AUSTRALIAN BANKERS' ASSOCIATION INC.

Tony Burke
Director, Industry Policy & Strategy

AUSTRALIAN BANKERS' ASSOCIATION INC.
Level 3, 56 Pitt Street, Sydney NSW 2000
p. +61 (0)2 8298 0409 **f.** +61 (0)2 8298 0402

www.bankers.asn.au

21 September 2012

Business Tax Working Group Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600
Email: BTWG@treasury.gov.au

Dear Working Group,

Business Tax Working Group Discussion Paper

Thank you for the opportunity to comment on the Business Tax Working Group Discussion Paper issued on 13 August 2012 ("the paper").

The ABA agrees with the Working Group that Australia should have an ambition to reduce its corporate tax rate over the medium term. Our submissions to the Australia's Future Tax System Review (AFTS) included the following recommendation:

> *"(Australia)… should set a medium term goal of reducing the Australian corporate tax rate to no more than 25% and that the rate needs to be periodically reviewed to judge whether it remains appropriate.*
>
> *…we consider that 25% is an appropriate target rate because a 5% cut would be viewed as material by foreign investors but would maintain Australia as a mid-level rate country in Asian terms…"*

We also agree with the Working Group that a lower corporate tax rate would improve productivity, by attracting new investment and increasing the quantity and quality of capital stock. Improving multi-productivity will drive GDP growth, and an increase in GDP should lead to increased tax collections for the Government. In the current domestic and international economic climate, improving productivity in Australia is even more important than it was in 2008 – when ABA made its first recommendations to the AFTS review.

The ABA believes that in relation to the challenges and opportunities for our national economy, the "medium term" for a rate reduction is much closer than we had considered in 2008.

In 2008/09 we suggested a goal for Australia as a "mid-level rate" country in Asia, but in that year the average corporate tax rate in Asia was 28%[1]. In 2012 it is 23%, with Hong Kong, Singapore and Taiwan at 16.5–17%. Australia does not have a mid-level rate. In the region only Japan, India, Pakistan and some small Pacific island nations have higher rates than Australia.

The ABA acknowledges however the need for fiscal prudence, and accepts therefore the Working Group's proposed "broad base, low rate" strategy, the implication of which is that a reduction in the corporate tax rate will need to be offset by based broadening measures.

The ABA believes that it should be possible to achieve a rate reduction of the order of 2-3% in the near term. On the estimates in the paper this would have a cost (if effective for the full year) of $3.6–5.3 billion in 2015/16. A range of base broadening measures will be required, and these need to be considered for all industry sectors.

[1] Nominal rates. Source: KPMG

The ABA has not taken a position on all the options in the paper, but would support the following:

- **Option A.3 — Reducing safe harbours for financial institutions**
- **Option B.1 — Reduce the diminishing value rate for depreciation from 200 per cent to 150 per cent**
- **Option C.1 — Abolish the Research and Development 40 per cent non-refundable tax offset**

The ABA also suggests that consideration be given to increasing the effective life of computer software from four to five years.

These measures would have a direct impact on the banking industry, as well as other sectors. Costings are not provided in the paper for all options, but there are estimates for B1 and C1, and the ABA has provided an estimate for the suggested change in software amortisation. Together these measures are estimated to deliver savings of at least $2.4 billion in 2015/16.

It is important to note that a reduction in the corporate tax rate will lead to new investment and growth and this will lead to volume-based increases in tax revenue. It would be counter-productive to implement new based broadening measures now, the combination of which would "overshoot" the target, that is, deliver revenue in excess of that needed to offset the rate cut.

Additionally, for any tax rate reduction there will be a one off need for taxpayers to restate the carrying value of deferred tax balances on their balance sheets, and carry the impact through the profit and loss account as a reduction in reported earnings. As a result, where taxpayers hold significant deferred tax assets (DTAs), they will lose some of the Year 1 tax benefit reported at the tax expense line due to the need to value their DTA to the new company tax rate. Banks are likely to be impacted given that DTAs will be carried for bad and doubtful debt provisions. The full tax rate impact will however still arise when measuring the reduction in the amount of cash tax payable by taxpayers.

It would also be counter-productive, and strategically unsound, if measures were implemented without a rate cut, for short term fiscal gains. The outcome would almost certainly be in the longer term, a reduction in business growth and GDP, and a significant decrease in the rate of growth of corporate income tax revenue.

The ABA agrees with the Working Group that an Allowance for Corporate Equity (ACE) should not be pursued in the short to medium term. An ACE would require an increase in the corporate tax rate to offset the deduction, and would be very difficult to implement, with a significant risk of serious unintended consequences.

The ABA supports retention of dividend imputation. If the company tax cut is reduced some of the tax saved at the corporate level will still be collected by Treasury at the shareholder level, as the value of dividend imputation will be decreased.

Further comments on the ABA's recommendations are attached.

Yours sincerely,

____

Tony Burke

ABA comments

1. Corporate tax rate cut

Taxes generally have some impact on the provision of various economic inputs (e.g. capital and labour). Taxes on labour reduce the supply of labour, by impacting on the returns received by workers per hour worked. Taxes in capital income (e.g. company tax) increase the required return on equity. Generally, capital tends to be more mobile than labour, particularly internationally.

