

E. F. Cunich & Co
Consultation paper-
Interim report on the tax treatment of
losses

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CONSULTATION QUESTIONS

To support with the consultation process and assist in responding to the ideas in the interim report, the Working Group has put together a set of consultation questions. These questions are provided to help the community respond to the ideas contained in the interim report and allow the working group to properly consider all of the views held by businesses and the wider community.

1 — Decision making and the tax treatment of losses

1.1 How does the current tax treatment of losses affect decisions about your business or businesses that you are familiar with, in particular; decisions about:

a. undertaking new investment;

Our company is involved in horticulture where the timeframe between investment and positive cash flow is significant (generally five to 10+ years). During the late 1980s and 1990s the company consistently paid tax. Since 2000, after eight years of drought, we have recently experienced the three worst seasons (back-to-back) in 130 years of operation. The last three seasons of failed crop coincided with significant investment in new technology (approximately \$1.2m). The result of seasonal impact on business performance over the last 10 years is approximately \$2m of tax losses currently being carried forward. We estimate that it could take us 20 years of average to good seasons to fully utilise current accumulated losses.

Previous offers by the Government to encourage investment (e.g. accelerated depreciation of assets) only benefit companies that are making a profit at the time. While we had the opportunity to invest in new technology to improve business efficiency we opted against it because the only benefit would be additional accumulation of tax losses.

Cash flow (consistent and adequate) is our major concern at present. There are a number of proposed Government changes which will come into effect in the short to medium term (e.g. carbon tax, increased superannuation) which will further impact upon cash flow. For example, increasing superannuation by three per cent will require the business to spend an additional \$22,500 per annum (based on current annual wages). It is proposed that this will be offset by a reduction in the company tax rate. However; since our business has significant accumulated tax losses, the reduced tax rate has no value until the accumulated tax losses have been used.

In the present economic environment the benefits from the investment would not offset the additional finance costs and would not put us in a position to utilise existing accumulated tax losses. With our current level of accumulated tax losses and the way that they are currently treated by the taxation department, in conjunction with the proposed increases to superannuation and the implementation of a carbon tax, our business is reluctant to undertake any new investment until such time as the current accumulated losses have been used.

b. raising equity or debt?

Debt has been the main source of capital into the business; however, cash flow lag after significant invest means the banks are reluctant to provide additional capital. Business performance as a direct result of drought and flood has required our business to extend its debt levels. It is the intention of the business to reduce its current debt levels. This would allow it to reinvest in new innovations and technologies to improve business efficiency.

Equity partners, while interested, desire to see the business making a profit before committing. The ability to access current accumulated tax losses may be an incentive to invest provided the fundamentals are right within the business.

c. undertaking research and development and introducing innovations?

Research and development and introducing new technologies is time-consuming and expensive. Over the years we have accessed Government programs to implement new technologies (e.g. low interest loans through the rural assistance authority); however; these schemes require the business to make annual principle and interest repayments to the Government. In our case this equates to approximately \$20,000 per annum. At the same time we have accumulated additional tax losses while we wait for the benefit from the investment to be realised. In our case the ability to trade our tax losses with the Government to pay back the loan would be a significant benefit and provide far greater benefit than any of the options outlined in the interim report. While this would not apply across the board to all investments it could certainly apply to investments which are eligible for existing Government schemes where funds are loaned to businesses.

2 – Integrity provisions

2.1 How do the current integrity provisions (continuity of ownership test (COT) and same business test (SBT) affect decisions about your business or businesses you are familiar with?

Our business is currently developing a succession plan for the existing partners in the business to retire. The value of accumulated tax losses is significant; therefore, every decision regarding succession (transfer of assets, shares, sale of business etc) needs to be checked by our accountant to ensure that integrity provisions are met. This adds time, cost and complexity to the process.

2.2 Has the possibility of failing the COT and SBT stopped your business, or a business you are familiar with, from undertaking some activities? If so, how?

We are not in a position to allow the possibility of failing the COT and SBT to stop our business from undertaking the succession of the business. We have resided to the fact that some of the accumulated tax losses may be lost. As mentioned previously, it has added considerable time, cost and stress to minimise any losses.

2.3 What costs are incurred in meeting the COT and SBT?

There are a number of costs associated with meeting the COT and SBT including:

- Direct cost associated with accountants and legal advice (currently \$10,000; this is estimated to be around \$30,000 at the completion of the succession process)
- The opportunity cost of staff members working with professional service providers rather than working on other tasks for the business. This opportunity cost relates to lost production or lost revenue
- The cost of losing accumulated tax losses. Where there is no alternative option then accumulated tax losses will be lost. This requires the services of accounting and legal professionals to minimise the loss.

- Opportunity cost of losing potential investors (also the additional time taken to identify suitable potential investors)

2.4 What would be the impact on your business decision making of introducing:

a. an available fraction test?

