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Abstract

The asymmetric treatment of corporate losses arguably creates impediments to risk taking, investment and innovation, which ultimately detracts from productivity growth. To deal with this situation, the Tax and Superannuation Laws Amendment (2013 Measures No. 1) Bill 2013 received royal assent on 28 June 2013 and implemented a loss carry-back system based on prior recommendations of the Business Tax Working Group however this system has since been repealed. The Business Tax Working Group originally proposed four reform options by. With the loss carry-back now implemented and subsequently repealed, it is an appropriate time to cast an eye over these other options, whilst also considering the positives and negatives of the loss carry-back option. Such option was not intended to be the end of the matter but the first step to a reform of the use of corporate tax losses.

Keywords

Corporate tax losses, losses and tax reform, carry-back provisions

REFORM OF THE USE OF CORPORATE TAX LOSSES: AN APPRAISAL OF THE OPTIONS AND A CONSIDERATION OF THE NEXT STEPS

ANDREW SMAILES*

The asymmetric treatment of corporate losses arguably creates impediments to risk taking, investment and innovation, which ultimately detracts from productivity growth. To deal with this situation, the Tax and Superannuation Laws Amendment (2013 Measures No. 1) Bill 2013 received royal assent on 28 June 2013 and implemented a loss carry-back system based on prior recommendations of the Business Tax Working Group however this system has since been repealed. The Business Tax Working Group originally proposed four reform options by. With the loss carry-back now implemented and subsequently repealed, it is an appropriate time to cast an eye over these other options, whilst also considering the positives and negatives of the loss carry-back option. Such option was not intended to be the end of the matter but the first step to a reform of the use of corporate tax losses.

INTRODUCTION

“Allowing loss carry-back will encourage businesses to invest and adapt, and will mean companies in the slow lane can use their tax losses now—when they need to—rather than in the future when their businesses are performing better.”¹

The prevailing situation in Australia is a predominantly asymmetric treatment of corporate losses, as what carry-back exists is limited in terms of time and quantum. For many corporations,² losses may never be used, or may need to be carried forward for a number of years before being used thus the value of those losses declines while profits are taxed in the year they occur. This, in turn, impacts on effective tax rates. It is argued that this situation is mostly perceived by corporations engaging in innovation since these firms will often experience extended periods of loss and be insufficiently diversified to have other income to offset with these losses.³ This has been highlighted recently by the Business Tax Working Group (BTWG), following on from a consideration of the issue by the Henry Tax Review. It concluded that the current treatment of corporate losses in Australia may create impediments to risk taking, investment and innovation, which ultimately detracts from productivity growth.⁴

The BTWG proposed a number of reform options regarding the treatment of losses in corporations that aim to reduce these impediments.⁵ Following on from this, on 28 June 2013, the Tax and Superannuation Laws Amendment (2013 Measures No. 1) Bill 2013 received royal assent and a loss carry-back system, through a tax offset, was implemented based on one of the BTWG’s recommendations.⁶ This measure, at least from the BTWG’s perspective, was a near term recommendation leaving the issue of medium and long term reform unresolved. However, with fiscal pressure, this system was subsequently repealed.

This paper will critically assess the four reform options originally proposed by the BTWG because Australia is back to a blank slate, and conclude whether such reforms will arguably achieve their desired purpose in relation to losses; that is, firstly, a reduction in asymmetries and impediments to

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¹ Assistant Treasurer David Bradbury MP, Second Reading Speech Tax and Superannuation Laws Amendment (2013 Measures No. 1) Bill 2013, 13 Feb 2013)

² Corporation’ is used in this paper for brevity but a number of entities that are not strictly corporations will also be impacted by these changes, such as corporate limited partnerships.

³ Thomas Abhayaratna and Shane Johnson, ‘Revisiting Tax Losses’ (2009) 24 *Australian Tax Forum* 59; Saman Majd and Stewart Myers, *Valuing the Government’s Tax Claim on Risky Corporate Assets* National Bureau of Economic Research Working Paper no 1553 (1985).

⁴ Business Tax Working Group, *Interim Report on the Tax Treatment of Losses* (2011); Business Tax Working Group, *Final Report on the Tax Treatment of Losses* (2012).

⁵ Business Tax Working Group, *Interim Report on the Tax Treatment of Losses* (2011), 15.

⁶ Explanatory Memorandum Tax and Superannuation Laws Amendment (2013 Measures No. 1) Bill 2013.

innovation, risk taking and investment and secondly, a net benefit for the broader economy.⁷ Ultimately, this process is aimed at determining the issue of subsequent steps in relation to reform of the use of corporate losses. While the BTWG's final report has been long completed,⁸ the BTWG noted that 'the timeframe for completing this report was not sufficient to fully explore the net-benefit of potential loss reforms,⁹ this assessment still has relevance. The loss carry-back recommendation will remain part of this process as it provides a sense of completeness and an appropriate frame of reference in the ensuing analysis. Furthermore, in a medium- to long-term, any reform of the use of corporate losses will need to consider this new offset and thus it is important to consider the positives and negatives of this feature anew rather than view it as a given.

