Regulation impact statement – Temporary loss carry-back

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Background

The current treatment of losses does not contribute to companies' cash flow in an economic downturn, as they cannot access the tax value of a loss until they return to profitability. Additionally, the introduction of Temporary full expensing will generate large tax deductions for companies that invest in depreciable assets. In some cases this will create tax losses that would normally have to be carried forward and used to offset tax on future profits.

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. For large companies and consolidated groups that conduct a range of business activities, losses in one activity may be offset against profits from other activities, which provides some ability to utilise current losses.

However, companies that undertake only one business activity or suffer losses on the majority of their activities may not have other sources of income against which to offset their losses. These companies are required to carry that loss forward. 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, New Zealand, Singapore, the United Kingdom and the United States.

Tax loss carry-back allows companies that paid tax in previous years to utilise their current losses rather than carry them forward. Conceptually, the loss is carried back to reduce the earlier profit and the corresponding reduction in tax is refunded to the company.

Tax loss carry-back was introduced as a 2012-13 Budget measure. It was available for 2012-13 and was repealed after one year in 2014. It was designed to provide a permanent two year carry-back, limited to a carry-back amount of $1 million.

The economic analysis included in this RIS was made available to decision makers prior to a final decision being made. This RIS was finalised as part of the preparation of legislation after the final policy decision was made.

1. The problem

The Government has introduced a number of initiatives to support businesses withstand and recover from the economic effects of COVID-19. However, the current tax treatment of company losses will limit the effectiveness of some of those initiatives. Furthermore, for companies that suffer tax losses due to the economic effects of COVID-19, the requirement to carry those losses forward will delay access to the loss's tax value.

A key initiative aimed at helping businesses recover from the economic effects of COVID-19 is Temporary full expensing. This time limited incentive allows companies to deduct the entire purchase cost of depreciating assets, rather than deducting this amount over time as the asset depreciates in value. By bringing these deductions forward, the after-tax cost of assets is reduced which creates an incentive for businesses to invest. This investment will boost Australia's productive capacity over the longer run, leading to higher wages and living standards for all Australians. This investment will increase long-term productivity in the economy providing support for wage growth. Temporary full expensing will be available until 30 June 2022, creating an incentive to make investments before the measure terminates to qualify.

This tax treatment will change the timing of deductions significantly which will have the apparent effect of moving profits and losses between years. In general, profits will move out of years where eligible investment are made and towards subsequent years. In some cases this movement will generate tax losses and in other cases losses under the counterfactual policy will simply become larger. The current company tax treatment of these losses will dilute the economic incentive provided by Temporary full expensing.

Example 1. Quaternion Construction Limited purchases a piece of equipment for $1 million. Under Temporary full expensing the entire purchase price is deductible in the year of the purchase so if Quaternion Construction's taxable income before the purchase was $1 million then the purchase would reduce its taxable income to zero, saving $300,000 in tax that year (at the 30 per cent company tax rate). However, if Quaternion Construction's taxable income was only $600,000 before the purchase, its tax outcome would be a tax loss of $400,000. The related tax saving would only be $180,000 because without loss carry-back the tax value of the loss would have to be carried forward to offset future tax liabilities rather than being immediately accessible. The full tax value of the loss will eventually be realised if Quaternion Construction goes on to make sufficient profits but the delay in realising this value will reduce the attractiveness of Temporary full expensing and make the company less likely to change its decisions in favour of making new investments under the policy.

Temporary full expensing also changes tax outcomes in subsequent years because there are no depreciation expenses in those years for qualifying purchases. However, this does not eliminate the problem. The consequences of requiring tax losses to be carried forward still reduce the economic incentive created by Temporary full expensing because of the delay in accessing the tax value of the loss.

The other problem associated with loss carry-forward during an economic downturn is that while profits are taxed in the year they are realised, the tax value of losses generated by the downturn is not immediately available to affected companies. This asymmetry reduces the degree of economic stabilisation provided by the corporate tax system. With a more symmetric treatment of losses, corporate taxation would provide more support to the economy during downturns, and this support would be targeted towards firms that have been more seriously affected.

2. Why is Government Action Needed

The problems identified in the previous section occur within a regulatory system (the tax system). As a result, they can only be addressed by Government action. The objective of any reform to address these problems should be to provide earlier access to the tax value of losses for the period that Temporary full expensing is available at an acceptable fiscal cost without introducing further problems.