The available fraction test would be of benefit if we were looking to sell or merge the business with another entity as part of a consolidated group.

b. a purpose test?

A dominant purpose test would not be applicable to our business; we are not in a position to make investment decisions based on the purpose of obtaining losses. Our decisions are based on reducing risk and increasing cash flow and profitability.

2.5 What compliance costs would be incurred in meeting the above tests?

As per question 2.3

3 – Elements most valuable to businesses

3.1 What would be the impacts of a one-year carry back on your business (including impacts on decision making and cash flow)?

At present any carry back period would have no impact until all existing accumulated tax losses are used. At that point a one-year carry back would potentially have a positive impact on the business; however, due to the seasonal nature of our industry the timeframe would be too short. The short timeframe would mean that we would continue to make conservative decisions regarding business management, investment and growth opportunities. Cash flow would benefit although, depending upon seasons, the carry back amount may not be sufficient to assist the business to smooth out cash flow.

3.2 What would be the impacts of a three-year carry back compared to the one-year carry back?

A three year carry back would be better than a one year carry back as this would provide greater smoothing benefits regarding cash flow for our business.

3.3 What do you think of a loss carry back restricted by time? Should the carry back be restricted in terms of the amount of loss carried back instead of, or in addition to, the time restriction?

The longer the better with regards to loss carry back time restrictions. Capping the amount of loss carried back either by time or value should be considered on an industry basis rather than a blanket restriction across all sectors. This would account for variations between sectors and would make the restrictions specific and relevant rather than generic and potentially of little or no benefit.

3.4 What would be the impact on your business of limiting the loss carry back to the franking account balance?

Non applicable

3.5 Should loss carry back be limited to the franking account balance or the increase in the balance over the allowable time period?

3.6 Should the amendment periods applying to companies accessing loss carry back be increased?

3.7 What is the appropriate uplift rate to be applied to losses carried forward?

3.8 Of the possible reforms outlined in the interim report, which element or combination of elements would be most valuable from the perspective of your business or businesses you are familiar with? How would they be of benefit?

All the options outlined in the interim report, either individually or in combination, would be of benefit to our business, provided we were in a position where the business was paying tax. The examples in chart 1 (page 16)- constant profit, start-up company, recovery company only reflect companies where losses occur for two consecutive years only. In our experience the periods of taxable income and tax losses can be much longer (almost 10 year cycles in some cases). Based on this the proposed reforms outlined in the interim report would only occasionally be of benefit.

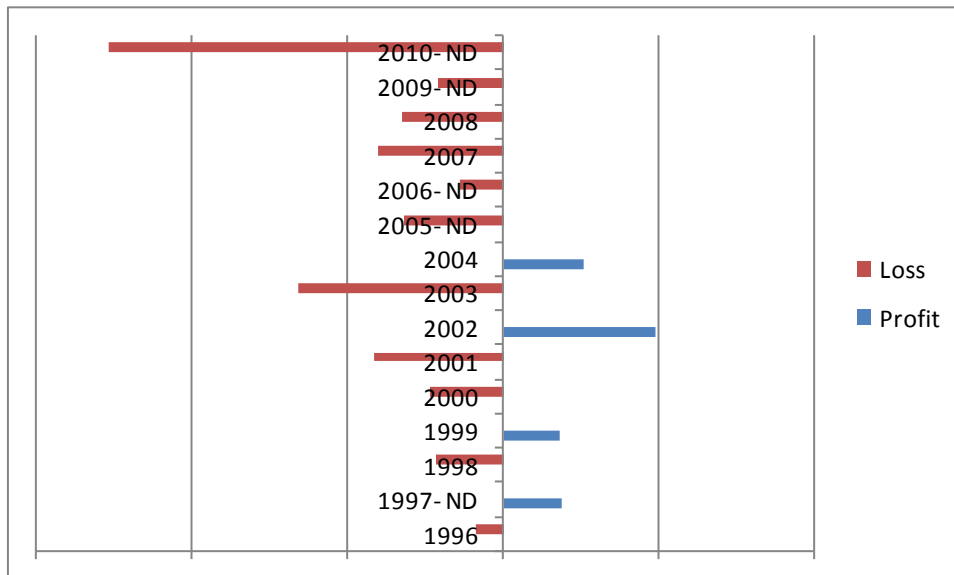
Therefore, I believe the options outlined in the interim paper would offer little benefit to our business. Businesses need a tax system that will assist them to recover quickly; this is good for the business, good for employees and communities and good for the economy and Government. The tax system should not place additional stress on the business or its cash flow. It should use the current business position (including tax losses) to change the profit and loss status of the business to speed up recovery and to get those businesses back into a position where they can employ more people and pay tax again.

