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The Secretary
Senate Economics Committee
Parliament House
Canberra ACT 2600

Dear Sir

Senate Economics Committee
Taxation Laws Amendment Bill (No. 5) 2003

We are writing to the Senate Economics Committee in respect of the inquiry into Taxation Laws Amendment Bill No 5 (2003), to make a submission on one particular aspect – the apparent decision of various senators to reject Schedule 8 which deals with the treatment of dividend income and tax losses in companies.

The purpose of this letter is to identify for the Senate Economics Committee that:

1. this measure is critical in order to achieve a just and equitable outcome for corporate groups which are consolidating,
2. without it many corporate groups will find consolidation to be a tax trap which will cause them significant commercial damage,
3. we support these provisions and
4. the Senate should allow this desirable reform to take place.

We attach some technical analysis of why these measures are necessary, in the Appendix.

We summarise the rationale as follows:

Why does the offsetting of dividends and losses matter in consolidation?

Where dividends received by companies are franked, the dividends are grossed up and the franking credits received supplement the franking accounts of the recipient companies.

If a corporate group consolidates with its 100% owned subsidiaries, then dividends from 100% owned subsidiaries are ignored.

However, if a consolidated group receives dividends from a partly-owned company – say one in which it has a 10% interest or a 80% interest, the dividends are recognised for tax purposes.

However, if the recipient consolidated group has tax losses, then the dividend nevertheless erodes the value of tax losses in the recipient. The net effect of this is, depending on how one looks at it:

- the value of the tax losses is inappropriately lost; or

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- the value of the franking rebate is lost.

Issue Recognised by RBT in a specific recommendation

The Ralph Review of Business Taxation (RBT) proposed that the erosion of prior year tax losses by dividends should be dealt with – see Recommendation 11.5 of the RBT.

This is an unambiguous recommendation of the RBT. See these extracts from the RBT Report:

"Recommendation 11.1 Deduction for carry-forward losses

That entities (including consolidated groups) be able to choose the proportion of their carry-forward losses to be deducted in a year.

During consultation two main concerns were raised about the effect of distributions on losses.

- First, as noted in respect of Recommendation 11.4, concern was raised about the rate of absorption of losses under the gross-up and credit approach for preventing double tax through the entity chain.
- Second, concerns were raised that the proposed consolidation regime would force groups to apply distributions received by them to losses earlier than under the existing law. Currently, groups usually ensure that distributions from outside the group are paid to the holding company with any losses held by subsidiaries. Under the current loss transfer provisions, the holding company and subsidiary can agree on the amount of loss to be transferred. This allows the holding company the option of not absorbing group losses against distributions received by the holding company from outside the group. The pooling of group losses under consolidation would remove this option in the absence of a specific measure.

Both these concerns will be overcome by allowing entities (including consolidated groups) to choose the proportion of carry-forward losses to be deducted in a year. Under the current law, a company cannot choose the amount of carry-forward loss it wishes to deduct. A company is forced to claim the amount of loss necessary to absorb the excess of assessable income over allowable deductions. As noted, in contrast, under the existing loss transfer provisions, groups can choose the proportion of loss to transfer within the group.

The recommended measure will allow consolidated groups and single entities — as well as unconsolidated groups — to avoid having a carry-forward loss absorbed by grossed-up franked distributions received from other entities or groups. This will provide consistency of treatment across these taxpayers. It also provides a mechanism for single entities or groups to fully frank distributions of profit even when they have large carry-forward losses. By not fully claiming the losses, the group or entity could pay sufficient tax to frank the distributions.

Carry-forward losses will still have to be reduced by the amount of net exempt income derived by an entity, consistent with the existing law.

This measure will not apply to individuals or complying superannuating funds. Unlike entities, individuals and complying superannuating funds will not be affected by the absorption of carry-forward losses by franked distributions received by them. The proposal

> to refund excess imputation credits effectively gives these taxpayers the full benefit of the losses immediately." (emphasis added).

