CORPORATE TAX
ASSOCIATION
of Australia Incorporated

28 September 2012

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

Attention: Business Tax Working Group Secretariat

By email: BTWG@treasury.gov.au

Business Tax Working Group (BTWG) Discussion Paper

The Corporate Tax Association (CTA) welcomes this opportunity to comment on the Business Tax Working Group Discussion Paper (DP) and the proposed base broadening options.

There are a number of overarching observations we would make in respect of the DP and the BTWG's stated objectives.

- No doubt the BTWG is well aware of the difficulties associated with running a process that is based on a zero sum game. Obviously, the CTA strongly supports company tax reform but in the context of a broader debate about the mix of taxes that covers all taxes including the GST base and rate (per international trends), rather than only looking to the company tax base to pay for company tax cuts. To this end, the CTA supports the Business Council of Australia's (BCA) submission to the BTWG and its comments on the need for and characteristics of comprehensive tax reform.

- The CTA acknowledges and supports the BTWG's endorsement of the recommendation made by the Australia's Future Tax System Review for Australia to reduce its company tax rate over the short to medium term to 25%, but not at any cost. It is imperative that the BTWG understand the net effect of the various trade-offs being considered, from both a cost and behavioural perspective. On this point, we share the BCA's concerns on whether the size of the corporate tax rate reduction as funded via the removal of any of the base

Level 11, 455 Bourke St,
Melbourne Victoria 3000
Telephone: (03) 9600 4411
Facsimile: (03) 9600 4055
Email Address: admin@corptax.com.au

broadening options would be big enough to offset the short to medium impacts on the economy.

- There are genuinely held concerns around whether Treasury has the data available to accurately cost trade-offs so that the size of the corporate rate cut is commensurate with any changes to the base in dollar terms. This concern has also contributed to a general sense of unease around committing to any definite changes on the basis of inaccurate numbers. We recognise this is not an easy task. The CTA is working with Treasury to help address this concern in the thin capitalisation space via the thin capitalisation survey, but concerns remain that further work on costings needs to be undertaken on all base broadening options canvassed.

- The recent MRRT experience, combined with the government's aim of delivering a Budget surplus in 2012-13 in increasingly tough economic and operating conditions, has heightened concerns that the revenue gained by the proposed funding options might be directed to funding other policy initiatives than a corporate tax rate cut. Further, rather than provide a corporate tax rate cut, the government's Budget focus may lead it to considering raising taxes. The CTA would be very concerned if this was to occur, being contrary to the required policy to attract investment. In this context existing key taxes, including diesel fuel credits, should remain unchanged. We note that the BCA has expressed similar concerns in its submission, both in the context of the background to the BTWG and the current economic climate.

- The CTA supports the BTWG's conclusion that an Allowance for Corporate Equity (ACE) should not be pursued at the present time. The complexities and uncertainty associated with such a regime, the uncertainty being faced by business from developments in the global economy, combined with the limited international experience in implementing ACE reforms mean it is an unrealistic option for Australia in the short to medium term.

With these observations in mind, we have focussed our attention on assisting the BTWG understand the likely impact the proposed base broadening options will have on existing and new investments.

1. Interest Deductibility and Thin Capitalisation

Although the CTA acknowledges the recent global trend towards deleveraging, it does not agree with the comments in the DP on the Australian thin capitalisation regime perhaps being “overly generous”, and note that this is not supported by any empirical evidence. Given Australia’s regime is based on all “economic” debt, there is a strong argument that Australia’s regime should have a higher safe harbour ratio than those that are limited to related party legal form debt (which is the test applied by most other countries).

In relation to the proposal to reduce the safe harbour ratio from 75% to 60%, the CTA’s position on the viability of this option is highly dependent on the aggregated data which will be provided to Treasury once the CTA has collated the results of the thin capitalisation survey.

The Arm’s-length Debt Test

The proposal of removing the arm’s-length test altogether was met with some resistance by CTA members, particularly in the context of infrastructure projects where unrelated party arm’s-length dealings could fall foul of a lowered safe harbour ratio. We agree with this position – interest deductions attributable to arm’s-length unrelated party dealings should not be impacted by any proposed changes to the thin capitalisation rules.

