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Common issues and pitfalls in tax loss preservation and loss carry back

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CONTENTS

1 Overview ... 3

2 ATO guidance on errors they are seeing ... 4

3 Elements of this offset ... 6

3.1 Corporate tax entity ... 6

3.2 Years applicable ... 6

3.3 What years can loss be carried back to? ... 6

3.4 Filing requirements must be complied with ... 7

3.5 Choice ... 7

4 Amount of Loss Carry Back Tax Offset ... 9

5 Other Limitations and Anti-avoidance ... 10

5.1 Turnover ... 10

5.2 Requirement that maintained status as corporate tax entity ... 10

5.3 Specialist restrictions ... 10

5.4 Integrity rule ... 11

6 Carry forward of tax losses ... 12

6.1 Effect of bankruptcy, vs effect of other forms of administration ... 12

6.2 Trust loss highlights ... 12

6.3 Companies/CTE loss pointers ... 13

7 Matters which Need to be Considered ... 15

1 Overview

Tax advisers need to assist their clients in confirming and claiming tax losses. Whether they are claimable in the first place is enough of an issue; but how they are claimed may affect future tax planning. I intend to cover:

- Applying loss carry back – the do's and don'ts – and what we have learned in the first months of the new legislation
- Continuity of ownership issues
- The same or similar business test; and
- Practical planning opportunities and problems (including whether claiming full expensing and then using loss carry back is an acceptable approach).

The law was introduced and passed quickly during October 2021,[1] having been announced in the Budget on 6 October.[2] As Mr Sukkar (Assistant Treasurer and Minister for Housing) said in his second reading speech on 7 October 2021:[3]

> … companies with a turnover of up to $5 billion will be able to apply their losses against profits taxed in a previous year as far back as the 2018-19 income year. This temporary measure will available until 2021-22.[4] It will allow these businesses to access cash by using their losses now, to stay in business, rebuild and invest, rather than waiting until they return to profit.

The measure has now been extended to the 2022/2023 year.[5]

It is intended that the temporary full expensing measures will interact with loss carry-back.[6] This means in practice that a company will generate a loss on electing to apply those other measures, leading to tax offset based on carry-back to a previous year.

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1 *Treasury Laws Amendment (A Tax Plan for the COVID-19 Economic Recovery) Act 2020*; Act No.92 of 2020. See 2020 *Australian Income Tax Bills* (CCH), from ¶116-150.

2 2020 WTB 40 [1076]

3 2020 *Australian Income Tax Bills* (CCH) ¶116-152

4 Author's note – this was subsequently extended to the 2022-2023 year.

5 2021 WTB 19 [403]

6 See fn 10.

2 ATO guidance on errors they are seeing

This is a costly measure. The extension alone was budgeted to reduce receipts by $2.8 B over forward estimate.[7]

The mechanism used is to allow a tax offset (rebate), which is refundable. For simplicity, the company does not amend the prior year to claim the tax offset.[8]

We have heard from ATO about common mistakes, made in claims.

Some of these are issues arising from the returns themselves. I am not a return preparer, so I will not comment on those further. But all practitioners should be alive to the fact that ATO will be watching these and all other issues listed, at least.

ATO has advised:[9]

> We have noticed some common errors with recent claims for loss carry back (LCB).
>
> To prevent these mistakes and ensure we can process your client's company tax return as quickly as possible, review their records carefully when calculating their tax offset and completing the LCB labels. You can also take the following tips into consideration:
>
> - Correctly calculate the tax offset – To calculate the tax offset you need to use your client's tax rate in the income year in which they made the loss. For example, generally a base rate entity carrying back a tax loss made in the 2020–21 income year should use the base rate entity company tax rate for the 2020–21 income year, which is 26%.
> - Use the correct income tax liability amount – The amount of your client's tax offset cannot exceed their income tax liability for the income year they are carrying the loss back to. This is the amount at label T5 Tax payable in the calculation statement of your client's company tax return for that year.
> - Get the franking account balance right – The amount of your client's tax offset cannot exceed their franking account closing balance at the end of the claim year. We recommend a review of your client's franking account is undertaken prior to lodging their company tax return.
> - Complete all mandatory labels – If you are claiming LCB, it's important that you complete all of the required LCB labels in item 13 as well as the opening and closing franking account balance labels in item 8 of your client's company tax return. Use our company tax return instructions to help work out which labels you need to complete.

