CPA Australia Ltd
ABN 64 008 392 452

Level 20, 28 Freshwater Place
Southbank VIC 3006
Australia

GPO Box 2820
Melbourne VIC 3001
Australia

Phone 1300 737 373

Outside Aust +613 9606 9677

Website cpaaustralia.com.au

20 September 2012

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

By email: BTWG@treasury.gov.au

Dear Sir/ Madam

SUBJECT: SUBMISSION ON DISCUSSION PAPER CONCERNING POTENTIAL FUNDING OPTIONS TO FINANCE CORPORATE TAX RATE CUT

CPA Australia represents the diverse interests of more than 140,000 members in 114 countries throughout the world. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders. Against this background, we provide this submission concerning the discussion paper issued by the Business Tax Working Group (BTWG) on 13 August 2012. The discussion paper canvasses various measures that, if implemented, would broaden the business tax base and enable a reduction to the corporate tax rate.

In making this submission we recognise that any of the potential reforms need to be appropriately costed to determine the possible savings potentially available, and that the broader commercial consequences of each proposed reform need to be carefully clarified to ensure that any detrimental implications are rigorously reviewed prior to the finalisation of any tax law changes.

We have also included a copy of our organisation's earlier submission on the BTWG's initial review on the tax treatment of losses dated 2 November 2011 **(Appendix A**) as it is relevant to our response to this most recent discussion paper. It detailed a number of potential funding options which we proposed should be explored to identify savings which could be applied to fund prospective tax reform.

We make the following specific comments in respect of the Discussion Paper:

1. On balance we believe that the most viable reform canvassed is set out in Option A.1 being a re-calibration of the existing thin capitalisation provisions in Division 820 of the Income Tax Assessment Act (1997) which broadly accords with Recommendation B of our earlier submission. However, we believe that a reduction in the safe harbour maximum debt limit from a 3:1 to a 1.5 debt equity ratio should be an aspirational goal which should be progressively implemented over time. Accordingly, we suggest that the debt equity ratio be initially reduced to a 2:1 debt to equity ratio for an appropriate transitional period of, say, 3 years before a 1.5:1 debt to equity ratio is implemented. Such an approach would enable affected taxpayers sufficient time to acclimatise to the revised regime by adjusting their financing arrangements. We concur with the proposal that this change should also be accompanied by the removal of the arm's length test and the arm's length minimum capital amount tests for non-financial and financial entities respectively, and by a general reduction in the worldwide gearing ratio from 120% to 100%

2. We suggest that there is some merit in determining the viability of reducing the diminishing value depreciation rate for depreciating assets from 200% to 150% as set out in Option B.1 should it be necessary to identify appropriate savings. We note that the 150% rate generally applied prior to the 2006-07 Federal Budget without creating any manifestly adverse behavioural impacts on business.

3. We are opposed to any of the proposed options to reform the research and development tax incentive as set out in Option C of the Discussion Paper as we believe that the design features of the incentive have already been significantly refined to ensure that it is a very targeted concessional program. Moreover, in

our view the maintenance of such a program for corporate Australia is essential if we are to engender an innovative business culture in the private sector and increase national productivity.

We note that the Discussion Paper does not canvass the merits of reforming the tax consolidations regime by either reducing or completely removing the cost base uplift under the allocable cost amount (ACA) method that arises where there is a public takeover of a company by the head company of a consolidated group. For the reasons detailed in our earlier submission, see Appendix A, we recognise that this cost base uplift may create asymmetrical tax outcomes.

For example, certain vendors of shares will obtain tax relief under the CGT general discount on any premium paid on shares whilst that premium will also result in higher cost bases and tax written down values of assets for consolidated groups. Unlike the bulk of the reform options canvassed in the discussion paper there does not appear to be any equitable justification for such an anomalous treatment being maintained. Accordingly, we strongly recommend that this savings option be more fully explored before reliance is placed on the reform options canvassed in the discussion paper, all of which appear to have some detrimental effect on business albeit to varying degrees.

If you have any questions regarding the above, please contact Mark Morris, Senior Tax Counsel, on (03) 9606 9860 or via email at mark.morris@cpaaustralia.com.au.

Yours faithfully

Paul Drum FCPA
Head – Business and Investment Policy

T: +61 3 9606 9701
E: paul.drum@cpaaustralia.com.au

CPA Australia Ltd
ABN 64 008 392 452

Level 20, 28 Freshwater Place
Southbank VIC 3006
Australia

GPO Box 2820
Melbourne VIC 3001
Australia

Phone 1300 737 373
Outside Aust +613 9606 9677
Website cpaaustralia.com.au

Appendix A

2 November 2011

Mr Chris Jordan
Chair - Business Tax Working Group
c/- Rob Heferen
Executive Director, Revenue Group
The Treasury
Langton Crescent
PARKES, ACT 2600

By email: rob.heferen@treasury.gov.au

Subject : Business Tax Working Group (BTWG)

Dear Chris

We are writing to you in respect to possible changes to the tax treatment of business losses to relieve the taxation of new investment in the near term as announced by the Deputy Prime Minister and Treasurer in his closing address to the Tax Forum on 5 October 2011 and subsequent media release of 12 October 2010.

