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2 February 2012

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

By Email: BTWG@treasury.gov.au

Dear Sir/ Madam

Subject: Business Tax Working Group (BTWG) – Interim report on the tax treatment of losses

CPA Australia represents the diverse interests of more than 139,000 members in 114 countries throughout the world. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders.

Against this background, we welcome the opportunity to comment on the issues raised in your interim report.

Please contact me if you wish to discuss any of the points raised in the attachment to this letter.

Yours faithfully

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Head - Business & Investment Policy

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Attachment

1. Funding

At the outset, we note that the statement in the report that 'the costs of any reform options will need to be offset by savings from business taxation measures to achieve a revenue neutral package'. In the absence of any costing of the reform alternatives set out in the report, it has been difficult to identify where offsetting savings might be obtained elsewhere in the tax system since the quantum of the required savings is unknown. Accordingly, we have not been able to accurately assess the viability of each proposed measure or the combinations of those measures. Our comments should be read in this context. We also recommend that costings on each of the alternatives be prepared to enable more meaningful consultation on each of them going forward.

Notwithstanding the above disclaimer, and as previously submitted to the BTWG by our organisation, we consider potential revenue savings to fund such loss reform could be possibly funded from removing or ameliorating some existing tax concessions as follows:

- consider reducing the extent of, or removing completely, the cost base uplift under the Allocable Cost Amount (ACA) that arises under the existing income tax consolidation regime where there is a public takeover of a target company by a consolidated head company;

- consider reducing interest deductions under the thin capitalisation regime so that public companies and large closely held groups can only obtain interest deductions to the extent that they do not exceed a 2:1 debt/equity ratio under the safe harbour test ; and

- rationalise the tax deductions available under the capital allowance regime by either reducing or removing accelerated tax depreciation for certain depreciating assets that have a statutory effective life.

2. Decision-making and the tax treatment of losses

The report indicates that the current tax treatment of losses creates a bias against risk taking and illustrates this by comparing the effective tax rate of two investment choices, the less risky one having a rate of 30% and the more risky one giving rise to an increased rate of 50%. In practice, such an approach to assessing the viability of an investment is uncommon with the assessment typically depending on commercial rather than tax considerations.

In the case of new investment, the viability of an investment is typically modelled on the basis that losses will continue to be available (unless there has been a prior failure of the Continuity of Ownership (COT)). The tax benefit of expected losses would be taken into account.

Similarly, in the case of raising equity or debt, our experience has been that losses are not frequently a consideration. However, a decision to raise debt that would give rise to interest deductions may be affected by the existence of prior year losses. That is, a company may be less inclined to raise debt that would either give rise to further losses or impede the utilisation of prior year losses.

3. Comments on alternatives

3.1 Element A – remove the COT and SBT

The removal of the COT and SBT would significantly increase the ability of a company to use its carry forward losses to reduce its current year taxable income, and we agree that integrity measures would need to be introduced to ensure that companies do not abuse the tax system.

Further, since any proposed amendment will need to be revenue neutral, the removal of the COT and the Same Business Test (SBT) would necessitate the abolition or scaling back of one or more tax concessionary measures. Therefore, as an alternative to the complete removal of the COT and SBT,

we suggest that these integrity rules be retained but with modifications. A further advantage of retaining the COT and the SBT is that practitioners are familiar with the rules.

The changes that could be made to the COT would include the introduction of the long-awaited amendments for companies whose shares have unequal rights to voting power, dividends and capital distributions which, once enacted, should greatly increase the ability to satisfy the COT.

Moreover, the requirements of the SBT could be relaxed to make it less onerous for companies to satisfy the test. At the moment, a company does not satisfy the SBT if it derives assessable income from a business of a kind that it did not carry on before the failure of the COT, or a transaction of a kind that it had not entered into in the course of its business operations before the failure of the COT. In our experience, many companies have found it difficult to satisfy both limbs of the SBT.

Furthermore, although there is a significant body of case law on the SBT and the ATO has released guidance (primarily Taxation Ruling TR 1999/9), the application of the test in practice can be difficult and time consuming.

In summary, our view is that the proposed amendments to the COT for companies with shares that have unequal dividend, capital and voting rights should be introduced as soon as possible.

In addition, consideration should be given to amending the SBT to make it less onerous. For example, this could be achieved by allowing the company to carry forward a loss under the SBT where the same business was being 'substantially' carried on, and excising the new transactions and new business tests. Alternatively, a de minimus test could be introduced so that the SBT does not need to be passed in respect of losses incurred by companies which are small business entities as defined under Division 328 of the Income Tax Assessment Act (1997) below a certain dollar threshold.

We also note that the removal of the COT and SBT would, as the report highlights, require the introduction of alternative integrity tests. The introduction of new tests would potentially increase compliance costs (at least, initially) because of the need for practitioners to acquaint themselves with the new tests. The available fraction test would also require market valuations. Furthermore, the ambit of the tests would presumably be further refined over time through amendments, case law and ATO guidance.

3.2 Element C – time limited loss carry back

Since loss carry back rules have been adopted in several major jurisdictions, we consider that there is merit in considering the adoption of these rules in Australia.

In the absence of any costing of this alternative, consideration should be given to a one-year loss carry back. The Government should also consider introducing exceptions to the one-year rule in certain circumstances. For example, in the United States, there are exceptions to the general two-year carry-back rule for losses as a result of casualty, theft or a presidentially declared disaster, which are eligible to be carried back three years, and farming losses that may be carried back five years.[1] Given that one of the objectives of the reform elements identified in the report is 'reducing the bias against riskier investments and, at the same time, improving the cash flow for struggling businesses', the introduction of variable term carry back rules would allow the targeting of specific businesses or industries where a need has been identified for healthy risk-taking or assistance.

In addition to a time restriction, consideration could be given to a cap on the amount of losses that may be carried back. For example, the carry back amount is capped at €1 million in France and €10 million in the Netherlands.[2] This may also help to address the potential risk of variability in company tax revenue that is highlighted in the report.

Should revenue constraints put a limit on the scope of potential loss carry back relief we believe that it may be preferable to limit any carry back relief to an eligible small business entity whose aggregated turnover does not exceed $2 million, and set a reasonable cap on the amount of any loss carry back by such an entity.

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[1] *Internal Revenue Code*, subsection 172(1)(b). http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00000172----000-.html

[2] OECD, *Corporate Loss Utilisation through Aggressive Tax Planning* (2011), p32 (reproduced in Appendix B of the report)

4. Other reform options – blackhole

We agree that section 40-880 should be amended to allow expenses to be written off over a shorter time period for businesses that are starting up or winding down.

5. Other issues

We note that the report only addresses losses of companies. However, we consider that the review should be extended to losses of other entities. We note that many businesses are carried on through trusts. Given that the same policy issues identified in the report can arise in relation to trusts, our view is that the BTWG should also consider potential reforms to the trust loss rules.