And ATO has also advised:[10]

> Avoid common errors, including:

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[7] 2021 WTB 19 [403], $1.9 B over the medium term.

[8] See fn 10.

[9] ATO website, document QC 66535, viewed 9 Oct 2021, https://www.ato.gov.au/Tax-professionals/Newsroom/Your-practice/Avoid-mistakes-when-claiming-LCB/

[10] ATO Website, document QC 64421, viewed 9 Oct 2021, https://www.ato.gov.au/business/loss-carry-back-tax-offset/how-to-claim-the-tax-offset/%23Commonerrors?anchor=Commonerrors#Commonerrors

- entering the wrong amount at one or more labels – for example, the amount of tax loss incurred in the 2020–21 income year carried back to the 2018–19 income year is entered at the label Tax loss for 2020–21 income year carried back to 2019–20
- disclosing an incorrect opening or closing franking account balance because of errors made when preparing the franking account, such as
    - missing entries
    - failing to reduce franking credits for any deferred debits (which could result from an amount of R&D tax offset refunded)
    - treating franked dividends received or paid incorrectly (for example, debiting instead of crediting)
    - including Quarter 4 PAYG instalments for an income year prior to year end
- calculating the tax losses incorrectly
- calculating the tax offset incorrectly, such as
    - not using the tax rate for the income year in which you made the loss in step 1d of the calculation – for example, a base rate entity carrying back a tax loss made in the 2020–21 income year should use a tax rate of 26%
    - not using the tax payable amount at T5 in the company tax return for the income year you are carrying the loss back to as the amount of your income tax liability in step 2 of the calculation.

So, we know already what is going wrong, in terms of return preparation. The above can be incorporated into checks of returns and disclosures.

But there are more fundamental questions.

3 Elements of this offset

3.1 Corporate tax entity

The first issue is that the taxpayer must be a "corporate tax entity".[11]

This covers companies.

(It can also extend to a corporate limited partnership or a public trading trust. I am going to leave those entities to one side.)

3.2 Years applicable

As legislated, the loss years were years ended 2020 and 2021, together with 2022 if that is the "current year".[12]

It was announced in the Budget on 11 May 2021 that the government "will extend the eligible tax loss years to include the 2022-23 income year" so that refunds "resulting from loss carry back will be available to companies when they lodge their 2020-21, 2021-22 and now 2022-23 tax returns".[13]

So far as I can tell, legislation to implement this has not been passed. *Treasury Laws Amendment (2021 Measures No. 5) Bill 2021* has also not yet been passed, but that Bill deals with other issues to do with making a choice for loss carry back, including introducing new section 160-16.

The years during which the entitlement to tax offset can be claimed are defined by reference to being "current years" in section 160-5(a). Those are currently listed as the 2021 and 2022 income years. Presumably 2023 will now be added.

3.3 What years can loss be carried back to?

As legislated, loss can be carried back to any of the following years provided there was an income tax liability: years ended 2019, 2020 and 2021. 2021 is only relevant if the "current year" is the year ended 2022, though I imagine this will change if the extension is passed by Parliament.

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[11] It must be a corporate tax entity throughout the current year: s160-5 of the *Income Tax Assessment Act 1997 (Cth)*.

[12] Section 160-5(c).

[13] 2021 WTB 19 [403], referring to Budget Paper No. 2 page 30.

3.4 Filing requirements must be complied with

There is a requirement that the company has satisfied filing requirements for its income tax return in the "current year" (year of claim) and each of the five income years before the current year. The requirement goes further, however.

First, the company must have lodged its income tax return for the year in question, in each case. Or, the company must have been not required to lodge an income tax return for the year in question. Or, finally, the Commissioner must have made an assessment of the company's income tax for the year in question.

