DEWINGS
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Loss carry-back rules back in play

This year's Federal Budget included a return of the loss carry-back rules. In effect these provisions allow companies that have made a loss in the current year to use that loss to get a refund of tax paid on profits from earlier years. This could provide a handy cash flow injection for businesses struggling through the coronavirus pandemic, but there are some limitations.

The original loss carry-back measure was introduced by the Gillard Labor Government, but was only in place for a short time before the incoming Abbott Coalition Government overturned it.

The basic idea is simple. Under the existing carry *forward* rules, when a business makes a tax loss during a financial year, that loss is available to be offset against future profits. It's effectively a deduction in future years, which ensures that deductible expenses incurred during a loss year are not wasted. Once you're at zero profit, you pay no tax. Further deductions beyond that can't reduce the amount of tax payable any lower than nothing, so carrying that loss forward to future profit years allows a business to receive the benefit of those deductions at some point in the future - **provided it eventually makes a profit**.

And that's the big caveat. It's fair to say that many businesses that are making losses right now don't really need the benefit of those deductions at some point in an uncertain future. They need it now. This is especially so when many businesses that have been upended by a freak, once-in a lifetime event are otherwise healthy, profitable enterprises. They may have good reason to believe they could be successful again, but how long will this current challenge go on for, and will the business be able to survive long enough to recover the benefit of losses it is making now? Further, what use would a Government relief measure that allows for the full-expensing of assets in the year of purchase be to a business that is already paying no tax due to a complete loss of profitability?

That's what 'carrying back' a loss addresses. Rather than carrying forward a loss to hopefully claim against potential future profits, the loss can be carried back and used to create a refund of tax paid on prior year profits.

By way of a simple example, imagine a company made a profit of $300,000 for the 2018-19 year and paid tax at 27.5%, for a total tax bill of $82,500. Because of the downturn created by the pandemic, it finds itself making a loss of $100,000 for the 2019-20 financial year. Ordinarily, there is no immediate tax benefit for that loss. Instead, it is carried forward and is available to offset against future profits, should there be any. By 'carrying back' that loss, the company instead gets $27,500 of the 2018-19 tax paid back as a refund. That's $27,500 cash injected back into a struggling business rather than being held over for an indefinite period of time, or even lost forever if the business ultimately never returns to profit and/or fails.

The re-introduction of the measure also makes the full-expensing of assets more attractive to struggling businesses. Let's say that same business also has the opportunity to buy new equipment valued at

$200,000 (and importantly, the capacity to fund it). This has the effect of increasing the 2019-20 loss from $100,000 to $300,000. If losses can only be carried forward though, there's no real tax advantage in the current environment. A loss of $100,000 and a loss of $300,000 result in the same amount of tax payable - zero. But if there are sufficient profits available to access from 2018-19, the business can now get a refund of up to $82,500!

There's virtually no doubt the two are connected. The Government had been making the level of asset write-off for businesses more and more generous over the last 12-18 months or so, especially once this crisis began, but at some point many businesses would struggle to get any benefit from it, if they were generating losses.

So what are the specifics of the new rules?

1. **In its current form the measure is only available to companies.** Non-incorporated entities cannot take advantage of this relief opportunity. When you consider that the majority of Australian Small-Medium Enterprises (SMEs) don't operate within a company structure, this is a staggering and almost cruel limitation. There is more complexity involved when carrying back losses in some structures (how, for example, do you recoup tax paid in trusts where profit has already been distributed to beneficiaries?), but this shouldn't preclude some alternative form of this relief measure being available to these entities.

2. **The measure is available to companies with annual turnover of less than $5 billion**. That covers the vast majority of companies registered in Australia and, as far as we're aware, all of our readers who operate a business through a corporate structure.

3. **Losses made in the 2019-20, 2020-21 and 2021-22 financial years can be carried back**. Significantly, included here is the financial year that has just concluded (2019-20). But a frustrating restriction on the usefulness of the benefit is the timing. While 2019-20 losses can be carried back, they can't be claimed until the 2020-21 company tax return is lodged. This has likely occurred so that 2019-20 tax return software and forms won't require amending, but it means that the cash flow benefit could be delayed by 12 months or more, unless PAYG instalments are varied. For some businesses, this could be too late.

4. **Tax losses can be 'carried-back' to tax paid on profits from the 2018-19, 2019-20 and 2020-21 financial years**. To put it more simply, losses can only be carried back as far as the 2018-19 financial year, and only for two years after that. The inclusion of 2020-21 means that if a company continues to make profits for now, but ends up making a loss for 2021-22 down the track, this future profit is still available for the 2021-22 year.

5. **There is no limit on the dollar amount that can be claimed**. The original loss carry-back rules from 2012-13 capped the maximum amount that could be refunded at $300,000 per annum. There is no such cap with these new rules. However, it's important to note that...

6. **Companies can't claim more than the total amount of tax that has been paid.** While the dollar amount that can be refunded is theoretically uncapped, a company can't recover more than the total amount of tax paid during eligible prior years, because it is a refund of tax paid. Much like a tax refund on an individual income tax return, you generally can't get back more than you've actually paid.

7. **Companies also can't claim back more than whatever balance is currently available in the franking account of the company.** This is so as to avoid creating a franking account deficit as a result of a refund. It makes sense too. If dividends have been paid out to shareholders by the company on prior year profits, and with those dividends franking credits have also been passed on for the tax paid by the company, credit for that tax has already been received by shareholders. A company therefore can't 'double-dip' by also getting a credit back itself through these provisions.

8. **There is no obligation to carry back losses**. Companies can still choose to carry forward losses if they prefer, in whatever proportions they choose, and will have to do so once either the total balance of their franking account is exhausted or all eligible prior tax paid has been recovered (whichever is the lower balance).

9. **The relevant tax rate should also be taken into account**. For the vast majority of SMEs operating a though a company, the company tax rate is reducing over the relevant period. For the 2019-20 year it's 27.5%, falling to 26% for 2020-21 and 25% for 2021-22. This will mean that while a current year loss can be claimed against prior year profits, which may have been taxed at a higher rate, it will only be refunded at the rate applicable to the year the loss is incurred. For example, if a loss of $100,000 for 2021-22 is carried back to 2019-20 where tax was paid at 27.5%, the refund on that amount will effectively be calculated at 25% - a difference of $2,500.

No doubt there's plenty more to unpack here, and there will be numerous as yet unforeseen implications to be considered and issues to be worked through. Like any new measure, it's not without some inequities, but overall the Government has done a good job of making it relatively simple and accessible for struggling companies. However as a business relief and stimulus measure, it precludes a vast section of the SME community by restricting access only to those operating through a company, and it could be further improved if there were some means of carrying back a 2019-20 loss in the 2019-20 company tax return.

If you have any questions about these measures or anything that was announced in the Federal Budget, please contact us.

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