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BY EMAIL

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

Email: BTWG@treasury.gov.au

Dear Sir/Madam

INTERIM REPORT ON THE TAX TREATMENT OF LOSSES

BDO welcomes the opportunity to provide a submission on the *Interim report on the tax treatment of losses* (the Interim Report), prepared by the Business Tax Working Group and released for public consultation on 11 December 2011.

Our submission on the issues addressed in the Interim Report, as well as some additional related matters, is attached as an Appendix.

Should you have any questions, or wish to discuss any of the comments made in the attached submission, please do not hesitate to contact me on (02) 9286 5527 or Peter Bourke on (08) 6382 4941.

Yours sincerely

Mathew Wallace
National Tax Counsel
Corporate and International

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APPENDIX

This document sets out the submission of BDO in relation to the *Interim report on the tax treatment of losses* (the Interim Report), prepared by the Business Tax Working Group (BTWG) and released for public consultation on 11 December 2011.

Unless otherwise indicated, statutory references are to the *Income Tax Assessment Act 1997*. References to the ITAA 1936 are to the *Income Tax Assessment Act 1936*.

Summary

We make the following submissions in respect of the Interim Report and related matters:

- **Priority of reforms to the tax treatment of losses**

  We rank reform to the tax treatment of losses as being of the highest priority in the current environment. Accordingly, while only a short time period has been allowed for providing submissions on the reforms canvassed in the Interim Report, we consider this as a positive, provided that meaningful reform in this critical area is progressed with similar urgency.

- **Request for details of the counter balancing measures and further consultation**

  We note that the BTWG's terms of reference provide that the costs of any reform options will need to be offset by savings from business taxation measures to achieve a revenue neutral package. However, such counter balancing measures are not addressed in the Interim Report. It is therefore not possible to fully evaluate the reform options canvassed in the Interim Report. Accordingly, we submit that the proposed counter balancing measures in relation to the proposed reforms should be announced and that there then be an opportunity for further consultation prior to implementation of any reforms or counter balancing measures.

- **Carry back of tax losses**

  Although the carry back of tax losses is not the first reform option canvassed in the Interim Report, we submit that it would be the most beneficial as it may provide some immediate relief from the financial distress of being in a loss situation. Further, the carry back of tax losses would bring Australian "in step" with the taxation systems in many competing economies. We therefore support the introduction of carry back of tax losses, subject to the following submissions in relation to its implementation.

  - ***Carry back period of at least 3 years***

    We submit that carry back period should be at least 3 years. This would make the carry back of tax losses of more use to companies as, in our experience, it is common for companies to experience multiple loss years (often aligned with the long term economic cycle) rather than following a pattern of profits and losses in alternate years. Further, we note that Interim Report acknowledges at the paragraph 115:

- a carry back period of between one and three years would be consistent with international practice; and
- a two or three year carry back period would provide greater opportunities for carry back to occur and a better ‘smoothing’ impact on the tax treatment of companies.

Alternatively, if the carry back of tax losses is implemented with a carry back period of less than three years, we submit that the carry back period should be at least 3 years for a company that is wound up.

- ***Limitation on carry back of tax losses***

We concur that a company’s capacity to carry back a current year tax loss should be limited by reference to its franking account balance.

- ***Carry back of tax losses should be available to all companies***

We submit that the carry back of tax losses should not be restricted to companies of a certain size. . Many large companies do not have diversified operations or, if they have, the performance of their different operations is not necessarily uncorrelated. Further we submit that the larger a company is, the more significant impact that its performance may have on the Australian economy.

- **Uplift of tax losses**

We support the introduction of uplifting tax losses by the ten year Government bond rate. We consider that this would ameliorate the erosion of the real value of tax losses due to inflation. Other things being equal, this should encourage the progression of projects with long payback periods and those with high risks.

- **Relaxation of the integrity measures for carry forward of tax losses**

We submit that the SBT be replaced by a dominant purpose test whereby losses would be lost if a transaction was entered into for a dominant purpose of utilising the losses.

Alternatively, if the SBT is not so replaced, we submit that its requirements should be less stringent. For example:

- the current requirement for a business to remain “identical” could be relaxed to be “materially the same”, with materiality being defined by reference to a specified threshold;
- the “new business test” and the “new transactions test” in paragraph 165-210(2)(a) and (b) should be repealed.

