

## **Chapter 17**

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### **Impact of Losses**



## Impact of Losses

17.1 The profit of a trading undertaking as presented in its financial statements is the difference between its revenue and expenses. In general, costs incurred wholly and exclusively for the purpose of trade can be offset against revenues in computing taxable profit.

17.2 Loss relief can apply in the case of companies, sole traders and persons who are trading as partnerships. The main focus of this chapter is on losses of companies which account for the bulk of losses claimed.

## Corporation Tax Loss Relief

17.3 Companies are liable for Corporation Tax in respect of all profits arising from either income or gains. These are taxable as follows

- Trading income is taxed at a rate of 12.5%.
- Non-trading income<sup>144</sup> is taxed at 25%.
- Some manufacturing companies have their profits taxed at an effective rate of 10%<sup>145</sup>.
- Capital gains are chargeable to Corporation Tax at a rate of 25%.

17.4 Where following the determination of the taxable result of a company there is a net loss, that loss can be utilised to reduce Corporation Tax in the current, preceding or subsequent accounting periods.

- In the current accounting period, trading losses can be set off against trading and non-trading profit, including chargeable gains<sup>146</sup>. Relief on non-trading profit and chargeable gains is provided on a value basis<sup>147</sup>.
- Group relief allows one company in a group to surrender its trading loss in the current accounting period to another group member for offset against profits in the corresponding accounting period.
- Carry back of losses<sup>148</sup> allows trading losses to be carried back against profits in the previous tax period. This type of relief allows a cash flow benefit to the company concerned through the repayment of tax already paid.
- Any unused trading losses can be carried forward against future profits of the same trade indefinitely but must be used against the earliest available profits.
- Where a trade is discontinued, a trading loss incurred in the last 12 months of the discontinued trade, may be carried back and set against trading income in the same trade in the preceding three years, resulting in a reduction of the tax liability or repayment of tax.

<sup>144</sup> Non-trading income includes Case III income including discounts, interest and foreign income, Case IV income, including patent royalties and miscellaneous income and Case V income, which includes rental income from land and buildings in the State. Also included at this rate is trading income from 'excepted trades', which includes dealing in land and trading income from mining and petroleum operations.

<sup>145</sup> This is no longer available since 31 December 2010.

<sup>146</sup> Overall, annual results are netted and losses in the year on one activity can be netted against another.

<sup>147</sup> This ensures that the value of any loss relief allowed remains the same irrespective of the rates of tax that apply to the activities concerned.

<sup>148</sup> Carry back of losses is only available to companies chargeable to Corporation Tax. It is not available to sole traders and partnerships where the persons are chargeable to Income Tax.

17.5 In some cases companies can claim capital allowances (as an offset against profit) in relation to certain types of capital expenditure. A loss created or augmented by capital allowances is treated as a trading loss. A full list of capital allowances available is set out at Annex A.

17.6 My 2009 report examined the extent of loss relief in relation to Corporation Tax. However, because of deficiencies in Revenue's information systems it was not in a position to generate information in relation to the amount of losses actually used in any year and was unable to provide information in relation to the value of losses unused and available for carry forward to future years.

17.7 During 2010, Revenue introduced changes to the assessing system to allow it to estimate the amount of losses and capital allowances that were not used in a particular tax period. However, due to the structure of the tax returns, it is not yet in a position to differentiate between unused losses and unused capital allowances.

## Restrictions on Loss Utilisation

17.8 The extent to which reported losses are utilised is dependent on the generation of profits against which to offset them. In addition, the utilisation of loss relief is limited in circumstances where

- a return is submitted late
- a trade is discontinued
- the company is one of the credit institutions participating in the NAMA scheme.

17.9 Where a tax return is submitted late, the offset of losses is restricted. The restrictions are graded by reference to the delay in filing and there is a monetary cap on the level of each restriction<sup>149</sup>. The restrictions apply to the offset of losses against profits in the current and immediately preceding accounting period. The restriction does not amount to a complete denial of loss reliefs since losses can be offset against later accounting periods. The adverse effect on a company failing to submit its return on time will be a cash flow one.