We also note that the BTWG has also been asked to look at other options in the longer term such as reducing the corporate tax rate further or alternatives such as allowances for corporate equity (ACE).

This submission focuses on potential options in the short-term for improving the tax treatment of losses (such as the introduction of appropriate loss carry-back rules) as well as options for funding such a change to the existing law in this area.

We note in this regard that Recommendation 31 of the Henry Tax Review (HTR) indicated that companies should be allowed to carry back a revenue loss to offset such a loss against its prior year's taxable income, with the amount of any refund limited to a company's franking account balance.

In support of this proposed approach, the HTR noted the bias in current company tax arrangements in respect to the asymmetric treatment of gains and losses. To improve current loss arrangements, the HTR argued that companies should be allowed to carry-back and offset a revenue loss against a prior year's taxable income, subject to the amount of any refund being limited to the company's franking account balance. It noted also that the introduction of such a rule would also improve the automatic fiscal stabilisers.

We also note in this context that the 2011 Federal Budget announced changes that will allow infrastructure projects to carry forward losses with an uplift factor to maintain their value. Consistent with this approach, therefore, we submit that the BTWG should consider the indexation of prior year losses for businesses generally in order to maintain their real value in appropriate circumstances.

It is also relevant that carry-back options ranging from one to three years are common in other comparable jurisdictions including in Canada, the United Kingdom, France, Germany and Ireland as well as the United States which extended its provisions during the GFC to allow small businesses to carry back 2008 losses for up to five years. While the HTR recommended a one-year limit, it might be appropriate to explore a longer timeframe as per the position in other relevant jurisdictions such as the United Kingdom where any additional loss carry back period beyond the initial year is capped in both time and amount so that it is effectively both limited in application and quantifiable in the context of the impact on government revenues.

Certainly the ability for taxpayers to carry back losses would be a great benefit for those companies who have made prior year profits but perhaps as a consequence of the GFC or the multi speed economic conditions are now in years of tax losses.

Of course it is not of assistance to all businesses - only those who have earlier year tax profits but not those in start-up phase.

Therefore consistent with the earlier approach adopted in respect to infrastructure projects, CPA Australia recommends consideration could also be given to the indexation of prior year losses for businesses without a prior year profit, including start-ups, to maintain the real value of such losses going forward.

Another matter for consideration are the actual rules relating to tax losses. In particular, we believe the BTWG should explore the merits of possibly modifying the COT and the SBT restricting the use of prior year losses so that companies can grow or change direction without fearing the loss of tax benefits. For example, small businesses in particular often have to restructure during adverse economic times where the commercial imperatives of remaining viable override concerns that tax losses may be foregone on a change in ownership or upon the acquisition or divestment of significant business activities.

While appropriate integrity rules may be necessary in the event of the introduction of more flexibility for companies to access prior year losses, it is important that such rules do not simply make it difficult for companies to utilise them and our view is that the existing general anti-avoidance provisions in the income tax law should be sufficient to prevent abuse of any new rules in this area.

It is relevant in this context to note that the recently completed Mirrlees Review of the tax/transfer system in the United Kingdom has argued for further improvements to the current UK loss carry-back rules either by permitting immediate rebates to be claimed in a wider range of circumstances, or by allowing tax losses to be carried forward with an interest mark-up to compensate for the delay before they can be utilised. The Review considered that such measures would be particularly of benefit to SMEs.

Changes to the treatment of tax losses as described above need to be funded. In this regard we note the government's commitment to not fund corporate tax cuts from higher taxes on working families, and the government's imperative to return the budget to surplus by 2012-2013.

Against this background and constraints CPA Australia also make the following suggestions for consideration by the BTWG:

- consider reducing the extent of, or removing completely, the cost base uplift under the Allocable Cost Amount (ACA) that arises under the existing income tax consolidation regime where there is a public takeover of a target company by a consolidated head company;

- consider reducing interest deductions under the thin capitalisation regime so that public companies and large closely held groups can only obtain interest deductions to the extent that they do not exceed a 2:1 debt/equity ratio under the safe harbour test ;

- rationalising the tax deductions available under the capital allowance regime by either reducing or removing accelerated tax depreciation for certain depreciating assets that have a statutory effective life, and

- extending the deductibility period over which eligible blackhole business capital expenditure can be amortised from 5 to 10 years.

The rationale for each of these potential savings measures is set out in Attachment A.

Please contact me if you have you would like to discuss the above matters or if you require any further information.

Yours faithfully

Paul Drum FCPA
Head – Business and Investment Policy
External Positioning

T: +61 3 9606 9701
E: paul.drum@cpaaustralia.com.au

ATTACHMENT A

We recognise that the Australian Government has committed to not fund corporate tax cuts by imposing higher taxes on working families whilst concurrently returning the Federal Budget to surplus by 2012-13.

Given this constraint we believe that such reforms should be principally financed from savings funded by recalibrating the corporate tax regime through reducing existing income tax concessions which are predominantly utilised by public company groups and large closely held groups. As a corollary we recommend that the any further tax loss relief should be principally directed to SMEs given the existing patchwork economy.

