Why Loss Carryback Is the Way to Safely Kickstart Economies

by Eng Kiat Loh

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In this article, the author examines loss carryback as a tax measure during the pandemic, identifies why countries are hesitant to use such measures, and explains why Singapore should liberalize its corresponding regime anyway.

When Australian Treasurer Josh Frydenberg announced on October 6 that the country's government will reintroduce a loss carryback tax scheme, he revealed what was possibly one of the worst-kept secrets in the world of impending tax reform.

As a preview article put it:

> A string of rich nations [has] introduced or expanded their loss carryback provisions this year because of the losses inflicted on usually profitable companies by the pandemic. They include the United States, Britain, Germany, Austria, Japan and New Zealand.[1]

The suggestion is that a loss carryback tool should be used widely during trying times — and is said to have been encouraged by the OECD.

While many countries already have rules governing the carryforward of losses, loss carryback regimes are less common. This article seeks to rationalize the reasons for the apparent reticence toward loss carryback regimes, using Singapore's tax framework as a primary example along with a few other countries.

Revenue Loss Concerns and Possible Safeguards

Although income tax was introduced in Singapore in 1947, a loss carryback system was not seriously discussed at the policy level until 2002, when it was offered as one of the tax recommendations of the Economic Review Committee (ERC, established December 3, 2001).

Before the loss carryback regime, carryforward relief was for many years the only relief available for losses[2] that could not be completely used because of insufficient taxable income.

It is fair to posit that as a tax recommendation of the ERC, the introduction of a loss carryback system was regarded as a move that would not lead to significant losses in government revenue. Indeed, the ERC recognized that while a loss carryback system could lead to greater uncertainty in government revenue, there should be no long-term impact[3] on revenue because the system already allows losses to be carried forward. Put another way, losses (in theory) defer

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[1]Rob Harris and Shane Wright, "'Loss Carry Back': The Scheme to Help Businesses on the Brink," *The Sydney Morning Herald*, Oct. 2, 2020.

[2]The term "losses" is used for brevity and clarity, although Singapore's loss carryback regime (as well as carryforward relief) extends to unused capital allowances and trade losses, subject to relevant conditions and exclusions.

[3]That said, the ERC indicated its recognition that a revenue loss arises only if the company does not recover from its current losses and subsequently fails.

subsequent taxes when carried forward to relieve future taxable profits; with loss carryback, the focus is to refund recent taxes paid. A loss carryback system therefore creates timing differences for tax collection but may not result in loss of revenue to the government.

Be that as it may, although the loss carryback recommendation was provided to the Singapore government for consideration in time for the 2002 budget, it was not until the 2005 budget that a loss carryback regime was introduced. At the time of introduction, a loss carryback was subject to a cap of SGD 100,000 (about $73,000).[4] Setting a cap clearly signified that the original intent of the loss carryback scheme introduced in that budget some 15 years ago was meant to help small businesses cope with cash flow problems.

Singapore also restricted the number of years[5] that carryback losses are allowed. Taken together, those restrictions seemed to allow Singapore to get used to the potential loss of revenue associated with the loss carryback regime.

The proposed Australian loss carryback measure will be available to corporate tax entities (which include corporate limited partnerships and public trading trusts) with an aggregated turnover of less than AUD 5 billion ($3.52 billion). Entities falling below that threshold can apply tax losses against taxed profits in a previous income year. That demonstrates yet another simple safeguard, particularly for countries concerned that revenue collection from their largest corporations would be affected.

A 'Frank' Discussion of a Tax Problem

One of the limits to the Australian loss carryback system is that the amount carried back cannot generate a franking account deficit (so it will be limited to the company's franking account balance).

The concept of franking account deficit is sometimes viewed as a structural constraint in an imputation system, which the OECD has described as:

> A system under which part or all of the corporate income tax paid by a company on its profits is credited against the personal income tax liability of the shareholders in receipt of dividends. The imputation reduces or eliminates the double taxation of distributed profits which arises under the classical system of taxation.[6]

The relevant rule is that corporate profits would have to be taxed before the necessary franking credits are created to enable a dividend payment. Alternatively, corporate tax liabilities are accelerated, through a franking account deficit mechanism to enable the dividend payments.

The interaction of the loss carryback regime and an imputation system can thus be somewhat unwieldy. The first is meant to facilitate a corporate income tax refund, while the second can conversely induce prepayment of corporate income tax through the payment of unfranked dividends.

Singapore addressed that kind of design dilemma when it commenced the phasing out of its imputation system (a process completed by December 31, 2007), alongside the introduction of another form of tax loss relief (group relief).[7]

For countries still on imputation systems, however, those items should be considered in the context of any intended introduction or liberalization of loss carryback regimes.

'Cash Is King,' or FOMO

From a cash flow benefit perspective, with Singapore's prevailing corporate tax rate of 17 percent and a maximum amount of SGD 100,000 allowed for loss carryback, the framework can at best provide a company (whether large or small) with an income tax refund of SGD 17,000 in a relevant year.

[4] The capped amount had been increased before, notably around the time of the 2008 global financial crisis when a SGD 200,000 cap applied temporarily.

[5] As one of Singapore's 2020 budget measures, the carryback relief system will be enhanced for tax year 2020, with the maximum number of tax years that the qualifying deductions can be carried back to increased from one to three.

