AVCAL

The AUSTRALIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION Limited

25 September 2012

Business Tax Working Group Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

By email: BTWG@treasury.gov.au

Response to Business Tax Working Group Discussion Paper 13 August 2012

Dear Sir/Madam,

AVCAL welcomes the opportunity to comment on the Business Tax Working Group's discussion paper of 13 August 2012 ("**Discussion Paper**"). We understand that this is a first step towards a more robust analysis and dialogue on the improvement of the Australian business tax system. AVCAL will continue to engage and remain an active participant in the consultation in improving the business tax system.

AVCAL's comments and specific recommendations on particular points raised in the Discussion Paper are set out below.

Merits of a reduction in the company tax rate

AVCAL is supportive of the BTWG's comments on how tax impacts the productivity of the business system. Amongst Australia's major global trading partners, Australia's corporate tax rate remains one of the highest. The global average tax rate for 2012 was 24.39% with the OECD Countries' average being 25.25%. Compared with other countries in the Asia Pacific with whom we compete for investment dollars, Australia's corporate tax rate is in stark contrast with the other high growth economies in the region such as China (25%), Singapore (17%), Hong Kong (16.5%) and Malaysia (25%).

AVCAL strongly agrees that for Australia to reach its full potential as a global economic player, its business tax system must be simple to understand and comply with, be competitive and attracts new investment whilst maintaining the revenue base and economic efficiency. To date, Australia's complicated and antiquated tax system has proved a real impediment for foreign investors.

In this context, AVCAL agrees with the merits of lowering the corporate tax rate whilst balancing revenue requirements. A competitive tax system is fundamental to stimulating growth in the economy.

Base broadening options – the R&D tax incentive

AVCAL notes that the R&D initiative of the Government's was strongly welcomed by AVCAL when it was first announced and later implemented. For our Venture Capital members, who all invest in relatively small, early-stage, research-intensive companies, the R&D Tax credit provides a significant benefit. Their companies tend to be cash-starved as they are growing rapidly and still carrying out substantial R&D.

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Therefore AVCAL is anxious to reinforce the BTWG approach to leave the 45% tax credit for smaller companies alone. It is a critical piece of the funding jigsaw to enable commercialisation of technology through spin-outs and small rapidly expanding companies.

The Discussion Paper questions the stimulatory effect of the R&D concession on larger businesses. Innovation in science and technology plays a key role in the growth of any economy and driving productivity growth. As such, AVCAL cautions that further quantitative data should be gathered before adopting any of the options offered by the BTWG. Further, any final decision by Government should not penalise innovation in Australia.

AVCAL's constituents are and will remain strong supporters of technological innovation in Australia. AVCAL does not want to see another wave of valuable skilled human capital moving to the Silicon Valley for lack of Government support.

Base broadening options - Interest deductibility and thin capitalisation ("thin cap")

AVCAL remains actively engaged in the discussions regarding thin cap reform. AVCAL agrees with the BTWG's observation that when compared with other jurisdictions, Australia's thin capitalisation regime is onerous.

There are flaws in the alternative safe harbour tests, particularly the arm's length debt test, that make that test difficult to satisfy. Nevertheless, the safe harbour test will not suit every taxpayer or industry, particularly those involved in the property and infrastructure industries, nor those taxpayers that have large quantities of unbooked goodwill but strong cash flow.

Retention of an arm's length rule would seem to be consistent with the harmonisation of domestic transfer pricing principles with those which apply in the context of Australia's double tax treaties.

For these reasons, AVCAL does not support the abolition of the arm's length rule.

Further, the reform should not focus on reducing the safe harbour maximum debt limited to 60% of adjusted Australian assets, and eliminating the world wide gearing test premium. Certainly, such reform should not be implemented without transitional relief for taxpayers with existing debt facilities, for the natural term of those facilities. In the venture capital and private equity context, AVCAL notes that failure to introduce transitional measures may be hard-felt as it may not be possible to refinance investee entity balance sheets within the reduced thin capitalisation ratios; and this is particularly harsh where interest withholding tax continues to be collected on interest which is denied deductibility. Such double taxation would not sit well within the context of fair and equitable tax reform.

Without any quantitative data, AVCAL reserves any comments on implementing any limitation on interest deductions which are imposed by reference to EBITDA. However, AVCAL questions the merits of this test. Its unsuitability, particularly in the context of entrepreneurial businesses, quickly growing businesses, those in a "turn around phase" (that is, those typically invested into by AVCAL's constituents), is highlighted in the context of the volatile nature of the earnings these businesses can have. Typically, venture capital and private equity investee companies tend to have debt packages negotiated at the time of investment, which are locked in for a significant length of time; and typically contemplate organic growth of business earnings during the term of the debt. In this context, an EBITDA test may impose a significant obstacle to supporting the growth of Australian businesses.

Any change in the thin cap regime should not be introduced without robust consultation with business and should only be introduced prospectively.

AVCAL supports the recommendations made by the ICAA in their submission dated 21 September 2012.

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We would welcome the opportunity to this discuss the matters raised in this letter with you in further detail. Please do not hesitate to contact me on +61 2 8243 7000 or Ian Scott of Ernst & Young on + 61 2 9248 4774 and Tasha Chua +61 2 9248 5613 (AVCAL's advisers on this matter).

Yours sincerely

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