17.10 Normally, the transfer of a trade from one company to another constitutes the discontinuance of that trade and trading losses are not available for carry forward. However, unused losses of a trade that is transferred from one company to another may be used by that other company where it carries on the same trade and an interest in the trade of not less than 75% is held by the same persons before and after the change.

17.11 In the case of participating<sup>150</sup> institutions in accounting periods commencing after the passing of the National Asset Management Agency Act<sup>151</sup>, the maximum amount of losses carried forward that can be used in each period is half of the excess of group trading profits over group trading losses for that period, so that a minimum of 50% of group trading profits will remain chargeable to tax in each period. This restriction effectively lengthens the period of time over which loss relief may be used by the participating institutions.

<sup>149</sup> Where a return is more than two months late, the use of losses is restricted to 50%, subject to a maximum restriction of €158,715. Where the return is less than two months late, the restriction is reduced to 25% or a maximum of €31,740.

<sup>150</sup> There are five credit institutions participating in the NAMA scheme – three banks and two building societies.

<sup>151</sup> The National Asset Management Agency Act 2009 amended the Taxes Consolidation Act 1997 to restrict the use of losses.

## Chapter Focus

This chapter reports the results of a review that set out to establish

- the trend in the value of losses reported, by sector, in respect of accounting periods between 2007 and 2009
- the extent of utilisation of losses and capital allowances in 2009 which was the last full year for which tax returns have been submitted
- the level of unused losses and capital allowances being carried forward in 2009.

While it focused specifically on Corporation Tax, information is also included on Income Tax loss relief.

## Information on Losses

17.12 In the case of companies, Revenue does not have information on the extent of losses incurred until nine months after the end of the relevant accounting period, at which point Corporation Tax returns are filed. For example, Corporation Tax returns for accounting periods ending December 2009<sup>152</sup> were required to be submitted by September 2010.

### *Trading and Manufacturing Losses*

17.13 In relation to tax returns submitted in respect of accounting periods ending in 2007, 2008 and 2009, Revenue compiled details for each year that showed

- the unused losses brought into that accounting period
- the losses reported in that period.

These are set out, by sector, in Figure 91.

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<sup>152</sup> The accounting period is a period chosen by the taxpayer.

**Figure 91 Trading and Manufacturing Losses – Corporation Tax Returns 2007 to 2009<sup>a</sup>**

Sector	2007		2008		2009	
	Losses forward €m	Losses in period €m	Losses forward €m	Losses in period €m	Losses forward €m	Losses in period €m
Financial Intermediation	1,546	8,815	5,777	9,024	13,941	22,989
Real Estate, Renting and Business Activities	1,705	1,120	2,992	3,710	2,815	3,182
Construction	358	436	390	998	855	1,319
Wholesale and Retail Trade	596	497	553	841	1,154	1,140
Manufacturing	579	1,569	762	1,465	1,171	1,907
Other <sup>b</sup>	1,069	1,544	1,221	1,344	1,721	1,515
<b>Total</b>	<b>5,853</b>	<b>13,981</b>	<b>11,695</b>	<b>17,382</b>	<b>21,657</b>	<b>32,052</b>

Source: Office of the Revenue Commissioners

Notes: a This information was derived from Corporation Tax returns, due in September 2010 in respect of accounting periods ending in 2009.

b Other includes agriculture, hunting and forestry, fishing, mining and quarrying, electricity, gas and water, hotels and restaurants, education, health and social work, public administration and defence, other community, social and personal service activities, activities of households, extra territorial organisations and bodies and all other sectors unknown.

17.14 There is an upward trend in the losses disclosed in the relevant tax returns. The losses incurred have risen from €14 billion in 2007 to €32 billion in 2009. Similarly the losses brought into the year have increased from €6 billion in 2007 to €22 billion in 2009.

17.15 Unsurprisingly, the biggest increase in trading losses reported in the 2009 tax returns is in the financial intermediation sector where losses totalling €23 billion were reported – making up 72% of the total losses disclosed.

## Losses Available for Offset against Profits

17.16 The current structure of the Corporation Tax return does not allow for the identification of

- the actual level of losses utilised in the year
- losses and capital allowances that are surrendered for group relief
- the value of losses unused and available for carry forward to future years.