The important point to note is that it is not simply five years. It is the "current year" and each of the five income years before the current year, a total of six years.

Section 160-5(e) says nothing about returns for other taxes. Before the legislation was widely seen, I understand there was concern about whether it extended to, for example, a missed BAS or the like. However the defined term used is "income tax return" which is defined as "a return under section 161, 162 or 163 of the *Income Tax Assessment Act 1936*: section 995-1(1).

Section 161 refers to the annual return of income tax. Section 162 refers to further returns and information that might be required by the Commissioner. Section 163 refers to special return for the purposes of the *Income Tax Assessment Act 1936*.

3.5 Choice

The company must make a loss carry back choice for the "current year".[14] The formalities in section 160-15 involve the following.

First you have to specify an amount. You have to say with precision how much of the company's tax loss is to be carried back to each specified year, and from what specified year to which specified year.

Secondly, the choice has to be in an approved form, and must be made by the day the company lodges its income tax return for the "current year", unless the Commissioner allows a later filing.[15]

Proposed section 160-16 will, if enacted, permit an entity to change a loss carry back choice by notice in the approved form. Essentially, the time limit for change is the limited amendment period in terms of section 170 of the *Income Tax Assessment Act 1936* for an assessment for that income year.

The term "limited amendment period" is defined in section 170(14) as the period within which the Commissioner may amend the assessment under specified provisions of section 170. For example, item 2 in subsection 170(1) provides a limited amendment period of only two years for certain

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[14] Section 160-5(f).

[15] There was a transitional issue for companies that balanced other than on 30 June, but that is of historical interest only now. The transitional issue required a separate form and for the separate form to be filed about a week before the income tax return.

companies, though item 4 specifies four years after the day on which the Commissioner gives notice of the assessment to the taxpayer, more generally.

But the rules here are more complex than that, and time will be of the essence in filing any change to the loss carry back choice.

Proposed section 160-16 is in *Treasury Laws Amendment (2021 Measures No. 5) Bill 2021*, which passed the House of Representatives on 10 August 2021, but has not passed the Senate let alone going to Royal Assent.

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4 Amount of Loss Carry Back Tax Offset[16]

There is a limit to the tax offset you will be paid for the current year. There is a formula to work out the limit.

I will speak of the current legislation, as it is uncertain how the extension of the loss carry back will affect the current drafting. We do not have a Bill for the extension yet.

The first limiting factor is that you cannot get a loss carry back tax offset for the current year which is greater than the company's franking account balance at the end of the current year.

ATO has warned that they must necessarily review the franking account, in looking at claims for this offset. The franking account is often the Cinderella of the tax accounts. The ATO have helpfully suggested that this is an opportunity to straighten out any anomalies in the franking account. A common anomaly seen is recognition of a fourth quarter company tax instalment within the financial year, when the instalment is actually paid after the end of the financial year. It is possible to see how that error would occur, and perhaps over time that error would flatten out or be of little consequence normally. However it will be picked up in a review conducted for loss carry back tax offset.

So the balance of the franking account is one limit. But the limits are the lesser of the franking account balance at the end of the current year, and the "sum of the loss carry back tax offset components" for the 2019, 2020 and 2021 income years.[17]

This is where some complexity and recordkeeping comes in. Essentially the loss carry back tax offset component for each of the relevant years has to be looked at.

If the loss carry back choice for the current year does not attempt to carry back any tax loss to a particular income year, the loss carry back tax offset component is nil, understandably.

Otherwise, there is a mechanical method of carrying back the loss to the income year, reducing the tax loss by the net exempt income for the income year (unless already utilised), and then multiplying the result by the "corporate tax rate for the loss year".

Obviously, once you have used up the income of a year, it cannot be used again to generate a further offset.

Finally, there are restrictions for foreign residents (other than NZ franking companies).

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[16] Section 160-10.

[17] 2021 income year comes into calculation if the "current year" is the 2022 income year.