The interim report (in clauses 35 & 36) discusses the transferability of tax losses between taxpayers. Conceptually, for our business, this would have the greatest merit and would be far more beneficial than the other options outlined in the interim report. To minimise the risk of misuse restrictions could be put in place to ensure that the transfer of tax losses to generate cash flow could only be used to improve the business performance (e.g. accumulated tax losses are transferred to the bank and the capital raised is used to pay down debt). This option would allow us to significantly de-risk our business at a time when cash flow is tight and capital is difficult to raise for business improvement investments.

Given the scenario outlined above I would like to present the following recommendations for consideration as an alternative (or additional option) way to manage tax losses:

- Government investment loans for business investment (e.g. Rural Assistance Authority- Special Conservation Scheme)
 - the Government would allow business owners (after a period of time) to transfer accumulated tax losses to the Government to pay-back Government investment loans. This would be extremely beneficial for businesses to close the gap between investment and a position of taxable profits
- natural disaster relief
 - Australia has experienced a large number of natural disasters recently (fires, floods, cyclones). In a large number of cases the Government has declared the regions “natural disasters” and made funding available in the form of low interest loans to approved applicants. While this is welcome relief the loan is required to be paid back and as such it puts additional cash flow pressure on the business at a time when cash flow is limited. In a lot of cases businesses may struggle to generate a profit for a number of years (after the natural disaster) and therefore the business would accumulate tax losses rather than pay tax. Swapping accumulated tax losses for loan repayments would provide considerable benefit.
 - It could be argued that the carry back options would meet this requirement; however, the carry back option would be limited to those who meet the criteria paying tax in the required period prior to the disaster (refer to chart below)

- For example, over the last 15 years our business has been eligible for no less than five natural disaster (marked as ND on chart) events. In each case we were eligible to borrow \$150,000 from the Government in the form of a low-interest loan.
- The table below shows the seasonal variation for part of our business. As you can see the losses in some of these years has been significant (Note: some of these losses relate to depreciation on significant investments)
 - A one year carry-back option would only be beneficial in four years out of 15 for approximately 80 per cent of the accumulated tax loss value
 - A three year carry-back option would be far more beneficial



- Transfer accumulated tax losses to another business
 - While the interim paper touched on this point briefly I believe that this option has considerable merit and should be seriously considered. It would be possible to develop the rules and laws necessary to restrict the misuse of this option. For example the transaction could only occur between unrelated parties (e.g. business and bank) the value of the transaction could be at pre-determined values (e.g. dollar for dollar swap of tax losses for debt minimisation).
 - For our business we could swap 50 per cent of the accumulated tax losses with the bank to be debt free. We could use part of the remaining tax losses to swap with the Government to pay back natural disaster loans. In doing so our business would be much more robust and would be paying tax in the next financial year.

I believe that these options would have far greater benefit to our business than the options outlined in the interim paper. While the options in the interim paper may offer some benefit in the future, at present the adoption of any or all of those options would mean that our business would still not start paying tax for the next 20 years and would continue to be very conservative in its investment decision making.

By implementing the recommendations (transfer of accumulated tax losses) that I have outlined our business would be in a position to pay tax in the next financial year and we would be in a position to consider investing in new projects and/or technologies. In summary the benefits would be:

- Accumulated tax losses would be used to “wash-out” natural disaster loans or business development loans (business liability to the Government) without the need for additional budget funding from the Government (although it may impact of forecast future Government earnings)
- Businesses would reduce their level of accumulated tax losses which means they would be in a position to pay tax much sooner

- Using accumulated tax losses to pay off loans means that business expenses (interest) are reduced. This will potentially result in an increase in profitability and the likelihood of paying tax sooner
- The ability to transfer accumulated tax losses to another company would generate much needed cash flow or reduce business liabilities
- Employees would retain their jobs and local communities would benefit as a result of businesses continuing to spend money
- Businesses would be in a position to spend additional capital on recovery projects
- Businesses would be able to quickly restructure increasing the likelihood of remaining viable during difficult economic conditions

4 – Broader changes to the tax system

4.1 How would you rank reforms to the tax treatment of losses against other changes to the business tax system?

Reforms to the tax treatment of losses would rate higher for our business at present than other reforms to the business tax system, provided they would add benefit. The current proposed options wouldn't add immediate benefit to our business. This comment is based on how it would apply directly to our business which has a high level of accumulated tax losses and an expected long period (approximately 20 years) under the current system before the business would commence paying tax again.

4.2 How would you rank reforms to the tax treatment of losses against other forms of Commonwealth regulation?

Any reforms to the tax treatment of losses which can assist businesses to smooth out either seasonal variation in profitability or investment decisions are positive provided that the reforms are attainable by businesses. If the business is unable to access the reforms due to the current financial position of the business and the current economic climate then it will be little more than window dressing.

Assuming that the outcomes are attainable and positive for businesses then I would rate reforms to the treatment of tax losses well ahead of any other forms or Commonwealth regulation.