The main problems created by providing earlier access to the value of tax losses are related to the integrity of the tax system. Providing early access to tax losses significantly increases the difficulty of denying dishonest claims before they are processed under self-assessment and recovering amounts that have been paid out inappropriately.

More broadly this proposal is consistent with a number of policies the Government has introduced that aim to support the economy recover from the effects of COVID-19. The aim of supporting companies recover is consistent with the broad thrust of policy and it specifically compliments Temporary full expensing by preserving the incentives it provides in certain cases.

3. Policy options

No change – option 1

While not changing the tax treatment of losses would not address the policy problem associated with delayed access to the tax value of losses, it would avoid the integrity problems associated with all of the identifiable reforms.

Loss Refundability – option 2

The first option that requires new policy would be a loss refundability measure. This would more closely resemble a purely symmetrical tax treatment of losses and profits by allowing tax losses to be refunded in the income year in which the tax loss occurs. For example, if a company makes a tax loss of $1 million, it would receive a $300,000 tax refund in their income tax assessment for the year in which the loss is realised (at the 30 per cent tax rate).

While this approach would meet the aim of providing earlier access to the tax value of losses, it would create significant integrity concerns. In particular, loss refundability raises the possibility of fraudulent taxpayers making a net profit from a tax scheme. The systems and laws used to administer the income tax system are not designed to mitigate this type of risk. For example, if a business ceases operating, there is little recourse for the Commissioner of Taxation to take action against a taxpayer to recover an inappropriately claimed refund. Other key integrity concerns include schemes to generate tax losses on paper to receive the tax refund, noting that once a refund is issued it is difficult to recoup. A related yet distinct concern is international corporations could artificially shift their losses to their Australian subsidiaries to receive the tax benefit using related party transactions. This option would also increase the risk of loss trading whereby failing businesses are acquired for the tax benefits of the losses. These integrity risks will deteriorate the existing tax base and unduly distort commercial decisions.

The level of resources required to mitigate these risks would be significant given that even with the current asymmetric treatment of tax losses, around one third of companies made a tax loss in a typical year when the economy is growing. Implementing loss refundability would require significant structural change, as it would be exceedingly difficult to implement loss refundability temporarily with sufficient integrity.

Temporary Loss Carry-Back – option 3

A third option is to allow companies to carry-back losses incurred in a given year against taxed profits in earlier years. The primary difference compared to loss refundability is that Temporary loss carry-back has a more limited application in that it requires profits in earlier years. It also raises fewer integrity issues because taxpayers can only ever claim back tax that was paid in the past.

For example, if Jamie's Coffee Pty Ltd had taxable income of $5 million and paid $1.5 million in income tax in 2018-19 but due to the impact of COVID-19 restrictions makes a tax loss of $2 million in 2019-20. Under the treatment of losses in the current law, Jamie's Coffee Pty Ltd would carry these losses forward until it made a taxable profit. Under Temporary loss carry-back it will receive a tax refund of $600,000 in recognition of this loss.

Temporary loss carry-back has the advantage that it was previously designed and introduced in Australia in 2012-13 and was available until it was repealed in 2014. The previous experience with loss-carry back means that many of the implementation and integrity issues were considered and the old framework provides an advanced starting point for a reintroduction. It should also be noted that when loss carry back was repealed, the repeal was part of the broad repeal of the Minerals Resources Rent Tax together with the tax measures that it funded, rather than identified short comings of the loss carry back regime.

Temporary loss carry-back also has the advantage that it is more targeted towards firms that were previously viable, reducing the risk that it supports firms that were already experiencing weakness prior to the current health crisis. Previously weak firms will have more limited access to the benefits of Temporary loss carry-back due to a lack of prior taxed profits.

There are a number of design choices associated with a loss carry-back regime. In this case, given the need to support Temporary full expensing, the policy should match the qualification criteria for that scheme. The key criteria are that Temporary full expensing ends on 30 June 2022 and that it is only available to businesses with turnover below $5 billion per year. The corresponding rules for Temporary loss carry-back would be that it ends after the 2021-22 income year and that it has the same qualifying turnover limit.

One complicating factor associated with Temporary loss carry-back is its interaction with the imputation system. This system uses tax credits to impute tax paid at the company level to domestic shareholders that receive dividends. Temporary loss carry-back needs to be designed to prevent the refund of tax that has also generated imputation credits that have been distributed and claimed by shareholders. Such an outcome would effectively credit tax paid at the company level twice, resulting in net tax refunds when considered across the whole tax system. To prevent these outcomes, Temporary loss carry-back can be limited to previous tax amounts that have not generated distributed credits.