CURRENT LOSS TREATMENT

Without going into excessive detail, the general situation is that a corporation can deduct a tax loss of a previous year in a later year when it generates sufficient net assessable or exempt income,¹⁰ although a company now has access to the limited loss carry-back offset, implemented recently and outlined shortly. However, a corporation will not be able to deduct a loss in a later income year if it does not pass the applicable integrity tests; generally either the continuity of ownership test (COI) or the same business test (SBT).¹¹ In particular, the SBT requires that a corporation carry on the same business throughout the test period¹² and that it not enter into new businesses.¹³ The rationale for these rules is that benefit of the tax loss deductions should accrue to those who had to bear the loss in the first place.¹⁴

As mentioned earlier, from 28 June 2013, under the now repealed section 160-10 of the *Income Tax Assessment Act 1997* (Cth), a corporate tax entity, which includes but not strictly limited to a corporation,¹⁵ can claim a limited offset. The conditions for access to this offset (called the 'loss carry back offset') in the current year are that:

- either the current or the last income year ('middle year') are loss years;
- that there was an income tax liability in either the middle income year, or the one before that;
- that lodgements for the last five years are up to date; and
- that a choice is made before the time the income tax return for the current year is lodged.¹⁶

A corporation can carry back losses from current or prior income a maximum of 2 years from the current year, provided that there is a taxable year within that period. The amount of the offset in the current year is determined by multiplying the amount of the loss carried back to a middle or prior year by 30%, up to the tax liability in that year.¹⁷ Losses can only be carried back once. Thus, if an entity has a loss of \$100 in the current year and tax payable of \$15 in the middle year, the offset for the current year would be limited to \$15. Furthermore, if the entity carries back the maximum amount of losses, being \$50 ($\$50 \times 0.3 = \15), there would only be \$50 of remaining losses to carry back in later years. A separate calculation is required for amounts carried back to the middle income year and to the year prior to that. The total current year offset, encompassing the sum total of both year amounts, cannot be more than \$300,000 or the franking account balance of the entity in the current year, whichever is smaller.¹⁸ Thus, if the entity has paid a franked dividend subsequent to the tax liability years, the loss offset will be limited. As with other loss provisions, a range of integrity measures are included in relation to the offset; namely that there are limitations on the offset when it interacts with

⁷ Business Tax Working Group, *Final Report on the Tax Treatment of Losses* (2012); 2. Note that the BTWG also briefly mentions black hole expenditure under *Income Tax Assessment Act 1997* (Cth), s40-880 and these provisions will not be dealt with here as the provisions are of less general relevance than losses broadly and reform of the provisions were largely bypassed in the BTWG's final report.

⁸ Business Tax Working Group, *Final Report on the Tax Treatment of Losses* (2012) (Released to the public on 13 April 2012).

⁹ Above n 6; 2.

¹⁰ *Income Tax Assessment Act 1997* (Cth), s36-17.

¹¹ *Income Tax Assessment Act 1997* (Cth), s165-10.

¹² *Income Tax Assessment Act 1997* (Cth), ss165-12, 165-130(1).

¹³ *Income Tax Assessment Act 1997* (Cth), ss165-12, 165-130(2).

¹⁴ Above n 4, 8; Above n 6.

¹⁵ *Income Tax Assessment Act 1997* (Cth), s995-1.

¹⁶ *Income Tax Assessment Act 1997* (Cth), s160-10.

¹⁷ *Income Tax Assessment Act 1997* (Cth), s160-15.

¹⁸ *Income Tax Assessment Act 1997* (Cth), s160-15.

transferred losses or excess franking credits¹⁹ and when the offset is part of a scheme.²⁰ The final point to note about this offset is that it is a refundable offset under section 67-23 of the *Income Tax Assessment Act 1997* (Cth), which is important because the conditions of the offset specifically envisage a situation of current year loss. However, this system was repealed and the old status quo of no carry-back was revived with the existing SBT and COT rules.

IMPLICATIONS

The result of the current loss treatment for corporations, even during the period of implementation of the loss carry back offset, is that the real value of losses decreases or is forgone entirely over time, if a corporation fails to generate sufficient profits or pass the integrity tests.²¹ This situation still occurs because the loss carry-back offset itself is both time and quantum limited so that there remains a large stock of asymmetrically taxed losses. As a result, there is a higher effective tax rate on those corporations that generate losses in some years which acts as an impediment to risk taking.²² As innovation is naturally a subset of risk taking, a specific link is drawn between the loss treatment for corporations and the incidence of innovation.²³ The contention that the treatment of losses is an impediment to innovation is supported by a wide array of international and domestic literature.²⁴ Nonetheless, the treatment of losses is not the only determinant following innovation.²⁵ In turn, productivity growth in the overall economy is partly driven by risk taking and innovation.²⁶ The current treatment of losses for corporations and its implications for innovation in particular have a

¹⁹ *Income Tax Assessment Act 1997* (Cth), s160-30.

²⁰ *Income Tax Assessment Act 1997* (Cth), s160-35.

²¹ Above n 4, 9; Above n 6; Allan Auerbach, *The Dynamic Effects of Tax Law Asymmetries* National Bureau of Economic Research no 1152 (1983); John Creedy & Norman Gemmell, *Corporation Tax Asymmetries: Effective Tax Rates and Profit Sharing* University of Melbourne Department of Economics Research Paper no 1028 (2008); Michael Cooper & Matthew Knittel, 'Partial Loss Refundability: How Are Corporate Losses Used?' (2006) 59(3) *National Tax Journal* 651; Rosanne Altshuler and Allan Auerbach, *The Significance of Tax Law Asymmetries: An Empirical Investigation* National Bureau of Economic Research no 2279 (1987); Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59.

²² Above n 4, 11; Above n 6; Saman Majd and Stewart Myers, *Valuing the Government's Tax Claim on Risky Corporate Assets* National Bureau of Economic Research Working Paper no 1553 (1985); Ralf Ewert and Rainer Niemann, *Limited Liability, Asymmetric Taxation And Risk Taking – Why Partial Tax Neutralities Can Be Harmful* CESIFO Working Paper No 3301 (2010); Martin Fochmann and Martin Jacob, *Behavioural Explanation of Tax Asymmetries* Magdeburg University Working Paper Series no 21/2011 (2011); Michael Cooper & Matthew Knittel, 'Partial Loss Refundability: How Are Corporate Losses Used?' (2006) 59(3) *National Tax Journal* 651; Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59; Allan Auerbach, *The Dynamic Effects of Tax Law Asymmetries* National Bureau of Economic Research no 1152 (1983); Rosanne Altshuler and Allan Auerbach, *The Significance of Tax Law Asymmetries: An Empirical Investigation* National Bureau of Economic Research no 2279 (1987); John Creedy & Norman Gemmell, *Corporation Tax Asymmetries: Effective Tax Rates and Profit Sharing* University of Melbourne Department of Economics Research Paper no 1028 (2008).