[6] OECD Tax Database Explanatory Annex, "Part II: Taxation of Corporate and Capital Income" (updated Sept. 2020).

[7] That enables companies to deduct unused capital allowances, trade losses, or donations of one company from the assessable income of another company in the same group. For more information, see Inland Revenue Authority of Singapore, "Group Relief" (last accessed Oct. 8, 2020).

That said, that best-case scenario under the loss carryback regime often cannot even crystallize — particularly for start-ups. Consider hypothetical Company A, whose first year of assessment on incorporation was 2017. It had SGD 120,000 of assessable income in tax year 2018 but suffered tax losses of SGD 100,000 in tax year 2019. If A seeks loss carryback, it may find itself getting an income tax refund of only approximately SGD 1,000 (instead of SGD 17,000) referable to the 2018 tax previously paid.

The mechanics are fleshed out in greater detail on the Inland Revenue Authority of Singapore website. Broadly explained, the result can be attributed to A qualifying for the tax exemption scheme for new start-up companies, which is limited to a qualifying company's initial years and allows it to claim a large exemption for lower levels of otherwise taxable income; and the impact of automatic rebate on tax otherwise payable. The particular example (as shown on the website) of obtaining a refund of only SGD 1,000 despite using the full SGD 100,000 loss carryback limit is part of a broader warning to taxpayers to ensure that a loss carryback is beneficial to them before making a claim, because elections made for loss carryback are irrevocable.

For some, the result could challenge the narrative that cash is king, because the scenarios compared clearly show that allowing the losses to be carried forward instead of back results in higher tax savings overall. Therefore, the fear of missing out (FOMO) on more substantial dollar tax savings could prevent a loss carryback election. That may be particularly so for countries whose tax systems allow for unlimited loss carryforward subject to fulfilling requisite conditions, such as Singapore's.

As I call for liberalizing Singapore's loss carryback regime by adopting an uncapped approach, there would be other tax planning complexities to consider, such as judiciously choosing the rate of tax depreciation for some assets to achieve overall tax savings and efficiency.

Indeed, on its website, New Zealand's Inland Revenue Department instructs taxpayers that they must let it know if they are going to use the loss carryback scheme. No reasonable tax authority is likely to mandate the use of loss carryback over the prevailing loss carryforward option likely available under that country's rules. Therefore, while acknowledging that the loss carryback regime could improve a taxpayer's cash flow, the downside is that it can be complex for taxpayers and create blind spots from an overall and longer-term tax-efficiency perspective.

Uncapping Loss Carryback Is the Way Forward

Singapore needs to move toward an uncapped loss carryback approach — or, at the very least, increase the SGD 100,000 cap significantly.

In a contemporaneous setting, the fiscal history of an organization like Singapore Airlines (which reportedly recently recorded the first annual net loss in its 48-year history) could help rationalize the mechanics, albeit as an extreme example.[8] Simply put, an uncapped[9] loss carryback regime could allow Singapore Airlines to obtain an income tax refund of about SGD 36.04 million if its reported full-year net loss of SGD 212 million is referable to only one main legal entity and approximates current-year unused trade losses to be effected at 17 percent for Singapore tax purposes; and its reported earnings of SGD 683 million in the previous year were similarly referable to only that same main entity and were largely taxable at 17 percent in Singapore.

The potential refund of SGD 36.04 million is calculated by multiplying SGD 212 million by the 17 percent tax rate — but the point is that if the scope of the loss carryback regime with a SGD 100,000 cap was to operate, the income tax refund could have been only SGD 17,000. If one were to make inferences from recent press reports disclosing the pay packages of affected air crew, it may be that a refund of SGD 17,000 is not even sufficient to fund a month's salary for an experienced pilot.

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[8] I call this extreme because if a turnover cap restriction akin to Australia's of less than SGD 5 billion is used, Singapore Airlines may be excluded from an uncapped loss carryback regime.

[9] A restriction on the maximum number of years loss carryback can apply to should continue, however. In this example, by continuing to limit the number of tax years (currently three as announced in the 2020 budget) to which loss carryback can apply, the worst-case scenario for loss of government revenue can never extend to the income taxes previously paid and referable to Singapore Airlines' first 45 years. In the above numerical example, the first 47 years of income taxes previously paid will remain intact for now.

At least two OECD member countries (Canada and Ireland) do not impose a numerical limit on the losses, even if they do regulate the number of years the relevant losses may be carried back. It is my understanding that those uncapped approaches predate the COVID-19 pandemic.

For a counterexample in adopting or liberalizing a loss carryback regime, one may wish to point to Hong Kong, which has apparently resisted strategic reform to its tax system for over 50 years. However, as a territory with a very narrow tax base — for instance, it is somewhat of an outlier by not having a broad-based consumption tax regime — it is probably not the best example to follow in this discussion.

But beyond country-specific comparisons, potential safeguards against major losses in government revenue have been addressed and residual unease can possibly be managed by imposing a turnover threshold like Australia's. While a liberalized loss carryback framework can increase complexities for taxpayers in terms of the tax choices to be made, that is perhaps a quid pro quo exchange in attaining flexibility to seek meaningful tax refunds and Singapore at least has the advantage of no longer having to contend with complicated franking deficit impediments. Therefore, to move forward, it is time for Singapore to ride the internationally observed loss carryback momentum by relaxing its own rules decisively. ■