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5 Other Limitations and Anti-avoidance

5.1 Turnover

The company cannot carry back an amount of a tax loss for an income year unless it was either a small business entity for the income year, or satisfied a turnover test of "less than $5 billion" which is calculated using some tests applied in the small business entity provisions.

Although there has been a deal of discussion about the $5 billion threshold, and indeed some recent guidance, I will simply mention the guidance in a footnote.[18]

5.2 Requirement that maintained status as corporate tax entity

If the entity in question has changed status, and has not always been a corporate tax entity, then there are limits on the ability to carry back the tax loss under section 160-25.

Again, as this is likely to be a specialist area, I will not set out the details.

5.3 Specialist restrictions

There are restrictions on carrying back an amount of a tax loss in certain specialist circumstances. Transfers between companies in the same foreign banking group are excluded. There is also a restriction on use of a loss generated when a company joins a consolidated group or multiple entry consolidated group, recalling that the loss is transferred by the joining entity to the head company.

The loss carried back cannot exceed the amount that would be the company's tax loss for the year if section 36-55 were disregarded. This is a rule that deems a tax loss to exist where a corporate tax entity has excess franking offsets for an income year.[19]

Finally, in terms of specialist rules, you disregard the income tax liability of an entity for an income year to the extent it consists of an income tax liability of a subsidiary member of a consolidated group or MEC group that is taken to be an income tax liability of the entity under the entry history rule in section 701-5.

If you have any of those situations, you will need to consult 160-30, and ATO commentary about it.

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[18] Refer to the draft determinations and final determination all issued on 15 October 2021, TD 2021/7, and TD 2021/D2-4.

[19] Australian Federal Income Tax Reporter, paragraph 176-660.

5.4 Integrity rule

There is a specific integrity rule under section 160-35 aimed at preventing an entity being cleaned out of current year tax losses (by carry back), where that entity is to be sold to someone else.

The rationale is to avoid a situation where the company would fail continuity of ownership, and would also fail same or similar business tests in new hands.

The explanatory memorandum indicates briefly the types of matters that are concerned, and which are of relevance to section 160-35:

> 2.63 However, potential new owners may wish to acquire an existing entity and introduce new technology, business practices and product lines that will better position it to meet the commercial challenges of the future may find that they do not satisfy the continuity of ownership and same of business tests in some circumstances.
>
> 2.64 The specific integrity rule for loss carry back denies a corporate tax entity a loss carry back tax offset it would otherwise be entitled to where there has been a change in the control of the entity arising from a disposition of membership interests and, considering all of the relevant circumstances, one or more parties entered into a scheme to obtain the tax offset.
>
> 2.65 Losses that cannot be carried back as a result of the integrity measure can still be carried forward and claimed as a deduction against the income of future years provided the requirements for doing so are met.[20]

[20] Explanatory memorandum for *Treasury Laws Amendment (A Tax Plan for Covid-19 Economic Recovery) Bill 2020*, paragraphs 2.63-2.65.

6 Carry forward of tax losses

There are few developments in carry forward losses this past year.

But there is always room for recalling the basics, particularly after businesses have had a hard 2 years' trade.

6.1 Effect of bankruptcy, vs effect of other forms of administration

Bankruptcy is a status peculiar to humans. A company cannot go "bankrupt".

Thus section 36-35 (about bankruptcy, or being released from debts under a bankruptcy law) only applies to humans.

Annulment of bankruptcy formally meant the human was not taken to be bankrupt for these purposes: *Oates v FCT* 1991 ATC 4060. That has been reversed: section 36-35(2).

Neither a trust nor a company goes bankrupt, as such. Various forms of administration occur, and can impact on the ability to claim losses. But the impact is not via section 36-35.

For a trust, it is the trustee which is responsible, legally, for debts. The trustee may go bankrupt (if a human), or suffer other forms of administration (if a company). But there are measures which regulate how tax losses are claimed for the trust estate. The trust loss provisions limit the former traffic in trust losses, which we witnesses after the events of October 1987.