²³ Above n 4, 11; Above n 6; Margaret McKerchar and Ann Hansford, 'Achieving innovation and global competitiveness through research and development tax incentives: Lessons for Australia from the UK' (2012) 27 *Australian Tax Forum* 3; Margaret McKerchar and Margaret Dreaver, 'The Influence of Tax Reform on Entrepreneurship and Management Practices in the Small Business Sector in Australia' (2008) 3(2) *Journal of the Australasian Tax Teachers Association* 129; Organization for Economic Co-operation and Development, *Government R&D Funding and Company Behaviour: Measuring Behavioural Additionality* (2006); Review of the National Innovation System, *Final Report* (2008), 109.

²⁴ Valerio Filoso, 'The Corporate Income Tax: An Entrepreneurial Perspective' (2010) 13 *The Quarterly Journal of Austrian Economics* 99; Julie Cullen and Roger Gordon, *Taxes and Entrepreneurial Activity: Theory and Evidence for the US* National Bureau of Economic Research no 9015 (2002); Margaret McKerchar and Ann Hansford, 'Achieving innovation and global competitiveness through research and development tax incentives: Lessons for Australia from the UK' (2012) 27 *Australian Tax Forum* 3; Margaret McKerchar and Margaret Dreaver, 'The Influence of Tax Reform on Entrepreneurship and Management Practices in the Small Business Sector in Australia' (2008) 3(2) *Journal of the Australasian Tax Teachers Association* 129; Organization for Economic Co-operation and Development, *Government R&D Funding and Company Behaviour: Measuring Behavioural Additionality* (2006); Review of the National Innovation System, *Final Report* (2008), 109.

²⁵ Margaret McKerchar and Ann Hansford, 'Achieving innovation and global competitiveness through research and development tax incentives: Lessons for Australia from the UK' (2012) 27 *Australian Tax Forum* 3; Above n 4; Above n 6.

²⁶ Above n 4, 5; Above n 6; Julie Cullen and Roger Gordon, *Taxes and Entrepreneurial Activity: Theory and Evidence for the US* National Bureau of Economic Research no 9015 (2002); Chad Syverson, 'What Determines Productivity?' (2011) 49(2) *Journal of Economic Literature* 326; House of Representatives Standing Committee on Economics, *Report: Inquiry into Raising the Productivity Growth Rate in the Australian Economy* (2010).

wider impact outside of loss making corporations and their immediate stakeholders. For instance, a further subset of corporations that is particularly affected is mining exploration companies, and the profitability and viability of the mining industry in Australia is undoubtedly of great current relevance. It is no surprise, therefore, that asymmetric taxation of losses in corporations has been the subject of no less than three major governmental reviews in the last 15 years.

OPTIONS FOR REFORM

The BTWG has noted that in the current economic climate, the ability of businesses to be responsive and flexible will rest on an ability to take risks, which in turn is impeded by the asymmetric treatment of losses in corporations.²⁷ The BTWG proposed a number of reform options that aim to reduce the impediments introduced by the asymmetric treatment of losses.²⁸ The options are to:

- a. remove COT and SBT and introduce alternative integrity tests;
- b. allow losses to be refunded;
- c. introduce a time limited form of loss carry back; and
- d. apply an uplift factor to losses.

Option A

Option A is perhaps the least audacious of the options. That the COT and SBT are complex to apply in practice and act as strictures on business decision making has been widely acknowledged.²⁹ Two potential replacements are mentioned by the BTWG. The first is to use the available fraction rule which is used for losses in consolidated groups.³⁰ The second is to apply a dominant purpose test to disallow the use of losses, similar to that applied as part of Part IVA.³¹ It is suggestive of the wide spread consensus about the desirability of at least improving the integrity tests that all of the combinations of options in the BTWG interim report involve Option A. A broad conclusion, in the absence of more concrete draft legislation, is that these alternative tests may not hinder business decision making to the same degree of the COT and SBT which actively prevent the exploration of new businesses and the addition of new owners.³² However, they are not without their own complexities. While the improvement envisaged by Option A is worthwhile, it does not represent a fundamental change to the current asymmetric treatment of losses in corporations.

Option B

By way of contrast, Option B is the most drastic of the reform options. Option B offers a simple logic to it; to wit, if the problem is asymmetric treatment then the solution is to remove that asymmetric treatment by providing an immediate refund of the tax value of the losses.³³ However the corporation would, in many cases, still have to carry forward an actual economic loss, albeit a smaller one.³⁴ The exception would be for those entities in a tax loss position but are capable of economic profit.³⁵ According to the BTWG, Option B is 'not a viable reform element, as it would substantially increase the risks to government revenue and increase the potential integrity risks to the tax system'.³⁶ Unsurprisingly, no jurisdiction has adopted this option so far.³⁷

²⁷ Above n 4, 5, 15; Above n 6.

²⁸ Above n 4, 15.

²⁹ Above n 4, 16; Above n 6; Bernard Kent, 'Complexities of the Loss Carry Forward Provisions' (2011) 15(2) *The Tax Specialist* 106; Daniela Chiew and Tom Roth, 'So you Think you Have Losses' (2010) 44(10) *Taxation in Australia* 565; Andrew Strange, 'Topical Issues in Corporate Tax Losses' (2003) 13(1) *Revenue Law Journal* 99; Mark Pizzacalla, 'SME "Life Cycle" Imperative' (2012) 27 *Australian Tax Forum* 175.

³⁰ Above n 4, 18.

³¹ Above n 4, 19.

³² Mark Pizzacalla, 'SME "Life Cycle" Imperative' (2012) 27 *Australian Tax Forum* 175; Above n 6

³³ Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59.

