11 June 2013

Loss carry back rules one step closer to enactment

The highly anticipated 'loss carry back rules' are one step closer to becoming law after the House of Representatives passed the Tax and Superannuation Laws Amendment (2013 Measures No 1) Bill on 29 May 2013. In essence, the rules will allow companies and other corporate tax entities to 'carry back' a current year tax loss to earlier years, and obtain a refund for any tax they paid in that year. The Bill now moves to the Senate, which should consider the measures in the next month.

The loss carry back proposal stems from work undertaken by the Treasurer's Business Tax Working Group, and is intended to help businesses experiencing short term financial difficulties. It does this by essentially 'smoothing' a business' tax liabilities such that its tax liabilities over a number of years reflect its financial performance in those years, rather than its financial performance in a particular year. So, for example, if a company makes a loss in one year after a number of profitable years, the rules allow the company to obtain a refund of some of the tax it paid in its profitable year.

When do the loss carry back rules apply?

If they are enacted, the loss carry back rules will apply from the 2012-13 income year. However, as a transitional measure, losses in the 2012-13 year can only be carried back one year (ie to 2011-12).

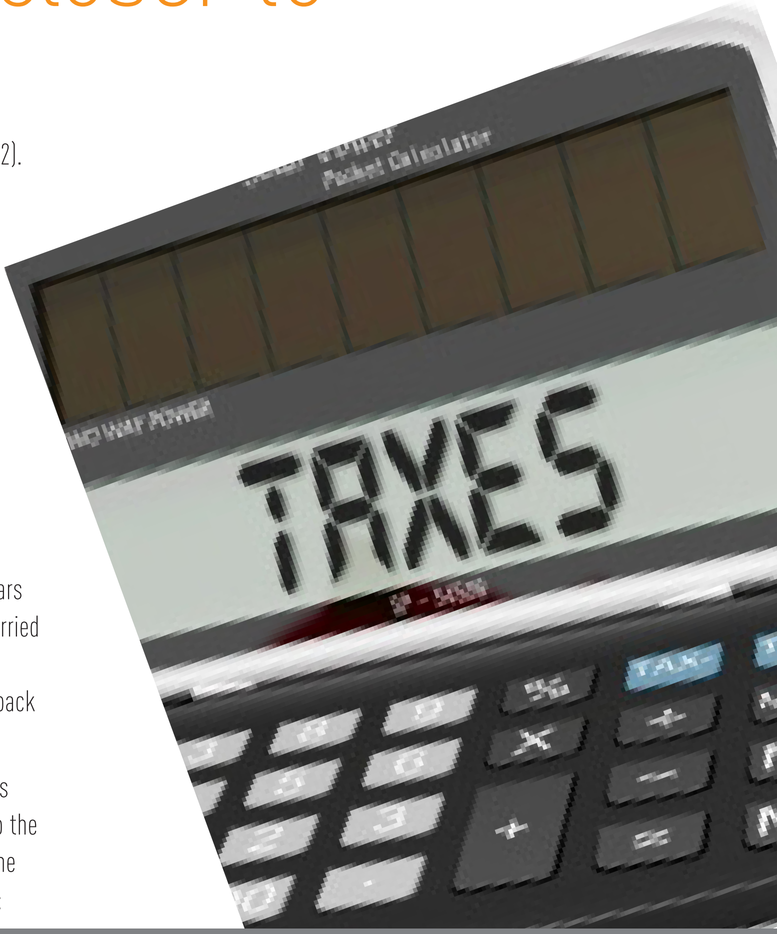
Who can access the rules?

The proposed rules will only apply to corporate tax entities. Corporate tax entities include companies and other entities taxed as companies, such as limited partnerships and public trading trusts. Individuals and trusts will not be able to access the rules because they are taxed in a different manner to companies.

How will the rules work?

For the 2013-14 and later years, the rules allow a corporate tax entity to 'carry-back' its current year loss to either of the two years before the current year (though in 2012-13 losses can only be carried back to 2011-12). In order to carry back a current year loss, the entity must have actually paid tax in the year it carries the loss back to. If it did not pay tax in that year, it cannot carry its loss back.

The carrying back of a loss is achieved by giving the entity a 'loss carry back offset' in the current year. The offset is refundable, so the entity can get a refund of tax when they lodge their tax return. The amount of the 'loss carry back offset' is capped at the lowest of:



- $1 million multiplied by the corporate tax rate (which currently equates to $300,000);
- the entity's franking account balance; or
- the entity's tax liability in the year it carries a loss back to.

In other words, the maximum benefit corporate tax entities can get under the measures is limited to $300,000.

Losses are not carried back automatically; entities must choose to carry back a loss when they lodge their tax return. There are additional questions in the 2013 company tax return form to accommodate the making of this choice.

Importantly, carry back will only available for revenue losses. Capital loss will not be eligible for carry back.

Not surprisingly, losses that are carried back cannot also be carried forward to future income years. A number of integrity measures have also been introduced, which essentially prevent schemes designed to engineer loss carry back refunds through changes in control of eligible companies.

Example of the rules in practice

The operation of the rules is demonstrated by the following example.

> In 2012-13 LossCo Pty Ltd made a tax loss of $2 million. However it had taxable income of $1.5 million in 2011-12 and paid tax of $450,000 in that year. It has a franking account balance of $600,000. It decides to carry its 2012-13 loss back to the 2011-12 year. LossCo can only carry back $1 million of its current year loss. It can get an offset equal to the lowest of the following amounts:
>
> - the tax value of the $1 million loss (ie $300,000);
> - its franking account balance of $600,000; or
> - its 2011-12 tax liability of $450,000.
>
> $300,000 is the lowest of these amounts, so LossCo gets a loss carry back offset equal to $300,000. Because the offset is refundable, LossCo will get a $300,000 refund from the Tax Office when it lodges its return. When it receives the refund it will have a debit (ie reduction) to its franking account of $300,000.

Points to note

The loss carry back rules are most likely to benefit entities experiencing temporary difficulties, rather than those experiencing sustained hardship. This is because entities must have paid tax (and hence presumably made a profit) in one of the two years before the current year in order to benefit from the measure. Entities that have experienced severe financial difficulty are likely to have sustained losses for an extended period of time, and will not have any profitable year they can carry losses back to.

Further, the measures are most likely to benefit small to medium sized taxpayers rather than larger businesses, given the cap on losses that can be carried back. Larger entities can still access the benefit, but are less likely to be attracted to its $300,000 maximum benefit.

Finally, entities considering carrying back a loss will need to weigh the immediate benefit of a loss carry back refund with its potential future disadvantages. The disadvantages of choosing a refund are that the entity's franking account will be reduced by the amount of any refund, and the loss cannot be carried forward to future years.

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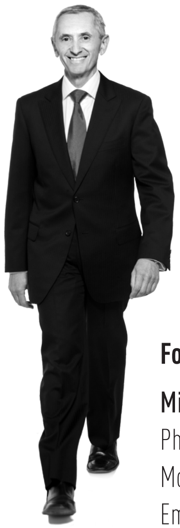

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