In support of the above, we note that:

- the stringent requirements of the current SBT often make its application uncertain; and
- the current SBT is inherently inefficient from an economic perspective as it can impose an economic penalty (i.e. the forfeiture of tax losses) on companies that seek to make changes to their businesses, or enter new businesses or transactions, in order for them to return to profitability.

The replacement of the SBT with a “dominant purpose” based test would be an alternative desirable reform.

- **Black hole provisions**

  We support shortening the period over which black hole expenditure is deducted under s40-880. This would reduce cash flow constraints on businesses being established or restructured.

  We submit that black hole expenditure in relation to the cessation of a business should be fully deductible in the year in which it is incurred. There is a risk otherwise that the deductions may be wasted (i.e. the amount taxed may exceed the actual profit).

  In addition, we submit that s40-880(5)(d) be repealed or amended. In its current form it gives rise to considerable uncertainty in relation to the breath of its operation.

- **Capital losses**

  We note that the Interim Report does not address the treatment of capital losses made by companies. However, we submit that capital losses made by companies should cease to be “quarantined” for use solely against capital gains and simply be deductible in the income year in which they are made. In this regard we note that capital gains made by companies are generally taxed in the same way as revenue gains (due to the “freezing” of indexation of the CGT cost base and denial of the CGT discount). Question then why capital losses made by companies are treated differently to revenue tax losses?

- **Prospective application of amendments**

  We support the reforms applying on a prospective basis, with the exception of reforms to the SBT in relation to existing tax losses. We submit that the application of the SBT to existing tax losses should be relaxed as discussed above.

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Detailed submissions

1. Short time for consultation not necessarily a bad thing – continued appetite for meaningful reform

We note that, for an area of such fundamental importance as reform of the rules dealing with the deductibility of tax losses, a relatively short period of time has been allowed for making submissions. Far from being the subject of criticism, we see this as a good thing, provided a similar level of urgency is maintained in implementing necessary reforms. In this regard, we trust that the reform process will not lose momentum in the manner apparent in other areas of taxation reform such as the long-running review of the controlled foreign company provisions.

In light of the number and extent of tax reform motivated reviews and changes in the last decade, one could be forgiven for assuming that taxpayers suffering from review and reform fatigue would have cried "enough". However, the message that we get from our clients, both in our daily interaction with them and, more formally, through the medium of the *BDO Tax Reform Survey 2011,* is that there remains a real hunger for appropriately directed reform.

In an increasingly competitive international environment, Australia cannot afford to grow complacent about the reform of our taxation laws and practices. Particularly in circumstances where there are real limitations on the extent to which Australia can compete on rate of taxation, it is essential that Australia's taxation laws should be benchmarked against international best practice, on an ongoing basis, and, to the extent that those laws fall short of such benchmark, appropriate changes should be enacted. The responses we received to the *BDO Tax Reform Survey 2011* demonstrate that the Australian business community continues to demand appropriately directed tax reform. We would submit that such demands are well justified.

2. Difficulties in making submissions without knowing the counterbalancing measures

We note (by reference to page iv of the Interim Report) that:

> "*As outlined in the Working Group's terms of reference, the costs of any reform options will need to be offset by savings from business taxation measures to achieve a revenue neutral package*".

It is difficult to sensibly comment on the manner in which the business taxation laws should be reformed and, in particular, express preferences for alternative design choices, without knowing either, the differential costs of such design alternatives or the measures that might be adopted in order to fund, and thus provide revenue neutrality in respect of, the posited reforms.

We note that notwithstanding the many reform initiatives in the last decade, there remain many inequities, inefficiencies and unnecessary complexities in the taxation environment currently faced by businesses. We would submit that initiatives aimed at removing such flaws should be pursued regardless of the "revenue neutrality" of resulting outcomes. At the very least, we hope that economic efficiencies to be gained from reforms and the potential

resulting increase in business taxation revenues are factored into any modelling of such outcomes undertaken by Treasury.

Bearing the above in mind, all of our submissions should be read as subject to the rider that we only support reform to the extent that any counterbalancing measures do not produce outcomes more unpalatable than those which are the subject of the reforms that they fund. To this end we submit that prior to implementation of the reforms, details of such counterbalancing revenue measures should be released and there should be a further opportunity to make submissions in respect of both the proposed reforms and such counterbalancing measures.

3. Carry back of losses

Although the carry back of tax losses is not the first reform initiative addressed in the Interim Report, we have addressed it first in our submissions as a reflection of our perception of its level of importance in the current challenging economic environment faced by Australian business taxpayers. The continuing strength of the mineral and resources sector, when aggregated into national economic growth figures, tends to cloak the genuine economic challenges faced by many taxpayers, including those, in particular, experiencing a negative impact from the current Australian terms of trade and resulting continuing historically high value of the Australian dollar.