³⁴ Ibid.

³⁵ Ibid.

³⁶ Above n 4, 15; Above n 6.

³⁷ Above n 4, 20; Above n 6; Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59.

Options C and D

Option C is fairly common in many jurisdictions.³⁸ It allows a corporation to utilise the value of tax losses sooner by carrying back those losses to earlier profit years and reducing the tax in those years. The only variable is the limit on the number of years that a loss can be carried back. This option was adopted temporarily in Australia via the form of a loss carry-back offset limited to a 2 year carry-back and aimed at smaller businesses (thus the \$300,000 cap).³⁹ Option D, on the other hand, directly addresses the reduction in the value of losses over time by indexing those losses so that they maintain their real value. However, Option D does not improve the utilisation of losses.⁴⁰ Before this paper goes on to critically assess these options, it is useful to examine the latest government reviews that preceded the BTWG review and how they proposed to deal with losses in corporations.

HENRY REVIEW AND RALPH REVIEW

The ubiquitous Australia's Future Tax System Review (the Henry Review)⁴¹ was the latest review before the BTWG review to deal with the treatment of losses in corporations. The Henry Review concluded that the asymmetric treatment of losses 'tend to discourage risk taking including entrepreneurial activity'.⁴² In response, the proposal of the review was Option C - that there should be a limited carry back of losses.⁴³ The BTWG, in comparison, provides a more multi-faceted approach, but that both reviews have proposed a carry back lends credence to this option at least. Conversely, the earlier Review of Business Taxation (the Ralph Review) focused largely on the operation of the integrity tests.⁴⁴ From this comparison, it is apparent that the BTWG has proposed reform options that are different in scope to those in preceding reviews, thus there is a need to evaluate them carefully.

BTWG RECOMMENDATIONS

In its final report, the BTWG recommended:

1. That the government note the savings options identified in this report and undertake consultation before making a decision to implement them;
2. That Option C, limited in time to 2 years and in quantum to \$1 million be introduced from 2013-14 (which was accomplished); and
3. That the SBT be reformed and an alternative test introduced.⁴⁵

The exact revenue impact of the options was not able to be fully elucidated nor fully explored by the BTWG.⁴⁶ It is perhaps predictable that the BTWG partially recommended options (A and C) which were supported by previous and less time constrained reviews. However, in implementing the loss carry-back offset, the government provided a revenue impact figure in the 2012-13 budget.⁴⁷ The costing over the forward estimates period (2013-14, 2014-15 and 2015-16) for the loss carry back offset was \$700 million.

HOW THE OPTIONS AFFECT THE PROFITABILITY OF CORPORATIONS

The BTWG used the net present value of after tax profits of three archetypal firms as a means to compare the effect of each option on effective tax rates in its initial report. The BTWG used:

³⁸ Above n 4, 20; Above n 6.

³⁹ Explanatory Memorandum Tax and Superannuation Laws Amendment (2013 Measures No. 1) Bill 2013.

⁴⁰ Above n 4, 22, 23; Above n 6; Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59.

⁴¹ Australia's Future Tax System Review, *Final Report* (2009).

⁴² Above n 34, 174; Jack Mintz 'An Evaluation of the Business Tax Recommendations of the Henry Review and the Australian Government Response' in Chris Evans, Richard Krever, Peter Mellor (eds) *Australia's Future Tax System: The Prospects After Henry* (2010).

⁴³ Above n 34, 176; Jack Mintz 'An Evaluation of the Business Tax Recommendations of the Henry Review and the Australian Government Response' in Chris Evans, Richard Krever, Peter Mellor (eds) *Australia's Future Tax System: The Prospects After Henry* (2010).

⁴⁴ Review of Business Taxation, *A Tax System Redesigned* (1999); Andrew Strange, 'Topical Issues in Corporate Tax Losses' (2003) 13(1) *Revenue Law Journal* 99.

⁴⁵ Above n 6, 34, 55.

⁴⁶ Above n 6; 2.

⁴⁷ Budget 2012-13, Budget Paper no 2 (2012)

- The constant profit firm;
- The start up firm (which moves from loss to profit over time); and
- The recovery firm (which moves from profit to loss then returns to profit).⁴⁸

These three firms all posit a return to profit, whereas this is not clearly the case in reality.⁴⁹ As a matter of fact, corporations will generally move through different stages in a life cycle and the impact of losses at each stage will be different.⁵⁰ To understand the overall value of losses, it is important to consider the returns that can be generated from business closedown for instance. It is also possible for firms to generate tax losses for a continued period of time, which may not totally reflect economic losses,⁵¹ and for such firms the effective tax rate is 0%.⁵² Thus, there are perhaps two further archetypal firms that have a clear stake in the treatment of losses. They are:

- The constant loss firm (which constantly makes tax losses); and
- The close down firm (which will not generate profits again).⁵³

Option A

With regards to Option A, 'to the extent that a company would not have failed the COT and SBT, the removal of these tests arguably has no effect'.⁵⁴ Those tests will generally fail where the corporation engages in a structural change to its business or its ownership organization which often correlates with innovation and risk taking.⁵⁵ Thus, many innovative firms could fail the COT and SBT through their ordinary activities, and many loss making firms may not survive as they try to move out of loss making activities and structures.⁵⁶ Option A is at best an incremental change to the asymmetry, though corporations engaged in innovation are more likely to fail such tests and thus, may perceive this change more readily.

Perhaps where the economic effect of option A would be felt most drastically is in relation to the constant loss firm and the close down firm. These corporations may have significant losses which are effectively locked in under the current COT. By removing the COT, the value of any accumulated losses could at least be realised, subject to the new integrity tests.⁵⁷ However, it should be noted that the effective tax rate may be significantly smaller than 30% when CGT discounts and rollovers for shareholders are considered. When a broader view is considered, further asymmetries may be created.