17.17 In 2009, a total of €9.5 billion was available for offset against profits (the equivalent figure for 2008 was €4.2 billion). This comprised

- trading losses brought into the year of €1.1 billion as well as €0.6 billion in respect of manufacturing losses
- trade and manufacturing losses incurred of €3.9 billion and €1.2 billion respectively
- capital allowances totalling €5.7 billion.

## Utilisation and Carry Forward of Losses

17.18 Revenue has calculated the amount of unused losses and capital allowances available for carry forward to future years from 2009 based on available information and estimates of the level of losses utilised in relation to group relief. It was estimated that approximately €9.6 billion by way of losses and capital allowances was available for carry forward and offset against profits for 2010 and subsequent years. This estimate was based on the data set out in Figure 92.

**Figure 92 Losses Available for Carry Forward, 2009 Tax Returns**

	Basis of calculation	€m
Current year losses and capital allowances <i>not used</i> before surrendering as group relief and prior to offset against prior years tax	Actual	36,290
Losses brought forward from an earlier year that have not been used	Actual	16,784
Less — Losses set off against prior years tax	Actual	(868)
Less — Losses/Capital Allowances surrendered via Group relief	Estimated	(2,573)
<b>Estimated Losses and Capital Allowances available for carry forward to future years</b>		<b>49,633</b>

Source: Office of the Revenue Commissioners

17.19 Using this estimate of €9.6 billion in relation to the value of unused losses at the end of 2009, together with information on the level of losses available for use in 2009 (€9.5 billion), it is estimated that approximately €19.9 billion of losses and capital allowances were offset against profits in 2009. The breakdown by sector is shown in Figure 93.

**Figure 93 Estimate of Losses Available, Utilised and Unused<sup>a</sup>**

Sector	Total Losses and Capital Allowances available 2009	Estimated amount utilised 2009	Estimated amounts unused at end 2009
	€m	€m	€m
Financial Intermediation	39,057	4,752	34,305
Real Estate, Renting and Business Activities	12,803	6,571	6,232
Manufacturing	5,708	3,551	2,157
Wholesale & Retail Trade	3,377	1,645	1,732
Transport, storage and Communications	2,922	1,204	1,718
Construction	2,472	601	1,871
Other <sup>b</sup>	3,207	1,589	1,618
<b>Total</b>	<b>69,546</b>	<b>19,913</b>	<b>49,633</b>

Notes: a This information was derived from Corporation Tax returns, due in September 2010 in respect of accounting periods ending in 2009.

b Other includes agriculture, hunting and forestry, fishing, mining and quarrying, electricity, gas and water, hotels and restaurants, education, health and social work, public administration and defence, other community, social and personal service activities, activities of households, extra territorial organisations and bodies and all other sectors unknown.

17.20 Around €34.3 billion of losses are available for offset against future profits in the financial intermediation sector. Just over half of this relates to three institutions participating in NAMA. Legislative provisions included in the National Asset Management Agency Act 2009 effectively mean that for those institutions that return to profitability, only 50% of profits in any year can be offset against available losses.

## International Context

17.21 A recent OECD report estimated that it may take some three to eight years for the overall stock of bank losses to be utilised<sup>153</sup>. The report drew attention to the increased risk faced by revenue bodies as a result of those losses. These included

- the increased risks of inappropriate transfer pricing<sup>154</sup> in the case of loss-making banking groups and of loss making affiliates within profit-making banking groups.
- the risk that corporate reorganisation could be used inappropriately to transfer profits or losses between different locations and allow an unintended use of losses.
- the risk that financial instruments would be utilised to transfer losses to entities or branches within a group in order to utilise losses, this would include the use of call or put options<sup>155</sup> and the purported transfer of risks through swaps, other derivatives and debt waivers.

17.22 The report noted that new avoidance techniques were emerging as some loss-making banks try to maximise the use of their commercial losses for tax purposes. The report concluded that tax audits should continue to play a key role in detection, deterrence and prevention of aggressive tax loss planning supported by international exchange of information and cooperation between revenue bodies.

## Income Tax Loss Relief

17.23 There is also provision to allow for the offset of losses against Income Tax. Loss relief can be granted in the current and subsequent years. Terminal loss relief is also available in the case of discontinuance of a trade or profession.