The higher the company tax rate, the higher the return required on equity to invest capital in Australia. A lower investment hurdle rate results in more investment options providing the returns necessary to put capital at risk. The impact of a cut in the company tax rate is to increase the stock of capital invested in Australia. Some of that increase can come from domestic capital accumulation. A portion will come from internationally mobile capital, which could be reallocated to Australia given the returns are relatively more attractive with a lower tax rate.

The higher the company tax rate, the lower the level of investment and capital accumulation in an economy. Lower capital accumulation in an economy tends to lower the earnings of workers. Investments in additional capital result in increased production per unit of labour input. More productive workers earn higher wages.

KPMG modelling for the Government's response to the AFTS review found that a 2% cut to the company tax rate increased GDP by 0.4% above baseline. In today's terms, using 2011/12 GDP, that would equate to an additional $5.9bn of economic activity.

The ABA believes that it should be possible to achieve a reduction in the corporate tax rate of the order of 2-3% in the near term.

2. Base broadening options

In examining options, the ABA has considered;

- The Working Group's original Terms of Reference;
- The principles set out in Appendix C to the discussion paper;
- The consultation questions at p.7 of the paper;
- The position of banks in the economy; and
- General economic and industry research.

The ABA has selected base broadening measures which will further the national interest, and allow, together with options suggested by others, a reduction in the corporate tax rate of 2-3%, in the near term.

2.1. Option A.3 - Reducing safe harbours for financial institutions

The ABA supports Option A.3.

As part of the change to the safe harbour there would need to be increased certainty over how a banking group's risk weighted assets are determined. Importantly, banks should only need to risk weight assets that are risk weighted for APRA purposes. Any measure to risk weight all group assets should as a minimum exclude policyholder assets held in life company statutory funds. Increasing the required capital to 6% and applying this to all group assets (including policyholder assets) would potentially result in having interest deductions denied, beyond the scope of the policy intent.

The increase in the safe harbour proposed in Option A.3 is material and the ABA recommends that issues in the current thin capitalisation rules be rectified at the same time, to address significant departures from the general principle that the rules for financial institutions should follow the approach taken by APRA.

These "anomalies" generate significant compliance costs for ADIs and (in our view) lead to inappropriate outcomes for tax purposes (on the assumption that prudential capital requirements set capital levels that are appropriate for tax capital purposes).

The two issues we believe should be addressed are:

- Application of ADI rules to non-bank operations of NOHC groups. Currently, APRA requires capital to be held against non-bank activities based on a methodology agreed with APRA, not the prudential standards governing ADIs (which under current law apply to the whole NOHC group for tax purposes). This leads to significant deviations in thin capitalisation capital levels for NOHC groups compared with actual levels required by APRA. This results in material compliance costs (because ADI prudential rules are not otherwise applied to non-bank activities), will often place NOHC groups at a disadvantage compared with non-ADIs carrying on the same activities and will generally result in the NOHC group having more onerous capital requirements for tax purposes than required by APRA (on the basis that the ADI prudential rules generally require higher levels of capital than the APRA approved methodology used by the NOHC).
  - We suggest the law be amended so that the safe harbour in respect of a NOHC's non-banking activities is determined based on the NOHC's APRA approved methodology.
- Application of ADI rules on a look through basis to tax consolidated group subsidiaries that are deconsolidated for prudential purposes, e.g. life companies. Again this creates deviations between thin capitalisation capital requirements and actual capital levels required by APRA. This ordinarily leads to the same results as described above.
  - We suggest the law be amended so that the safe harbour in respect of deconsolidated subsidiaries is determined based on the APRA approved methodology.

2.2. Option B.1 — Reduce the diminishing value rate for depreciation from 200 per cent to 150 per cent

In principle the ABA supports the reduction in the diminishing value rate of depreciation from 200% to 150% on the condition that it can be supported by an analysis that it would result in an alignment of an assets tax depreciation with the actual decline in economic value. Whilst a reduction in accelerated depreciation would have a greater impact on capital intensive industries, when combined with a company tax reduction, the net impact on the economy would be expected to be positive. The ABA believes that any decision to accept this proposal needs to be supported by an objective study and economic modelling.

2.3. Option C.1 — Abolish the 40 per cent non-refundable tax offset

To help fund a cut in the corporate income tax rate, which will have the effect of lowering the pre-tax hurdle rate required for investment and therefore offset some of the adverse impact of removing the non-refundable tax offset, the ABA supports Option C.1.

2.4. Additional options

Consistent with the comments made at point 2.2 above in relation to tax depreciation, the ABA suggests that consideration be given to increasing the effective life of computer software from four to five years. Any increase in the effective life would need to be consistent with the economic life of computer software, which would require further analysis. However, on face value an increase to five years would not be inconsistent with the current accounting amortisation period for the majority of the banking industry's expenditure on computer software. Given the banking industry's ongoing investment in technology platforms, an increase in the effective life of computer software would be expected to make a material contribution to the proposed reduction in corporate tax rate. For the four major banks this is estimated to be $130-140 m pa by 2016.