The BTWG has only gradually adopted Option A, which is incremental to begin with by looking only at the SBT. While it is worthwhile to reform the SBT as it actively prevents an entity from exploring new businesses, the practical reality for many corporations with losses is that capital is needed for such businesses. To acquire this capital, the corporation may need to obtain new equity investors and fail the COT. The BTWG has recommended an opt-in available fraction style provision that would 'drip feed' the value of losses where an entity fails the COT.⁵⁸ The BTWG has stated that a 10 year drip feed may be reasonable.⁵⁹ Putting aside that this may add further complexity, for many corporations, accessing the value of losses after 10 years may well be practically similar to not accessing the value of

⁴⁸ Above n 4, 15

⁴⁹ Mark Pizzacalla, 'SME "Life Cycle" Imperative' (2012) 27 *Australian Tax Forum* 175

⁵⁰ Ibid

⁵¹ Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59

⁵² Michael Cooper & Matthew Knittel, 'Partial Loss Refundability : How Are Corporate Losses Used?' (2006) 59(3) *National Tax Journal* 651; Michael Cooper and Matthew Knittel, 'The Implications of Tax Asymmetry for US Corporations' (2010) 63(1) *National Tax Journal* 33

⁵³ These two archetypes are partially reflected in the expanded archetype set in the BTWG's final report.

⁵⁴ Above n 4, 18; Myloan Huynh, 'Company Loss Recoupment Rules : Proposed Outlook for 2012' (2012) 46(8) *Taxation in Australia* 338

⁵⁵ Margaret McKerchar and Margaret Dreaver, 'The Influence of Tax Reform on Entrepreneurship and Management Practices in the Small Business Sector in Australia' (2008) 3(2) *Journal of the Australasian Tax Teachers Association* 129; Mark Pizzacalla, 'SME "Life Cycle" Imperative' (2012) 27 *Australian Tax Forum* 175; Cameron Rider, Lillian Hong, Ann O'Connell, Miranda Stewart, Michelle Herring, *Taxation Problems in the Commercialisation of Intellectual Property* IPRIA Report 01/06 (2006)

⁵⁶ Mark Pizzacalla, 'SME "Life Cycle" Imperative' (2012) 27 *Australian Tax Forum* 175; Cameron Rider, Lillian Hong, Ann O'Connell, Miranda Stewart, Michelle Herring, *Taxation Problems in the Commercialisation of Intellectual Property* IPRIA Report 01/06 (2006)

⁵⁷ Above n 4, 17; Above n 6.

⁵⁸ Above n 6, 44.

⁵⁹ Above n 6, 44.

losses at all. Thus Option A, and Option A as modified by recommendation 3, will at best only incrementally achieve the desired result regarding losses.

Option B

The immediate refundability of losses would mean that the effective tax rate for corporations making losses should not exceed 30%.⁶⁰ For the three archetypal firms used by the BTWG, it is demonstrated that the effective tax rate is 30%.⁶¹ The BTWG further states that ‘the NPV equivalent tax rate in all companies under immediate refundability is economically equal’.⁶² While it is possible to say that the effective tax rate on corporations should not *exceed* 30%, it is inappropriate to say that the tax rate will be equal when the constant loss firm is considered. For such a corporation, the ordinary effective tax rate is 0%.⁶³ If loss refundability is introduced, then instead of paying no tax, such firms may be in a position to receive a refund. This would further distort the existing asymmetries created by the taxation system between firms in a position of economic and taxable profit and those in a position of economic profit but taxable loss.⁶⁴ Loss refundability is ultimately not an absolute panacea for removal of asymmetries.

Option C

Loss carry-back, as proposed under Option C, is a common global measure⁶⁵ and was the main one proposed by the Henry Review⁶⁶ and the BTWG.⁶⁷ In theory, loss carry-back would reduce the effect of arbitrary tax year accounting and better reflect a corporation’s overall profit position.⁶⁸ In practice, the effectiveness of this system would be constrained by the imputation system, as a corporation could not apply tax losses against taxable income on which tax has been paid and imputed to shareholders.⁶⁹ This measure perhaps works best for corporations that can anticipate the possibility of abnormal loss years and subsequent recovery to profit, and therefore refuse to pay dividends immediately.

When the effect of this measure is compared across the various archetypes, only the recovery firm has any reduction in its effective tax rate.⁷⁰ For a start up firm, with no existing years of profit and for the constant loss firm, this option makes no change to the effective tax rate,⁷¹ though in the case of the constant loss firm the tax rate may be 0% anyway.⁷² Furthermore, the exact form of carry-back proposed by the BTWG is capped at \$1 million and limited to 2 years. As a result, the effect in relation to losses will be limited further. Option C, and Option C as modified by recommendation 2, is only an incremental solution to asymmetric treatment of losses in corporations.

Option D

The remaining option, when applying an uplift factor, is also at best an incremental solution. Indexation would not increase the utilisation of losses, which would still be dependent on the integrity

⁶⁰ Above n 4, 19.

⁶¹ Above n 4, 20.

⁶² Above n 4, 20.

⁶³ Michael Cooper & Matthew Knittel, ‘Partial Loss Refundability: How Are Corporate Losses Used?’ (2006) 59(3) *National Tax Journal* 651; Michael Cooper and Matthew Knittel, ‘The Implications of Tax Asymmetry for US Corporations’ (2010) 63(1) *National Tax Journal* 33.

⁶⁴ Thomas Abhayaratna and Shane Johnson, ‘Revisiting Tax Losses’ (2009) 24 *Australian Tax Forum* 59.

⁶⁵ Above n 4, 21.

⁶⁶ Above n 34.

⁶⁷ Above n 6.

⁶⁸ Thomas Abhayaratna and Shane Johnson, ‘Revisiting Tax Losses’ (2009) 24 *Australian Tax Forum* 59; Above n 6.