An issue of significant concern to respondents to the *BDO Tax Reform Survey 2011* was the impact of the Australian taxation system and environment on the international competitiveness of Australian business. One area where Australia is “out of step” with competing economies and, more specifically, their taxation systems, is in the treatment of taxation losses. In challenging economic times (as touched on above), variability of income flows and revenue streams can result in profits (and corresponding taxable income) in one year and losses (with corresponding tax losses) in another. As acknowledged in the Interim Report (para 25) “[t}he income year is an artificial construct ...”.

As addressed in the Interim Report, under the current Australian tax paradigm, tax losses cannot be “carried back” to a prior year, but instead can only be carried forward to be offset against future assessable income. Such treatment provides no relief from the immediate financial distress of being in a loss situation and can produce harsh and unfair outcomes where the behaviour of variables beyond the control of taxpayer can result in profits and losses in quick succession. A solution to this tax based inequity would be provided by taxpayers being permitted to carry tax losses back to previous profitable years. This would provide some immediate relief from financial distress and would more equitably address the variability of economic performance across periods exceeding 12 months in uncertain economic times.

The multiple tax year averaging or “profit smoothing” implicit in such an approach, is reflected elsewhere in Australia’s taxation laws, being already overtly provided in respect of primary producers, sportspersons and those involved in artistic endeavours. There appears to be no good reason for the denial of similar relief to others who also confront the challenges of variability in income and outlays.

The failure to provide carry back relief is at odds with the approach adopted by many of Australia's competitors. Thus, for example, as addressed in Appendix B to the Interim Report, each of Canada, France, Germany, Ireland, Netherlands, the United Kingdom and the United States of America provide some form of carry back of tax losses.

We are heartened by a similar recommendation (Recommendation 31) in the *Report to the Treasurer* from the Henry Tax Review. We would suggest, however, that the temporal limitation of such carry back to the one year, recommended therein, is overly restrictive. A three year or greater carry back period would strike a better balance between competing concerns in adopting such an initiative. In particular this would better address circumstances where a taxpayer experiences more than one year of loss, or a year of marginal profitability preceding a year of loss. In this regard, in our experience, it is common for companies to experience multiple loss years (often aligned with the long term economic cycle). Further, we note that Interim Report acknowledges at the paragraph 115:

- a carry back period of between one and three years would be consistent with international practice; and
- a two or three year carry back period would provide greater opportunities for carry back to occur and a better 'smoothing' impact on the tax treatment of companies.

Alternatively, if the carry back of tax losses is implemented with a carry back period of less than three years, we submit that the carry back period should be at least 3 years for a company that is wound up.

We submit that the carry back of tax losses should not be restricted to companies of a "certain size". The rationale noted in the Interim Report at paragraph 145 for such a restriction is that larger companies have diversified operations which increase their ability to ultilise losses, as profits from certain operations within their business could be offset by losses resulting from other operations in the business. However, we submit that there are many large companies that do not have diversified operations or, if they have, the performance of such operations is not necessarily uncorrelated. Further we submit that the larger a company is, the more significant the impact that it's performance may have on the Australian economy. Accordingly, we submit that the automatic stabilisation effect would justify allowing large companies to carry back of losses.

We acknowledge that, sensibly, such carry back should be limited, in the case of corporate taxpayers, such that the debit to the franking account arising from the resulting tax refund would not exceed the franking surplus of the company at the time of the carry back. There would appear to be no cause to further limit the quantum of such carry back other than it, obviously, not exceeding the quantum of taxable income returned in the relevant prior year. In particular, there would appear to be no sound basis for limiting the loss carried back to the "increase in the balance over the allowable time period" (see Consultation Question 3.5).