The number of years that taxpayers can carry a loss back can be limited, with shorter carry-back periods associated with lower fiscal costs, reduced integrity risks, and more precise targeting towards previously viable businesses. A shorter carry-back period also reduces the number of companies that are limited by the imputation considerations described above. This proposal considers Temporary loss carry-back to the last income year that was not affected by the economic effects of COVID-19, which is the 2018-19 income year. Other jurisdictions that have adopted loss carry-back have opted for carry-back periods of between one and three years.

Australia's previous loss carry-back regime limited the amount of loss carried back to $1 million. This limit reduced the fiscal cost of the measure and managed the integrity risk. This proposal does not have a limit on the amount carried back, reflecting the aim of supporting Temporary full expensing (which is also unlimited). As there are natural limits to this measure, not having a dollar limit on the amount allowed to be carried back is not as much of a concern as with loss refundability (option 2). Its temporary imposition also limits the ability of taxpayers to create structures that exploit the regime, on top of the integrity rules that can be applied from the 2012-13 measure.

The integrity issues associated with Temporary loss carry-back were largely considered during the design of the previous implementation of the regime in 2013. It would be appropriate to replicate the integrity rules that applied under the previous regime in 2013 which were designed to prevent schemes that have the purpose of claiming a tax loss carry-back benefit. These schemes would work by combining, in a single entity, the three main characteristics required to claim a tax benefit. That is, a prior tax profit, a recent loss and a sufficient franking account balance. Only introducing loss carry-back on a temporary basis would further limit integrity risks. Additional departmental funding to the ATO to upgrade internal systems would also assist in detecting integrity concerns associated with Temporary loss carry-back.

Loosening Loss Integrity Rules – option 4

The final option is to temporarily amend the current loss integrity rules. The current rules limit the benefit a company receives for providing new equity or their ability to alter the goods or services or business model while retaining access to previous losses.

The two integrity rules that could be relaxed to provide an effective benefit are the Continuity of Ownership Test (COT) and the Business Continuity Test (BCT), as they limit the availability of losses through mergers or acquisitions. COT requires that 50 per cent of a company's shares carrying all voting, dividend, and capital rights are held by the same persons. The BCT requires the acquired entity to maintain the same or substantially similar business activities to those that it carried on prior to the change in ownership.

Relaxing integrity rules makes companies in a loss position more valuable to larger corporations, especially those with large franking credit balances. However, for companies to receive a benefit from the policy it requires acquisition to some extent. There is a risk that this option would not be very effective in an economic downturn as most companies would likely be financially constrained to buy other businesses.

Obviously any relaxation of the integrity rules would raise integrity risks. In this instance some of these risks are associated with old losses that accrued before the current health crisis. Providing recognition for these losses reduces the targeting of this measure, raising its cost by supporting firms that were struggling to be viable before the health crisis.

4. Impact analysis

These options only affect corporate taxpayers. That is, companies and entities that are taxed like companies. In all cases the regulatory burden imposed by these options would either be zero (for option 1) or overwhelmingly smaller than the impact on the amount of tax paid by companies. These regulatory burdens are discussed in this statement, but the main considerations in the choice between options are the policy outcomes for taxpayer behaviour and the structure of the tax system.

The integrity risk associated with option 2 is structural in magnitude. Annual corporate tax losses over recent years (which were not affected by the health crisis) have been between 15 to 20 per cent of gross tax profits. The administrative systems that support the income tax system would not be able to scrutinise refunds at this level of losses (or greater levels in a downturn). It would also not be possible to increase the capacity of tax administration in the short time that this policy is available to support taxpayers. The introduction of further integrity rules to mitigate this risk would not only increase the level of administration required, but likely create a significant regulatory burden for taxpayers. Globally, no major economies provide general loss refundability for corporate income tax payers.

There are integrity risks associated with option 4 also, but this option has a further weakness due to its imprecise targeting. Assistance would rely on the existence of healthy companies that are interested in purchasing loss making companies to access the tax value of their losses. In a scenario where losses are concentrated in particular sectors of the economy, the pairing of loss making companies with profitable purchasers is likely to be difficult within sectors, further reducing the likelihood of a successful match.

The policy considerations associated with option 3 are the level of targeting of assistance provided, the degree of integrity issues and the associated regulatory burden.