⁶⁹ Above n 4, 21; Above n 6.

⁷⁰ Above n 4, 22; Above n 6; Thomas Abhayaratna and Shane Johnson, ‘Revisiting Tax Losses’ (2009) 24 *Australian Tax Forum* 59; Myloan Huynh, ‘Company Loss Recoupment Rules: Proposed Outlook for 2012’ (2012) 46(8) *Taxation in Australia* 338.

⁷¹ Jason McDonald and Shane Johnson, *Tax Policies to Improve the Stability of Financial Markets* Paper - Department of Treasury Australia (2010); Thomas Abhayaratna and Shane Johnson, ‘Revisiting Tax Losses’ (2009) 24 *Australian Tax Forum* 59; Michael Cooper and Matthew Knittel, ‘The Implications of Tax Asymmetry for US Corporations’ (2010) 63(1) *National Tax Journal* 33.

⁷² Michael Cooper & Matthew Knittel, ‘Partial Loss Refundability: How Are Corporate Losses Used?’ (2006) 59(3) *National Tax Journal* 651; Michael Cooper and Matthew Knittel, ‘The Implications of Tax Asymmetry for US Corporations’ (2010) 63(1) *National Tax Journal* 33.

rules as a legal matter and the future profitability of a firm as a practical matter.⁷³ However, the value of any accumulated losses would at least maintain close to real value.⁷⁴ Indexation would impact on recovery firms and start-ups,⁷⁵ but would not provide any relief for firms that do not have the future prospect of tax profits.⁷⁶ Even for firms that would potentially benefit, the BTWG interim report shows that while theoretically appealing, the practical problem with this option is the choice of uplift factor. If there is a discrepancy between the uplift factor and the discount rate, as there is in the BTWG report,⁷⁷ firms that suffer losses, which are uplifted may actually have an effective tax rate lower than 30%, meaning that further asymmetries are created.

Summary of economic impact

Each of these options, in particular Options A and C as recommended, will result in an incremental improvement for some archetypal corporations. The question then becomes whether this will remove impediments to risk taking, investment and innovation, and at what cost to the broader revenue and the economy.

INNOVATION, LOSSES AND TAXATION

The activity of innovation and successful innovation more importantly, does not rest solely on economic and tax concerns.⁷⁸ Resource based theory suggests that successful innovation depends on a range of tangible and intangible resources that can be purchased by additional capital, stemming from these options for instance, but cannot be substituted for capital alone.⁷⁹ The end result indicates that there may not be a significant increase in innovation unless the problem of innovation resources is dealt with at the same time as the implementation of these options. Instead, there will be redistribution and repricing of resources necessary for innovation. While the options may remove some economic obstructions to innovation, they do nothing for other impediments that may entail a more critical impact.

Additional innovation *on some scale* is almost certain to result, as under each option some firms will perform better economically. This being said, the specialised nature of the capital markets for innovation and the resource dependant nature of successful innovation has led past reviews to conclude that innovation 'is an issue which needs to be addressed in its own right, and not by default through a general tax concession'.⁸⁰ As a result, the reforms are perhaps not fit for the intended purposes if the only goal is to encourage innovation. However, the BTWG is targeting risk taking more broadly, and not just innovation⁸¹.

BEHAVIOUR ADDITIONALITY

A further concern is the concept of behaviour additionality; that is, whether the options will result in additional innovation, risk taking and investment or merely subsidise the existing behaviour.⁸² A key consideration will be whether public funds used for the reforms are merely replacing private funds

⁷³ Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59; Myloan Huynh, 'Company Loss Recoupment Rules: Proposed Outlook for 2012' (2012) 46(8) *Taxation in Australia* 338.

⁷⁴ Above n 4, 23; Above n 6; Myloan Huynh, 'Company Loss Recoupment Rules: Proposed Outlook for 2012' (2012) 46(8) *Taxation in Australia* 338.

⁷⁵ Above n 4, 24; Above n 6; Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59.

⁷⁶ Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59

⁷⁷ Above n 4, 24.

⁷⁸ Margaret McKerchar and Ann Hansford, 'Achieving innovation and global competitiveness through research and development tax incentives: Lessons for Australia from the UK' (2012) 27 *Australian Tax Forum* 3; Margaret McKerchar and Margaret Dreaver, 'The Influence of Tax Reform on Entrepreneurship and Management Practices in the Small Business Sector in Australia' (2008) 3(2) *Journal of the Australasian Tax Teachers Association* 129.

⁷⁹ Organization for Economic Co-operation and Development. *Government R&D Funding and Company Behaviour: Measuring Behavioural Additionality* (2006).

⁸⁰ Review of the National Innovation System, *Final Report* (2008), 109; see also Margaret McKerchar and Margaret Dreaver, 'The Influence of Tax Reform on Entrepreneurship and Management Practices in the Small Business Sector in Australia' (2008) 3(2) *Journal of the Australasian Tax Teachers Association* 129

⁸¹ Above n 4; Above n 6.

⁸² Organization for Economic Co-operation and Development. *Government R&D Funding and Company Behaviour: Measuring Behavioural Additionality* (2006).

which are not then used for additional innovation, risk taking and investment. Empirical research about existing R&D funding programs suggests that some additional behaviour regarding innovation will occur,⁸³ and that there will be some waste following additionality.⁸⁴ The amount of additional behaviour will be influenced by the fact that the options apply to all firms, even those that have access to large amounts of capital already, and for these firms concessions such as this are more likely to subsidise existing activities.⁸⁵

Any change that makes the treatment of losses and the effective tax rate more symmetric for some corporations, which all the options represent to an extent, will result in more risk taking.⁸⁶ This is a reflection of fundamental cost benefit considerations. Some of this behaviour will be supplementary; some will remain unchanged. It is possible that some new innovation, risk taking and investment will result from those options. A certain degree of waste is also likely to occur. The ensuing consideration is whether such additional risk taking, innovation and investment from the options provides a net gain after taking into account potential waste, for this is the ultimate rationale for the reforms.