EBITDA as a Fall-back Test

The use of the EBITDA test as a fall back to the safe harbour ratio was of some interest to those potentially impacted, particularly those with significant amounts of goodwill or intangibles not recognised on their balance sheets. However, given the potential problems associated with the EBITDA test in general (as outlined below) taxpayers would have to have the choice of adopting the existing safe harbour test or the EBITDA test on a year by year basis.

Applied this way, EBITDA could act as a kind of rough proxy for the arm’s-length test, with the advantage of being objective.

A Simpler Alternative – a Benchmark Rate Plus a Margin

One aspect of the thin capitalisation rules which should also be looked at is the way it interacts with the transfer pricing rules and the compliance costs this interaction creates for taxpayers. One way to address this issue would be to introduce a safe harbour interest rate test, which could be based on a benchmark rate plus a margin.

Using a benchmark such as LIBOR or one of the inter-bank lending benchmark rates plus an appropriate arm's-length margin would, in our view, go some way towards alleviating the compliance costs associated with the interaction of the regimes, as well as ticking the boxes of certainty and revenue integrity.

Capping Interest Deductions - an Alternative to the Current Thin Capitalisation Regime

CTA members strongly opposed the option of replacing the safe harbour ratio with a capped net interest deduction measured against EBITDA, primarily because of the uncertainties and transitional compliance issues they would be exposed to if such a test was introduced. Some of the concerns raised with an EBITDA test include:

- the need for certainty regarding modelling interest deductions when obtaining long term finance for large value capital intensive projects;
- exposure to changes in accounting standards (on this point, the application of accounting standards which allow mark-to-market versus historical cost is likely to produce different outcomes and will, therefore, have a different impact between industries);
- the impact of forces outside a company's control, such as foreign exchange movements and commodity prices;
- the impact on industries that engage in activities with long construction periods, which would equate to debt deductions not being realised for lengthy periods of time; and
- EBITDA not being an accurate reflection of a company's position in some circumstances.

It is also noted that for the large number of companies that are subject to cyclical trends, this test would produce perverse outcomes of higher tax payments in downturns (due to the capping of interest deductions resulting from lower EBITDA), and lower tax payments in boom times (where excess interest deductions are carried forward for offset against higher EBITDA). These outcomes could adversely impact on investment decisions during the cycles.

2. Depreciating Assets and Capital Expenditure

Diminishing Value Method

A number of CTA members rejected the notion that the current DVM rate represents a concession or distortion. Worth noting is the fact that the rationale behind the relatively recent increase of the DVM rate to 200%, that being to better align tax depreciation deductions with the actual rate at which assets decline in value, remains unchanged. That is, the judgements made and the policy rationales behind the increase of the DVM rate from 150% to 200% in the 2006-07 Budget remain sound and continue to hold. On this point, we note the following extract from the 2006-07 Budget papers on the increase of the DVM rate from 150% to 200%:

> "The current 150 per cent diminishing value rate does not fully reflect the true change in value of many depreciating assets. This results in depreciation rates that are generally too low for most plant and equipment. By increasing the diminishing value rate to 200 per cent, this measure will ensure that tax depreciation rates more closely align with economic depreciation."

Although this option can be seen as one which potentially impacts all taxpayers, in reality any change in this area will be most acutely felt by capital intensive industries. For some of these companies, any movement from the current 200% rate raises serious questions around the viability of committed and future projects, particularly in the current environment of strong international competition for hard investments and long lead times between construction and earnings.

Statutory Effective Life Caps

There seems to be little doubt that the relative attractiveness of investing in Australia over other countries would be significantly affected by any changes in this area, with likely flow on impacts of deferring or making marginal projects uneconomic. As with the policy rationale behind the increase in the DVM rate in the 2006-07 Budget, the judgements made and the policy rationales behind the introduction of statutory effective life caps remain sound – there have been no changes in the circumstances surrounding these industries which would warrant considering a change. In fact, some members have pointed out that some of the statutory caps, when looked at in the context of long lead times and the passing of time since their introduction, are already internationally uncompetitive.

In summary, the amount of revenue raised from removing statutory effective life caps would not come close to compensating those industries affected by any change in this area – and that is without giving due consideration to the significant strain some of those industries are already facing, the external factors that appear to be increasingly moving against them and the related sovereign risk concerns.