The level of assistance provided by these policies is linked to their long-term fiscal cost, so the level of targeting is a key policy consideration. Temporary loss carry-back will be available to eligible companies, with the key criteria determining eligibility being the presence of tax profits and losses in the correct years, together with having a sufficient franking balance. Sufficient franking credits at the end of the loss year is a requirement because once a company distributes their franking credit, which they receive for paying tax, their shareholders will typically use the franked dividends to offset their personal income tax liability. Without this limit, Temporary loss carry-back would generate double benefits because a refund of company tax would have to be paid both to the company and to its shareholders. Further, companies that have a franking account deficit at the end of the income year would be required to pay franking deficit tax (potentially with penalties). Data suggests that a lack of franking balance will affect only a small percentage of companies.

Temporary loss carry-back is being proposed in conjunction with Temporary full expensing to encourage business investment. In recent years around 40 per cent of investment in new depreciating assets by companies is from those in a tax loss position. Providing Temporary loss carry-back would increase the proportion of companies that receive an immediate tax benefit under Temporary full expensing. Without Temporary loss carry-back, these companies would have to wait before accessing the tax value of these deductions, potentially deterring them from making investment decisions.

The incentive created by Temporary full expensing is due to the bring-forward in timing of deductions for the purchase of a depreciating asset, which would ordinarily be spread over the effective life of the asset. Under Temporary full expensing these deductions are brought forward, which increases their present value thereby creating the incentive to invest. However, without Temporary loss carry-back, companies that experience a tax loss will have to wait until the tax loss is used to offset a future profit to enjoy the tax benefit, destroying the incentive. Temporary loss carry-back preserves the incentive for eligible companies.

The presence of the appropriate profit and loss years targets the benefit provided by Temporary loss carry-back to companies that were viable before the current health crisis. Requiring a current tax loss targets the benefit towards two broad populations. These are companies that have been negatively affected by the health crisis and companies that receive large tax deductions because they have taken advantage of Temporary full expensing (companies could have both of these attributes). In both cases Temporary loss carry-back will produce a cash-flow benefit to the company, represented by the change in the underlying cash balance. In the case of companies that have utilised Temporary full expensing, there is an additional benefit derived from the preservation of the incentive created by Temporary full expensing. These measures encourage business investment which is an important factor in Australia's economic recovery and increasing productivity and wage growth. Treasury estimates that the combined economic impact of these measures will generate an increase in GDP of $2½ billion in 2020-21 and $10 billion in 2021-22, and will create around 50,000 jobs by the end of 2021-22.

The regulatory burden placed on taxpayers by option 3 has been quantified using the Regulatory Burden Measurement Framework. The preferred option will increase compliance costs to corporate taxpayers and intermediaries by an average of $20 million per year. This includes a one-off compliance cost associated with moving from the current taxation treatment of losses to Temporary loss carry-back. There is also an increase in recurring compliance costs associated with adding new labels to record keeping systems. This would add around $115 of additional compliance cost per taxpayer based on 175,000 possible entities that may claim the Temporary loss carry-back. The regulatory impacts are provided in the table below. The calculation of the compliance cost and assumptions is provided at Appendix A.

Average annual regulatory costs (from business as usual)				
Change in costs ($ million)	Business	Community organisations	Individuals	Total change in costs
Total, by sector	$20	$0	$0	$20

The direct costs associated with option 3 is a reduction in receipts which is estimated at $4.9 billion over the forward estimates period. This is because the Temporary loss carry-back would be used to offset previous tax paid, resulting in a tax refund to the company. The ATO would receive $4.4 million in funding to administer Temporary loss carry-back and support taxpayers to understand and claim tax benefits.

The gross benefits provided by Temporary loss carry-back are due to the reduction in company tax paid. These amounts are estimated in the associated revenue costing and are orders of magnitude larger than the direct costs. The indirect cost associated with option 3 is the opportunity cost of the revenue forgone. An assessment of how the overall costs and benefits compare relies on an assessment of the fiscal and macroeconomic impacts of the proposal.

5. Consultation

Past reviews and stakeholder consultations have established that there is justification and support for introduction of a loss carry-back. Stakeholders expressed general support for a loss-carry back during consultation on the 2012-13 measure. General support for a loss carry-back was echoed by business community stakeholders more recently in the COVID-19 context as a mechanism to provide cash flow support to businesses.