BROADER IMPACT

Presumably, if there is an optimum level of risk taking in a perfectly neutral system, full refundability, or something approaching parity, may elevate the risk taking above such optimum level as a result of the limited liability of the corporate form.⁸⁷ This is because limited liability increases risk taking while asymmetries represent an impediment to risk taking.⁸⁸ Therefore, it is improbable that any option that reduces asymmetries on a greater scale is necessarily better for the overall revenue.⁸⁹ The exact revenue impact of the reform options has not been provided by the BTWG,⁹⁰ which makes it more difficult to assess whether the options will deliver a net gain for the economy, bearing in mind that less asymmetry is not always better.

Options B and C also result in a specific broader impact - i.e. the provision of much needed cash flow to businesses in loss years.⁹¹ There is no consensus whether this would be a positive measure from a

⁸³ Kenneth Klassen, Jeffrey Pittman and Margaret Reed, 'A Cross-national Comparison of R&D Expenditure Decisions: Tax Incentives and Financial Constraints' (2004) 21 *Contemporary Accounting Research* 639; Ibid; Department of Industry, Tourism and Resources, *How R&D Assistance Influences Company Behaviour: A Survey Investigating Behavioural Additionality Effects of the R&D Tax Concession Program* (2007); Department of Industry, Tourism and Resources, *The R&D Tax Concession – Impact on the Firm : Report on a Survey of 116 Firms* (2005).

⁸⁴ Organization for Economic Co-operation and Development. *Government R&D Funding and Company Behaviour: Measuring Behavioural Additionality* (2006); Department of Industry, Tourism and Resources, *How R&D Assistance Influences Company Behaviour: A Survey Investigating Behavioural Additionality Effects of the R&D Tax Concession Program* (2007); Department of Industry, Tourism and Resources, *The R&D Tax Concession – Impact on the Firm : Report on a Survey of 116 Firms* (2005).

⁸⁵ Review of the National Innovation System, *Final Report* (2008), 109; Margaret McKerchar and Ann Hansford, 'Achieving innovation and global competitiveness through research and development tax incentives: Lessons for Australia from the UK' (2012) 27 *Australian Tax Forum* 3.

⁸⁶ Ralf Ewert and Rainer Niemann, *Limited Liability, Asymmetric Taxation And Risk Taking – Why Partial Tax Neutralities Can Be Harmful* CESIFO Working Paper No 3301 (2010); Saman Majd and Stewart Myers, *Valuing the Government's Tax Claim on Risky Corporate Assets* National Bureau of Economic Research Working Paper no 1553 (1985); Martin Fochmann and Martin Jacob, *Behavioural Explanation of Tax Asymmetries* Magdeburg University Working Paper Series no 21/2011 (2011); Michael Cooper & Matthew Knittel, 'Partial Loss Refundability : How Are Corporate Losses Used?' (2006) 59(3) *National Tax Journal* 651; Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59; Allan Auerbach, *The Dynamic Effects of Tax Law Asymmetries* National Bureau of Economic Research no 1152 (1983); Rosanne Altshuler and Allan Auerbach, *The Significance of Tax Law Asymmetries : An Empirical Investigation* National Bureau of Economic Research no 2279 (1987); John Creedy & Norman Gemmell, *Corporation Tax Asymmetries: Effective Tax Rates and Profit Sharing* University of Melbourne Department of Economics Research Paper no 1028 (2008).

⁸⁷ Ibid. Ralf Ewert and Rainer Niemann, *Limited Liability, Asymmetric Taxation And Risk Taking – Why Partial Tax*

⁸⁸ Ibid. Ralf

⁸⁹ Ralf Ewert and Rainer Niemann, *Limited Liability, Asymmetric Taxation And Risk Taking – Why Partial Tax Neutralities Can Be Harmful* CESIFO Working Paper No 3301 (2010); Martin Fochmann and Martin Jacob, *Behavioural Explanation of Tax Asymmetries* Magdeburg University Working Paper Series no 21/2011 (2011).

⁹⁰ A point noted in a number of the submissions to the review. See Taxation Institute of Australia, *Submission to the Business Tax Working Group* (2012); Institute of Chartered Accountants in Australia *Submission to the Business Tax Working Group* (2012).

⁹¹ Above n 4, 19; Above n 6; Michael Cooper & Matthew Knittel, 'Partial Loss Refundability: How Are Corporate Losses Used?' (2006) 59(3) *National Tax Journal* 651; John Graham and Hyunscob Kim, 'The Effects

macroeconomic perspective. As loss years naturally correlate with periods of macroeconomic decline, loss refundability or loss carry-back can act as a stimulus measure for the broader economy and may help to regulate fiscal cycles.⁹² However, some would argue that the volatility in government revenue may not be beneficial and make downturns more pronounced.⁹³ It is also suggested that those incentives may lose their effectiveness if the entity in question is in a loss position and there are low cash flows in the economy - an appropriate time for these incentives to be applied.⁹⁴ Therefore, it is not desirable to arrive at an absolute or theoretical conclusion for whether the options will produce a net benefit for the economy.

CONCLUSION

The BTWG has proposed a number of reform options in relation to the treatment of losses in corporations, aiming to reduce impediments to risk taking, investment and innovation.⁹⁵ The final goal of these reforms is productivity growth.⁹⁶ Two of the proposed options, in a modified form, were adopted in the BTWG's final report, one of which has been implemented. However, this paper raises the question: what is next?

As examined so far, all of these options, specifically the modified options in the recommendations, improve the effective tax rate of *some* corporations that make losses. This will inevitably lead to *some* increased risk taking, investment and innovation by corporations. The options will achieve their purpose, in relation to losses, of reducing asymmetries and removing impediments to risk taking, investment and innovation in corporations, although only in an incremental fashion. Of all the options, full refundability is the best selection from a narrow point of view, as it reduces corporate asymmetries to the largest degree, despite the absence of neutrality.