A company might go into liquidation, into voluntary administration, or have a receiver or other controller appointed. Corporate tax entities carry forward tax losses under section 36-17, but subject to other controls.

Given the hard trading conditions recently, it is worth revising some of the high points for each of trusts and companies.

6.2 Trust loss highlights

The entitlement to a deduction remains under section 36-15, but trust loss provisions in Schedule 2F of the 1936 Act severely limit the ability to use such deductions.

I will concentrate on is:

- the deemed change in ownership or control for non-fixed trusts including discretionary trusts; and
- the income injection rules, more generally referred to as a scheme to take advantage of the losses (Sch 2F Division 270).

The change in ownership or control measures in Division 267-B are aimed at non-fixed trusts which are not "excepted trusts" throughout the period of concern. This is why an early family trust election may have value.

The conditions for claiming the loss as a deduction require compliance with:

- the two pattern of distributions tests (sections 267-30(2) & 267-35);
- the more than 50% stake test (section 267-40);
- change of control test (section 267-45, Division 269-E).

If the trust has navigated that, there is Division 270 applicable to all trusts, including "excepted trusts". Division 270 has to be considered even if there is a family trust election.

I think of Division 270 as a kind of "income injection" provision. The natural inclination, where a business has had a rough time, is to recapitalise or look for external assistance. This could be caught.

6.3 Companies/CTE loss pointers

Companies also face ownership and control continuity tests.[21]

I am going to assume those tests are triggered, as part of a restructuring, and focus on the business continuity test.

The "same business" test with which we are all familiar pre-2015 was transposed as the BCT into section 165-210. It still includes a "same business" component. But also you do not satisfy the business continuity test or BCT if the company gets income from a business of a kind that it did not carry on before the relevant test time. Also, undertaking new kinds of transactions leads to failure of the BCT. An anti-avoidance rule in section 165-210(3) prevents someone starting a new business or entering into new kinds of transactions before the "test time", if that is done for the purpose of attempting to pass the BCT at a later time.

The modification, relevant for loss years on or after 1 July 2015, was to introduce a so-called "similar business" test. This is relatively recent in the sense that the provision was only inserted in 2019, albeit applicable to income years starting on or after 1 July 2015.

Essentially, throughout the "business continuity test period", a company must carry on a business that is similar to the business it carried on immediately before the test time.

The following factors are taken into account in deciding that issue:

- The extent to which the assets, including goodwill, that are used in the current business to generate assessable income throughout the business continuity test period were <u>also used in its former business</u> to generate assessable income.
- The extent to which the activities and operations from which its current business generated assessable income throughout the business continuity test period <u>were also the activities and operations</u> from which its former business generated assessable income.

21 Divisions 165-A & 165-B

- The identity of its current business and the identity of its former business.
- The extent to which any changes to its former business result from development or commercialisation of assets, products, processes, services or marketing or organisational methods of the former business.

There is again an integrity measure in section 165-211(3), preventing someone who has sufficient foresight to see that they will incur a loss, entering into new businesses or new transactions prior to the test time.

The key word in section 165-211(1) is “similar”, though you must look at that word in the context of a provision about carrying on business. The Law Companion Ruling LCR 2019/1 provides practical guidance. Examples address some of the policy issues that drove the similar business test.

7 Matters which Need to be Considered

ATO has been quite clear that they are already seeing problems with the returns and paperwork that support loss carry back. Above, I emphasise the need to scrutinise the franking account, as the balance of the franking account is important to determine one potential cap on loss carry back offset.

A real source of risk with these measures is that we are still relying on press releases to some extent, and on a Bill which remains before Parliament in relation to other matters. Planning is thus always contingent on passage of these measures, and the form in which measures are finally passed.

Nevertheless, for companies which have suffered substantial loss due to current difficult trading conditions, the loss carry back tax offset represents a generous response by government. It has specifically been linked, at least in concept, to the measures for full deductibility of certain capital expenses introduced at about the same time. That is deliberate, as the government was looking to provide stimulus measures.

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