17.24 Total Income Tax trading losses used in 2009 were €20 million (€35 million in 2008). In addition, relief for trading losses of €791 million were unused in 2009 (€557 million in 2008) and was available for carry forward to future years.

17.25 Unused rental losses carried forward to 2009 from earlier periods for those liable to self-assessed Income Tax totalled €1.8 billion in 2009. The comparative figure for 2008 was €1.7 billion.

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<sup>153</sup> OECD, Addressing Tax Risks Involving Bank Losses 2010.

<sup>154</sup> Transfer pricing which relates to the charges made between related parties for goods, services or the use of property (including intangible property) is a key risk area in international taxation both in profit making and loss making contexts. The report recommended that Revenue bodies verify the consistency of claims under the arms length principle. Under the arms length principle, the remuneration of a subsidiary or profit allocation to a branch that is part of a multinational banking group has to reflect the functions performed, taking into account the risks assumed and the assets used by it.

<sup>155</sup> Put/call options are contracts that give the purchaser of the option the right, but not the obligation, to buy (a call option) or to sell (a put option) a particular financial instrument or commodity at a predetermined price (strike price) within a specific time span or on a specific date.

## Accounting Officers Views

I asked the Accounting Officer

- for Revenue's estimate of the overall impact of losses on future tax revenues and the results of any profiling exercises conducted by Revenue in this regard
- for her views in relation to the losses in the financial intermediation sector, Revenue's estimate of the timescale involved in utilisation of these losses and the restrictions imposed in relation to utilisation of losses by institutions participating in NAMA.

### ***Impact of Future Tax Revenues***

17.26 The Accounting Officer stated that it is difficult to estimate the future impact on tax yield of any overhang of unused losses. The use of losses depends on the capacity of companies to generate profits to absorb those losses and on the number of companies with significant losses that may never be absorbed because they will cease trading.

17.27 She stated that the profile of Corporation Tax payers is also a factor since

- A very significant proportion of Corporation Tax yield is concentrated in a small number of consistently profitable companies – mainly subsidiaries or branches of large multinationals. The yield from these companies will be unaffected by losses.
- A large majority of companies filing Corporation Tax returns either pay no Corporation Tax or a relatively small amount.

17.28 Given these factors, the Accounting Officer stated that it is unlikely that the overhang of losses will ever be fully absorbed and the amount of unused losses is likely to remain very significant.

### ***Losses in the Financial Intermediation Sector***

17.29 The Accounting officer noted that while the OECD report on tax risks involving bank losses estimates that it could take three to eight years for the overall stock of bank losses to be utilised, this estimate was based on aggregate data from 17 countries with varying rules in regard to the utilisation of tax relief on losses, including some that impose time limits on the carry forward of losses. Because of the uncertainties in this area, Revenue could not produce an estimate with an acceptable degree of reliability.

17.30 She noted that the OECD report on bank losses emphasises that the extent of governments' exposure to bank tax losses depends to a large extent on the likely availability of future bank profits against which these losses can be offset. In this regard

- A large proportion of the estimated unutilised losses of €34.3 billion at the end of 2009 are confined to a very small number of companies. Just five companies account for €28 billion (or 82%) of the unutilised losses at December 2009 – three are NAMA entities.
- In looking at the future impact of the losses it needs to be taken into account that two of the five institutions (accounting for about 45% of unutilised losses) are in the process of a 'wind down' over the next ten years and will not be allowed to take on any new business activities.

17.31 In relation to restrictions on the utilisation of losses in respect of institutions participating in the NAMA scheme, the Accounting Officer stated that the provisions in the NAMA Act do not include any restriction on participating institutions in relation to offsetting losses against previous years' profits and the normal rules apply whereby a company incurring a trading loss in an accounting period can carry that loss back for offset against the profits of its immediately preceding accounting period (of the same length).

## Conclusion

Reported losses have increased substantially between 2007 and 2010. Based on analysis of company tax returns due by September 2010, in respect of accounting periods ending in 2009, just under €20 billion in losses and capital allowances was utilised in 2009 and about €50 billion was unused.

€34 billion of the losses available for offsetting against profits related to the financial intermediation sector. A recent OECD report estimated that it may take three to eight years for the overall stock of bank losses to be utilised. Revenue was not in a position to provide an estimate of the timescale involved or the extent to which such losses would be utilised in relation to companies in the financial intermediation sector in Ireland.