None of the options will produce a perfectly neutral effective tax rate across all corporation archetypes. While perfect neutrality is practically impossible, to improve on this failing, the reform options would have to be introduced concurrently with reforms to various specific deductions, the tax rate, the imputation system and many other provisions.⁹⁷ The BTWG has proposed a number of savings options that may be implemented to offset the cost of the recommendations; however, these are not the reforms necessarily desired but budget balancing measures.⁹⁸ If the reforms truly deliver a net benefit, such saving measures will become unessential.

If the reform options proceed in isolation and without broader reforms, what is gained through additional neutrality between corporations may be lost in relation to inter-entity neutrality. These options only apply to corporations, whereas the effective tax rate for losses incurred by trusts, partnerships or individuals remains the same. As a result, the asymmetries between various entity types may be exacerbated.⁹⁹ For every extra movement of risk taking, innovation or investment that occurs in corporations, there may be one less act of such nature in other entity types, as asymmetries

of the Length of the Tax-Loss Carryback Period on Tax Receipts and Corporate Marginal Tax Rates' (2009) 62(3) *National Tax Journal* 413.

⁹² Above n 4, 19; Above n 6; Jason McDonald and Shane Johnson, *Tax Policies to Improve the Stability of Financial Markets* Paper - Department of Treasury Australia (2010); Michael Cooper & Matthew Knittel, 'Partial Loss Refundability : How Are Corporate Losses Used?' (2006) 59(3) *National Tax Journal* 651; John Graham and Hyunseob Kim, 'The Effects of the Length of the Tax-Loss Carryback Period on Tax Receipts and Corporate Marginal Tax Rates' (2009) 62(3) *National Tax Journal* 413; Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59; Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59.

⁹³ Jason McDonald and Shane Johnson, *Tax Policies to Improve the Stability of Financial Markets* Paper - Department of Treasury Australia (2010); Martin Fochmann and Martin Jacob, *Behavioural Explanation of Tax Asymmetries* Magdeburg University Working Paper Series no 21/2011 (2011); Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59; Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59.

⁹⁴ Jesse Edgerton, 'Investment Incentives and Corporate Tax Asymmetries' (2010) 94(11) *Journal of Public Economics* 936.

⁹⁵ Above n 4, 11; Above n 6.

⁹⁶ Above n 4; Above n 6.

⁹⁷ Thomas Abhayaratna and Shane Johnson, 'revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59.

⁹⁸ Above n 6; 59.

⁹⁹ Ralf Ewert and Rainer Niemann, *Limited Liability, Asymmetric Taxation And Risk Taking – Why Partial Tax Neutralities Can Be Harmful* CESIFO Working Paper No 3301 (2010).

lead to a flow of risk taking, innovation or investment to corporations.¹⁰⁰ A further problem with the options, therefore, is additionality if they are implemented in isolation.

As to the ultimate purpose of the reforms using the treatment of losses to drive productivity and growth, there are some further issues. In general, productivity is a multifaceted concept and the determinants are difficult to understand.¹⁰¹ More specifically, if the options are strictly targeted towards innovation and not merely risk taking in a broad sense, the options would seem inefficient and ill-suited to the specific capital market for and resource demands of innovation. There is no guarantee that the additional benefits of innovation in corporations will not be terminated by the downsides of excessive optimum risk taking, waste, increased loss trafficking to take advantage of international arbitrage,¹⁰² and from aggressive tax planning.¹⁰³ Options C and D practically provide no real reduction in complexity. For all options,¹⁰⁴ if there is no broader reform inconsistency may result, and inconsistency is a source of complexity.¹⁰⁵ Such complexity can provide an impediment to innovation and risk taking.¹⁰⁶

In conclusion, the reform options and the modified options in the recommendations will all achieve their desired purpose relating to losses if the sole object is to incrementally reduce asymmetries and impediments to risk taking, innovation and investment for some, but not all, corporations. In this aspect, full refundability is perhaps the best option. Whether any of the reforms and recommended options, when implemented in isolation and without broader reform, will achieve the purpose of improving productivity and providing a net benefit to the economy, is far from certain. The answer to the question put forward in this paper is that perhaps a more extensive reform of losses should be considered in the future with broad consultation and costing, to complement the up-to-date work on corporate losses through the loss carry back offset. This process should take into account broader options that give closer attention to refundable treatment of losses for most business entities, though full refundability is conceivably impractical.

¹⁰⁰ Jeffrey MacKie-Mason and Roger Gordon, *Taxes and the Choice of Organisational Form* National Bureau of Economic Research no 3781 (1991).

¹⁰¹ Chad Syverson, 'What Determines Productivity?' (2011) 49(2) *Journal of Economic Literature* 326; House of Representatives Standing Committee on Economics, *Report: Inquiry into Raising the Productivity Growth Rate in the Australian Economy* (2010).

¹⁰² Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59.

¹⁰³ Organization for Economic Co-operation and Development, *Corporate Loss Utilisation through Aggressive Tax Planning* (2011).

¹⁰⁴ Thomas Abhayaratna and Shane Johnson, 'Revisiting Tax Losses' (2009) 24 *Australian Tax Forum* 59.

¹⁰⁵ Bernard Kent, 'Complexities of the Loss Carry Forward Provisions' (2011) 15(2) *The Tax Specialist* 106.

¹⁰⁶ Margaret McKerchar and Ann Hansford, 'Achieving innovation and global competitiveness through research and development tax incentives: Lessons for Australia from the UK' (2012) 27 *Australian Tax Forum* 3; Margaret McKerchar and Margaret Dreaver, 'The Influence of Tax Reform on Entrepreneurship and Management Practices in the Small Business Sector in Australia' (2008) 3(2) *Journal of the Australasian Tax Teachers Association* 129.