Some of the possible corporate tax reform options you may wish to consider in effecting such a re-alignment of tax priorities are detailed below:

A. Public company takeovers and the cost uplift

In certain circumstances the head company of a tax consolidated group may obtain an uplift in the cost base or adjustable values of the assets of a joining entity on consolidation following a public takeover of a target company.

This is because the apportionment of the Allocable Cost Amount (ACA) over the assets of a takeover company will be greater than the inherited cost base or tax written down value of such assets as the head company will typically pay a premium for the shares acquired in the target company.

As a corollary the head company will thereafter typically have an increased cost base for the CGT assets and a higher adjustable value for capital allowance purpose for the assets it acquires on consolidation than the values it would otherwise have inherited.

These higher costs bases and tax written down values can be utilised in future transactions to potentially reduce capital gains, increase capital losses and increase tax deductions claimed for the decline in value of depreciating assets.

However, the vendor of the shares in the takeover company will often be able to also reduce the capital gain made on the sale of such shares (including any premium paid by the acquiring company on the takeover) under the CGT general discount where the seller is an individual, trust or complying superannuation fund.

Hence, there is a lack of symmetry between the amount of the assessed gain derived by the vendor of the shares and the cost base uplifts obtained by the acquiring head company on such a takeover.

This anomaly could be addressed by (fully or partly) denying the public company any cost base uplift on such a public takeover thereby ensuring that the prospect of any incremental tax uplift does not disproportionately affect the commercial merits of a public company takeover.

Alternatively, the cost base uplift could be retained by the head company on consolidation but the vendor of the equity in the subsidiary member could be (fully or partly) assessed on the amount of such an uplift to ensure that there is more symmetrical outcome for income tax purposes.

B. Thin capitalisation and debt deductions

CPA Australia recommends that the BTWG determine whether the amount of debt deductions (e.g. interest) available to taxpayers under the thin capitalisation provisions should be reduced by amending the safe harbour ratio from a 3:1 debt equity ratio to a 2:1 debt equity ratio.

Such a change could also be accompanied by a review of both the arm’s length test and worldwide gearing test to establish whether these alternate compliance tests should be retained.

Prima facie these initiatives would most typically affect the gearing practices of foreign owned multinational groups as most resident Australian groups would typically be less geared than corporate groups who are reliant on a 3:1 debt to equity ratio.

This approach is also congruent with the views previously expressed by Treasury that disparities in the average rate of tax have arisen where corporate groups have been able to reduce their tax liability by an above average reliance on debt funding vis a vis equity funding.

We recognise that any modelling of this proposal would need to comprehend how such a regime would compare with those of our major international competitors, and to indentify any major potential adverse impacts on inbound and outbound investment.

In recalibrating the thin capitalisation regime the current exemption for Australian resident entities whose assets are at least 90% or more are located within Australia should be retained in order to reduce unnecessary compliance. Similarly, the existing de minimis exemption should not only be retained but extended to mitigate the potential impact of the proposed changes on SMEs. In our view the de minimis test should be available where total debt deductions (inclusive of related party debt deductions) do not exceed $500,000 rather than be capped at the current $250,000 exemption threshold.

Also if such a measure was adopted we note appropriate transitional provisions would also be required.

C. Capital allowance provisions

CPA Australia recommends the BTWG consider the rationalisation of the deductions available for the decline in value of certain depreciating assets under the capital allowance provisions.

We note that Recommendation 28 of the Henry Tax Review canvassed the removal of the accelerated write off of capital allowances applying to investments in agriculture and to depreciating assets that have a concessional statutory effective life (e.g. aircraft, trucks and light commercial vehicles).

We broadly support the merits of exploring the withdrawal of the accelerated write off of depreciating assets that currently have a capped statutory effective life as a possible revenue saving measure.

As detailed in the Treasury Tax Expenditure Review for 2009-10 such an initiative may potentially result in savings of approximately $1 billion annually.

Such a measure would also simplify tax compliance as the depreciation of such assets would be subsumed into the general uniform capital allowance rules thereby ensuring more of a level playing field.

However, we strongly oppose any proposed removal of concessional tax depreciation deductions for taxpayers engaged in eligible agricultural activities as the provision of such incentives helps to assist our agricultural sector to secure our national food supplies which is of critical importance to the Australian economy in the future.

D. Blackhole expenditure – possible savings

While acknowledging that this is only a timing difference, CPA Australia also proposes that the BTWG consider an extension of the period over which eligible blackhole capital expenditure can be claimed from 5 to 10 years.

Notwithstanding the above, we strongly support the retention of the deduction for eligible business capital expenditure under the blackhole expenditure provisions where expenditure is not otherwise deductible, depreciable or otherwise included in the cost base of a CGT asset.

However, we recognise that there may be revenue savings if the write-off period over which costs can be amortised for tax purposes under these provisions was extended from 5 to 10 years thereby deferring the cost of such measures as the Federal Budget is returned to surplus over a sustained period of time whilst also funding require tax reform relief.

It may be that such a reform need only be temporary in nature, or may only have a limited life after which time it could be reviewed to determine the most appropriate write off period which should apply in more temperate economic times.