The RBT recommended mechanism was that the dividend rebate in relation to franked dividends should be converted into a franking rebate in order to avoid double taxation.

However the RBT was silent in relation to the similar issue in relation to current year losses being wasted by current year dividends received.

We suggest, having been involved in the Ralph RBT, that this was due to an oversight on the part of the RBT and the business community in presenting to the RBT in its preliminary analysis. The focus at the time was strongly on prior year losses and identifying the big issue, without an intense focus on the current year losses which create the same issue. This minor oversight is understandable when one considers the massive task undertaken by the RBT and by consultees to the RBT.

The issue was identified very soon after the RBT report was delivered in final form. We know, as participants in the Joint Design Team process and earlier focus groups, that this issue was one of the first issues raised to the consolidation policymakers and has been an enduring topic of discussion in the period from 1999 through to introduction of TLAB5 in 2003.

Why should there be a concession in consolidation?

Prior to consolidation, corporate groups receiving dividends from partly-owned companies were able to structure themselves so that the dividends come into companies which are protected from tax losses. That is, company groups could structure themselves so that where a dividend is received by an investor company in the group from a partly-owned company, then that investor company needs to be protected to ensure that it does not generate losses. This protection is typically achieved by ensuring that risky activities which could generate losses are conducted in other companies, which typically do not receive dividends from unrelated companies.

This is conventional tax planning, and this structuring issue has been a conventional and ordinary business dealing in corporate groups for decades.

So the value-eroding combination of dividends and tax losses in one company was eliminated by a separation of the franked dividends and losses into separate companies. This is an ordinary commercial structuring issue that has been prevalent in corporate Australia for decades.

Some companies are unable to separate their dividend income and loss-making activities:

(a) certain regulators require them to centralise all their activities into one company; or

(b) in small to medium companies the owners have not structured multiple companies to achieve the separation.

But we would suggest that most Australian company groups have structured their affairs to achieve separation into separate companies of loss-making activities and dividend income.

However tax consolidation made this conventional separation of activities into corporate entities impossible.

Why did the Government not limit the measure to consolidated groups?

It is absolutely clear that the policy rationale for this measure came out of consolidation, and the business community's involvement in the Joint Design Team around consolidation.

The professions and business groups which have participated in the Joint Design Team process have been adamant about the need for this measure, due to its risk of creating major commercial damage under consolidation if the measure is not implemented.

The precise policy rationale of the Government is a matter for the Government. We believe that the Government was motivated by a desire for equity, and a desire to ensure that there is not a more benign treatment (by allowing a deemed separation of dividends and losses for consolidated groups) than there is for non-consolidated groups. We think that the Government wanted to ensure that there was a level playing field which did not create an inappropriate attraction for companies to adopt consolidation.

Nevertheless, whatever the impact outside consolidation, we want to emphasise very strongly to you that this measure must be allowed for consolidated groups.

Otherwise, groups which consolidate, and which have, for decades past, maintained a separation of dividend income from non-wholly-owned subsidiaries and tax loss activities will find that on entering consolidation they will have a major new commercial risk, which might cause them significant economic damage.

Conclusion and recommendation

In our view, if this separation is not enabled to proceed, then consolidation will be seen to be a trap for corporate Australia, and corporate Australia will lose confidence in the equity of the tax system in this regard, and in the tax reform process around the implementation of complex interactive tax policies such as consolidation and the myriad issues which result from them.

Tax consolidation is commercially not optional for corporate groups. With the withdrawal of all other company group concessions there are no other options for wholly owned groups to protect against the value-destroying combination of dividend income and tax losses.

In the circumstances any action by the Senate for rejection of this measure will create a tax trap for consolidating groups.

Such action would represent a very dangerous precedent, and imperils the neutrality and proper outcomes of tax consolidation. It would amount to a selective implementation of consolidation, taking all the revenue-positive measures and not delivering other measures intended as an integral part of tax consolidation.

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If you would like to discuss these matters, please do not hesitate to contact Tony Stolarek on (03) 8650 7654, Trevor Hughes on (03) 8650 7363 or Ian Skinner on (02) 9248 5510.