However, based on its assessment of the profile of loss making entities it is Revenue's view that it is unlikely that a large proportion of the loss overhang will be absorbed since certain loss making banks are being wound down and are unlikely to have profits against which the accumulated losses can be offset.

Nonetheless, losses will have a significant impact on future tax revenues. The main tax collection impact would be in the financial intermediation and construction sectors where 88% and 76% of the cumulative losses available in 2009 were not utilised. By comparison, utilisation of losses was much higher in other sectors where, on average, over half of the available losses was utilised.

Net receipts of €3.94 billion were received in 2010 in relation to Corporation Tax. In 2009, 29% of the available losses were utilised. It is estimated that the utilisation of losses and capital allowances as set out in Figure 93 reduced the tax take by approximately €2.5 billion<sup>156</sup>.

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<sup>156</sup> An effective tax rate of 12.5% was used to estimate the effect of losses utilised in 2010.

## Annex A Capital Allowances

The categories of capital allowances and the relevant offset that can be claimed are set out below.

### Capital Allowances, Categories of Expenditure and Tax Relief Allowed

Category of Expenditure	Rate of Write-Off
Plant & Machinery	12.5% per annum over an 8 year period.
Taxis	40% on reducing balance basis.
Motor Vehicles	12.5% on a straight line basis - maximum qualifying cost is €24,000.
Industrial Buildings	Annual allowance of 4%, in respect of buildings used for manufacturing.
Market Gardening, Intensive Production of Livestock	10% per annum for 10 years.
Hotels and Holiday Camps	Allowance of 4% per annum over 25 years, 15% in certain specified circumstances.
Holiday Cottages	10% per annum over 10 years where the expenditure was incurred by 31 July 2008.
Guest Houses, Holiday Hostels, Caravan & Camping Sites	Annual Allowance of 4% over 25 years.
Certain Rented Residential Accommodation	15% per annum on a straight line basis for years 1 to 6 and 10% in year 7 for refurbishment expenditure incurred on multi-unit residential accommodation up to 31 July 2008.
Student Accommodation	100% allowance against rental income in the first year the property is let. Deadline for incurring qualifying expenditure under this scheme was 31 July 2008.
Section 23 Relief for Rented Residential Accommodation in qualifying areas	100% allowance against rental income in the first year the property is let. Deadline for incurring qualifying expenditure under this scheme was 31 July 2008.
Childcare Facilities	15% per annum on a straight-line basis for years 1 to 6 and 10% in year 7 where expenditure is incurred by 31 March 2012. 100% accelerated capital allowances are also available.
Private Nursing Homes, Convalescent Homes, Mental Health Centres	15% per annum on a straight-line basis for years 1 to 6 and 10% in year 7 where expenditure was incurred by 30 June 2011.

<b>Category of Expenditure</b>	<b>Rate of Write-Off</b>
Nursing Home Residential Units	15% per annum on a straight-line basis for years 1 to 6 and 10% in year 7 where expenditure was incurred by 30 April 2010.
Private Hospitals	15% per annum for years 1 to 6 and 10% in year 7 where expenditure is incurred by 31 December 2013.
Sports Injury Clinics/Third Level Education Buildings	15% per annum for years 1 to 6 and 10% in year 7 where expenditure was incurred by 31 July 2008.
Park & Ride Facilities, Multi Storey Car Parks	In the case of owner-occupiers, 100% accelerated allowances are available. Passive investors are entitled to claim allowances at a reduced rate of 50% in year 1 and 4% per annum thereafter. The termination date for incurring qualifying expenditure was 31 July 2008.
Area Based Schemes	Accelerated allowances of 50% with 4% per annum thereafter. The termination date for incurring qualifying expenditure was 31 July 2008.
Energy-efficient equipment	Allowances of 100% in year of expenditure for certain energy-efficient equipment purchased by companies for use in a trade.
Intangible Assets	Allowances based on accounting depreciation with the option for a straight-line allowance over 15 years. Allowances capped at 80% of trading income of the relevant trade in which intangible assets are used.

Source: Office of the Revenue Commissioners