament. However, the implementation process would be undertaken with a view to the legislation being introduced in the first half of 2013.