Yours sincerely

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Att

Some Notes on the Policy Development Progress – Preventing Wastage of 'Current Year' Losses

The Measure

1. In the 2002-03 Budget on 14 May 2002 the Treasurer announced that the income tax law would be amended so that companies would no longer waste current year losses against franked dividends. A press release by the Minister for Revenue and the Assistant Treasurer (No C59/02 of 16 May 2002) reiterated the announcement. Both announcements indicated that the method for ensuring no wastage would be settled after consultation with business.

2. It was announced that the amendments would apply from 1 July 2002.

3. Broadly, arising out of consultations it was agreed that the otherwise wasted loss be identified by reference to the unused franking rebate attached to a franked dividend and be allowed to be carry forward as a tax loss for the relevant income year.

4. This measure is related to Recommendation 11.5 of the Review of Business Taxation (RBT) (at page 418 of *A Tax System Redesigned* and attached) which proposed to deal with the similar wastage of losses but those incurred in a previous year of income. Under the recommendation companies would be allowed to decide what amount of carry forward losses they want to bring forward as an allowable deduction in a year of income. TLAB 5 also deals with this measure.

Background

What is a 'current year' loss?

5. In the context of this proposal a current year loss is a tax loss (the excess of allowable deductions over assessable and exempt income) that a company would have otherwise incurred for a year of income but for deriving franked dividend income in that year. For example a company may have a trading loss of $100 but also received a fully franked dividend of $70. In calculating its taxable income the company, from 1 July 2002, wil1 be required to gross up the franked dividend by including the $30 imputation credit. The $100 trading loss is deducted against the $100 grossed up amount with a resulting taxable income figure of $0. There is a notional entitlement to a franking rebate of $30 but it is not used.

How are they wasted?

6. In the example, if the company was able to quarantine the trading loss from its taxable income calculation then its taxable income would be the grossed up franked dividend amount of $100. However, applying the franking rebate reduces the tax on the taxable income to nil. The loss can be said to be wasted because the company can achieve a nil tax outcome without using the loss.

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7. An alternative way to view the outcome is that the franking rebate has been wasted. However, given there exists a mechanism for carrying forward losses and because of the approach set out in these instructions, conceptually, it is simpler to think of the outcome as a wastage of losses.

Pre-consolidation strategies to avoid wastage

8. A wholly owned group of companies is effectively able to quarantine trading losses away from franked dividend income in subsidiaries. The franked dividend income and other 'passive income' is held in a separate subsidiary - a 'dividend trap' company. (A common practice is for the holding company to be the dividend trap). The group loss transfer rules, whereby the group can elect to transfer amounts of losses, provides the mechanism to ensure those losses arc not wasted.

9. A single company that conducts all activities is unable to prevent such wastage. That is why one of the most fundamental of tax planning techniques is to use multiple companies to avoid wastage in the trading loss/franked dividend income situation.

Impact of the consolidations regime

10. The single entity treatment of consolidated groups will mean that the above technique for avoiding loss wastage will no longer be available. Also, consolidated groups will lose the ability to elect to transfer losses. Recommendation 11.5 of the RBT is designed to provide consolidated groups with a similar mechanism in relation to the transfer of prior year losses.

11. While these measures are a response to the impact of the consolidations regime they will apply to all companies not only those impacted by the consolidations regime.

The intercorporate dividend rebate

12. From 1 July 2002 the intercorporate dividend rebate is to be replaced by the franking rebate as the effective means of avoiding the double taxation of company profits. The above discussion has centred on wasting of losses where franking rebates reduces tax payable. Prior to 1 July 2002 it was the intercorporate rebate that would otherwise lead to the wastage.

Refundable franking rebates

13. From 1 July 2000 taxpayers who are eligible for franking rebates are entitled to a refund if their franking rebates exceed their tax payable. While companies will be entitled to franking rebates from 1 July 2002, for revenue reasons they will not be entitled to refunds of excess rebates which of itself would have provided a solution to the wastage problem.