Building Depreciation

The CTA did not receive much feedback on this option. However, it would appear that the limited revenue to be generated by winding back building depreciation would not warrant any change to this area of the law. Also relevant are the likely secondary impacts of this proposal on both the property market and the economy more broadly.

Exploration and Prospecting

Although Options B.7 to B.11 appear to be drafted in a way that suggests they should be read as an overarching option to depreciate both capital and revenue exploration expenditure over five years, we consider it necessary to look at each option individually.

Ordinary Exploration Costs

Turning first to Options B.9 and B.10, which propose to deny an upfront deduction for large companies for non-depreciating exploration expenditure. This option would mean that those companies whose business includes exploration would be denied a deduction for ‘bread and butter’ operating expenditure that would usually be deductible under section 8-1. Introducing such a measure would be akin to denying a company in the retail or banking sectors a deduction for advertising or expenditure incurred in developing its products or services. Although we understand that the deduction would still be allowable over a five year period, the difficulties associated with determining what is capital and what is revenue in the context of exploration should not result in an outcome where companies in the business of exploration are denied immediate deductibility for everyday expenditure. Companies in the business of exploring should be able to deduct their everyday exploration expenditure as all other industries do – in the year in which it is incurred.

Feasibility Costs

The option of excluding feasibility studies from exploration expenditure (Option B.11) is another area that has been met with strong opposition. Although we understand this is an area that has attracted the ATO's attention in recent times, we suspect this is more related to the size of the deductions rather than their legitimacy. The increasing size of deductions are related to two factors – increasing activity in exploration over recent years due to resource deposits being at a greater depth and of lower grade, and the need for more design work to be undertaken during the feasibility stage, primarily due to increasing cost pressures. In our view, as the costs incurred in the feasibility stage are essential operating costs, it is appropriate that they continue to be immediately deductible.

First Use Exploration Assets

The BTWG paper expresses concerns over significant deductions claimed in relation to transfers of exploration permits shortly before the permit converts to a production right. We acknowledge that this may be the case in some circumstances (where the Commissioner of course is free to argue that the requirements in section 40-80 are not met, as the permit is not actually first used in exploration, or alternatively seek to apply Part IVA). However, feedback from members indicates that in the majority of cases, transfers of interests in exploration permits occur many years before a decision to develop the project is made.

Also worth noting is the fact that many exploration rights do not progress into development (for example, because exploration is unsuccessful) and that at the time the expenditure on acquiring the exploration right is incurred, it is unclear what will occur (other than more exploration).

In addition, the tax system currently contains significant impediments to allow large developments to occur in a joint venture context (i.e.: there is no 'asset swapping' rule to allow venturers to align their interests at no tax cost as is the case in other jurisdictions). A very significant deterrent to major projects progressing is the misalignment between joint venture participants on commerciality, or the priority of a project over others in their portfolio. The tax system should not impede transactions that seek to align joint venture participants that want to prioritise a project development plan.

In light of these observations, the majority of members impacted by Options B.7 and B.8 have strongly opposed any change to this area of the law.

3. The R&D Tax Incentive

Although we acknowledge the point raised at paragraph 160 of the DP[1], there are some large corporates who rely on the R&D tax incentive to get marginal projects over the line and would be impacted by its removal.

When discussing the impact of the removal of the R&D tax incentive with these companies, there is broad consensus that a trade-off between the R&D concession and a corporate tax rate cut would result in the government effectively paying these companies to take R&D out of Australia to a jurisdiction with better incentives. This question has become more relevant in the context of the recent eligibility changes, which have excluded large elements of previously eligible R&D expenditure, leaving technology based mobile R&D. On this point, some members have also expressed concern about the appropriateness of revisiting and further restricting access to the R&D tax incentive just three years into a decade long innovation agenda.[2]

The CTA welcomes the opportunity to discuss any aspect of this submission further if required.

Yours sincerely,

(Michelle de Niese)
Assistant Director
Corporate Tax Association

---

[2] Commonwealth of Australia – *Powering Ideas: An Innovation Agenda for the 21st Century*, 2009.