Australian tax reviews

- *Australia's Future Tax System (2009)* recommended that companies should be allowed to carry back a revenue loss to offset it against the prior year's taxable income, with the amount of any refund limited to a company's franking account balance.
- The review noted that a loss carry-back would improve the asymmetric treatment of gains and losses and automatic fiscal stabilisers.
- The 2011 Business Tax Forum and 2012 Business Tax working group undertook further work that developed the original 2012-13 policy. This culminated in the *Final Report on the Tax Treatment of Losses (2012)*.

2019-20 Stakeholder views of loss carry-back

A number of stakeholders have made recent representations to the Government supporting the introduction of loss carry-back. The various proposals offered differed in detail but at least a two year carry-back was most commonly proposed. There was some interest expressed in loss refundability, but as a larger structural change rather than a temporary recovery measure.
A summary of these views is presented in the table below.

Stakeholder and source	Summary
BDO	Recommends the reintroduction of a tax loss carry-back to improve cash flow of affected companies and help them adjust to changing economic

Pre-Budget Submission 2020-21 *20 December 2019*	conditions. The loss carry-back period should be two years, available to companies that are eligible small business entities and restricted to those companies that have paid tax in the previous two years.
Business Council of Australia Pre-Budget Submission 2020-21 *4 September 2020*	A tax loss carry-back could support investment by allowing companies to offset current losses against previously paid taxes. This would support the cash-flow of previously profitable businesses in the current downturn. It would also support cash constrained businesses as well as investment by reducing the bias against investing in riskier projects, particularly for SMEs.
John Durie, 'Back to the future on tax' The Weekend Australian 5 September 2020	The Federal Government should revive the company tax carry-back provisions of 2012 that allows companies to make tax losses to get refunds for taxes paid in previous years. Tom Seymour (PwC Chief Executive) said from the government's perspective the tax take would be a timing issue: instead of a drop in tax receipts next year the fall would come from last year's receipts, which could be covered with borrowings.

Stakeholder views of the 2012-13 measure

- Prior the passage of the loss carry back in 2012-13, the Business Tax Working Group conducted extensive consultation with stakeholders and the business community. There were 24 submissions over the course of this consultation from representative bodies and companies. The summary of these views are:
  - **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. Notes the importance of tax losses to the integrity of the tax system and recommends a higher onus of proof rule, particularly for trusts.
  - **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 (e.g., 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.

6. Option selection/Conclusion

The significant integrity issues associated with option 2 prevent its practical application to address the policy priorities identified in section 2. Policy considerations also suggest that option 4 is not preferred given the very conditional nature of support it provides firms in loss positions requiring the acquisition of other companies that are in a loss position and/or have large franking credit balances. However in an economic downturn, it is possible this support would not be readily accessible.

The key consideration is between options 1 (no policy change) and 3 (Temporary loss carry-back). Option 3 is preferred on the basis of its contribution to the economic recovery from COVID-19.

7. Implementation and evaluation

The temporary nature of this proposal will mean there is limited opportunity for review whilst it is in operation. However, it will naturally be considered as part of the review of the Government's response to COVID-19 that will also consider the associated Temporary full expensing policy.

Furthermore, the previous implementation of loss carry-back was repealed to fund other spending priorities rather than because of the identification of any weaknesses in any historic evaluations.

Appendix A – Calculation of compliance costs and assumptions

Option name: Loss carry-back

The proposal would allow companies to carry back losses between the 2020 and 2022 income years against tax paid from the 2019 income year onwards.

Select affected client groups	Non-business individuals	Businesses
	○	⊙

Overall impact: This proposal is expected to result in a low overall compliance cost impact, comprising a low implementation impact and low impact in ongoing compliance costs.

Potential compliance costs	Total	Per client
Implementation	$12,000,000	$70
Ongoing (p.a.)	$14,000,000	$80
Aggregate impact over 2 year duration	$40,000,000	
Per year (2 years)	$20,000,000	

The level of confidence of the assessment				
Supporting evidence is weak. Data is not available, limited or unreliable.	Low ○	Medium ⊙	High ○	Supporting evidence is strong. Data is comprehensive and relevant.

Key issues and assumptions

The number of possible entities claiming the proposed loss carry back regime is approximately 175,000. This may be higher or lower but cannot be readily determined given the current economic support packages available that distort population figures. In addition, the 2020 income year lodgements are far from complete.

The above calculation has assumed that all eligible taxpayers will opt for the loss carry back. However, based on previous experience (2012-13 measure) only a percentage of the eligible population opted for the loss carry back.