We are concerned about suggestions in the Interim Report that, as a general proposition, the period for amendment to assessments of companies might be extended where there was a carry

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back of losses. Any extension to the period for amendment of assessments should be strictly limited to that which is necessary to give effect to a loss carry-back or amendments, within the time currently authorised, reducing the quantum of the loss in the applicable loss year available to be carried back. The reform initiative should not result in the ATO being authorised to re-examine, more generally, the tax affairs of the relevant taxpayer in respect of tax years which should otherwise be closed to such scrutiny. To do otherwise would be to impose a sanction, discouraging taxpayers from carrying back losses, and would run counter to the tenor of the Treasury *Report on Aspects of Income Tax Self Assessment*, published in December 2004, and the amendments to s170 of the ITAA 1936 made by Schedule 6 to the *Tax Laws Amendment (2010 Measures No.2) Act 2010.*

4. Uplift of losses

The asymmetry between the tax treatment of profits and losses (addressed in Part 2 of the Interim Report) is cast into sharpest relief in the context of businesses involving both substantial start-up costs and substantial lead times before they become cash-flow positive. The time value of money dictates that there is a tax induced bias against the establishment of, or investment in, such businesses in Australia (leading to material efficiency costs). Such bias would be materially reduced if an "uplift factor" were applied to such losses. While, ideally, such uplift factor would reflect the implicit cost of not investing those funds into investments providing immediate returns, a reasonable compromise might be achieved by applying the long term bond rate (or the long term bond rate plus a specified percentage).

5. Integrity measures

The current "continuity of ownership test" (COT) and "same business test" (SBT) offend materially against both the tax criterion of simplicity (in imposing material compliance costs on corporate taxpayers) and, more importantly, that of economic efficiency (in imposing an economic penalty on taxpayers who seek to make changes to a struggling business in order to return it to profitability). While the compliance costs are irksome, in our view, it is the economic efficiency costs that most urgently need to be addressed.

Where a company fails COT, it must satisfy the SBT in order to be able to deduct tax losses. However the SBT, particularly as it is applied and administered by the Australian Taxation Office, imposes unreasonable constraints on a company trying to turn around a struggling business. Thus, rather unhelpfully and, it is submitted, unnecessarily, in the oft cited judgment of Gibbs J in *Avondale Motors (Parts) Pty Ltd v FC of T* [1971] HCA 17, his honour stated (at para 13), in respect of the previous iteration of the SBT in s80E(1) of the ITAA 1936 that:

> "*It seems to me natural to read the section as referring to the same business, in the sense of the* ***identical*** *business, and this view is supported by a consideration of the purposes of the section.*" (emphasis added)

The strictness of the approach adopted by the ATO, on the basis of such interpretation, and aggressiveness with which it pursues that approach is well illustrated in the successful appeal

of the taxpayer before the Full Federal Court of Australia in *Lilyvale Hotel Pty Ltd v FC of T* [2009] FCAFC 21.

A "dominant purpose test, directed towards the purpose of an entity in acquiring a controlling interest in a loss company, could replace the SBT. Such a test should be framed in such a way as to acknowledge that the availability of the relevant tax losses need not be irrelevant, nor even, unimportant, to the relevant participants in activities which lead to the losses being deducted. To this end a "dominant purpose" threshold should be applied (and not a lesser threshold such as the "other than an incidental purpose" threshold applied in s855-30(5)). As with Part IVA of the ITAA 1936, such dominant purpose could be ascertained by reference to stated criteria and relevant facts and circumstances. Such an approach should not impose too onerous an administration burden on the ATO (see paragraph 93 of the Interim Report), where it only need be considered if some form of COT was failed.

If a dominant purpose test were not to replace the SBT, it is essential that the SBT be amended such that the cessation of activities that would inevitably lead to further exacerbation of the already existing loss position and/or development and pursuit of activities which would enable a company to render itself profitable, will not, inevitably, render its tax losses non-deductible where COT has been failed. In other words, the existing SBT stifles innovation and the growth and development of existing businesses, which is a problem of even more concern in the current challenging economic circumstances. One means of addressing such shortcomings could involve a redrafting of the SBT that makes it clear that "same" does not mean "identical", and that it is sufficient that activities which are similar or related to those that were carried on before failure of the COT continue to be carried on thereafter. For example:

- the current requirement for a business to remain "identical" could be relaxed to be "materially the same", with materiality being defined by reference to a specified threshold;
- the "new business test" and the "new transactions test" in paragraph 165-210(2)(a) and (b) should be repealed.

The transfer of the "available fraction" mechanism from the tax consolidation measures seems problematic. It is not apparent how such a mechanism would be applied, for example, where a new equity holder took 51% of the issued shares in a company and the remaining shares continued to be held by existing shareholders. It is also not clear that what might be considered a "cost" of consolidation should be imposed on a taxpayer that would not be accessing the corresponding "benefits" of consolidation. If considerable care were not taken, the existing measures might be replaced by ones that would be, at least, their equal in complexity and which would, potentially, impose their own inefficiencies.

6. Treatment of capital losses

The submissions made elsewhere in this document should be taken to apply equally to revenue and capital losses.

In addition, the income tax legislation should be amended so that companies that elect to forgo indexation can deduct net capital losses for CGT purposes, in the same way that they can deduct revenue expenses or losses ie such net capital losses should no longer be quarantined such that they can only be applied to reduce capital gains.

When Australia introduced the CGT provisions, with effect from 1985, they included a number of concessional treatments for capital gains, as compared to the income tax treatment of equivalent revenue gains. Most notable of these concessions, to the extent that they are relevant for this discussion, were:

- Indexation, by reference to the CPI, of components of the "cost base" of an asset for the purposes of calculating any capital gain, provided the asset was disposed of more than 12 months after its acquisition, with the intention that only "real", after adjustment for inflation, gains were assessable; and

- "averaging" such that, while the whole of a capital gain was assessable, only one-fifth of such capital gain was included in assessable income for the purposes of determining an individual's applicable marginal rate of tax.

Due to such concessional taxation of capital gains, it was decided that an appropriate integrity measure was the "quarantining" of net capital losses, such that they could not be deducted from assessable income in calculating a taxpayer's taxable income, but instead could only be carried forward and offset against net capital gains realised in subsequent years.

Due to amendments made in 1999:

- the CGT discount was made available to non-corporate taxpayers ;

- indexation of cost bases was "frozen" as at 21 September 1999, and

- "averaging" of capital gains was removed.

As a consequence of the 1999 changes, it is often the case that no concessions are available to companies in respect of the calculation of net capital gains. In other words, where a company realises a capital gain, it is often assessed and taxed to the company in an identical manner to the taxation of an equivalent revenue gain. Notwithstanding this, companies continue to be prohibited from deducting net capital losses from their assessable income of current or future years. This can result in the unsatisfactory situation of a company being assessed and taxed on taxable income while simultaneously carrying forward a "quarantined" net capital loss.

Provided a company is prepared to forgo any residual access to indexation of cost base in respect of capital gains there appears to be no good reason for the continued quarantining of such capital losses. We submit that the law should be amended so that such a company can immediately deduct such a capital loss, for all income tax purposes.

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7. Black hole provisions

The current 5 year write-off, under s40-880, for "black hole expenditure", is arbitrary, as to time period. The closest equivalent, on the receipt side, CGT event D1 (under s104-35), brings the whole of the gain from such a receipt to tax in the year of receipt.

As a minimum, black-hole expenditures in respect of the cessation of a business should be fully deductible in the year in which they are incurred. There is a risk, otherwise, that resulting deductions are wasted.

Serious consideration should also be given to accelerating deductibility, in other circumstances, in order to facilitate the establishment and restructuring of businesses and to provide greater symmetry with CGT event D1.

In addition there is a material argument that s40-880(5)(d) should be repealed or materially amended. In its current form it imposes considerable uncertainty in respect of the breadth of operation of s40-880.

8. Prospective application of amendments

The Interim Report argues (at point 3.7.1) that *"the reforms should only apply to new losses, as the reforms are targeted at removing distortions on future decision making"*. While such an approach might be justified in respect of other measures, we submit that such an approach, if applied to reforms in respect of the SBT, would be flawed, having regard to all three of the major tax policy criteria (equity, efficiency and simplicity) commonly applied in the assessment tax measures.

From a horizontal equity perspective, a company with "new" losses would be favoured over a company with "existing" losses, in being free to undertake activities, without threat to its losses, that the company with existing losses would, effectively, be precluded from undertaking.

There would, contrary to the implicit representation in the above-quoted passage from the Interim Report, be very significant efficiency costs, as follows:

- Companies with "existing" losses would continue to be constrained (where they had failed COT) from making the necessary innovations and changes to make themselves profitable without placing the deductibility of their losses at risk;

- Companies with new losses would have a significant advantage in attracting new investors compared to companies with existing losses, as such investors would be conscious of the differential consequences for such companies of any resulting failure of COT and the impact of such failure on the value of such companies; and

- Companies with a combination of existing and new losses would, effectively, be placed in the same position as companies with only existing losses, as they would not be able

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to avail themselves of new freedoms in respect of the new losses until they had exhausted existing losses

From a simplicity perspective, the result would be very poor. Existing companies would potentially have to apply a combination of all of the following:

- The existing rules, in all of their complexity;
- The new rules, in respect of any new losses
- The inevitable transitional and anti-avoidance rules dealing with interactions between the existing rules and the new rules.