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The General Manager
Personal and Retirement Income Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: BTWG@treasury.gov.au

Submission on discussion paper by Business Tax Working Group, dated 13th August 2012 - Lowering Company Tax Rate.

The Institute of Public Accountants (IPA) is one of the three professional accounting bodies in Australia, representing over 22,000 accountants, business advisers, academics and students throughout Australia and internationally. The IPA prides itself in not only representing the interests of accountants, but also small businesses and their advisors.

The IPA welcomes the opportunity to provide a submission on the abovementioned discussion paper.

The discussion paper prepared by the Business Tax Working Group on the Government's behalf, discusses the benefits of reducing the company tax rate and the options to pay for it. These would involve broadening the business tax base, by reducing or removing various tax concessions. Broadly the three categories identified are: interest deductibility (including thin capitalisation), depreciating assets and capital expenditure (including capped effective lives), and the R&D tax incentive for turnovers in excess of $20 million.

The IPA has advocated in its pre-budget submissions for a cut in Australia's company tax rate for some time. Such a rate cut will deliver economy-wide benefits that are in the national interest. As a result, The IPA supports reducing the company tax rate in the medium term from its current 30% to the 25% as recommended by the Henry tax review. In addition to increasing Australia's

attractiveness as a destination for foreign investment, a 25% rate is comparable to rates in similar sized OECD countries. A rate cut to 28% rate would be a step in the right direction. A wealth of reliable evidence indicates that the incidence of company tax falls on employees. This means that reducing the burden of company tax is expected to result in companies passing on the benefits to their employees, either in the form of increased wages or additional recruitment, increasing productivity and employment. A company tax cut would also reduce taxes on investment, driving an increase in savings and capital as well as innovation and entrepreneurship. All outcomes that are indisputably in the interests of all Australians. Such a cut would also reduce the incentive for profit shifting out of Australia, allowing us to retain a greater share of the profits generated here in Australia. Despite considerable future benefits, the Government ground rules in the discussion paper are clear. The company tax rate cut has to be paid for today, and from within the business tax system. To achieve this outcome, some business tax breaks will have to go, to make way for a reduction in the company tax rate.

Our detailed comments on the discussion paper are set out below. The IPA has a small business focus and we therefore have limited our comments to the issues predominantly that will impact on this sector. Whilst only 300,000 of the 2.5 million small businesses are incorporated, changes to company tax rates are still an important factor for these entities. Our main overriding concern will be that the potential benefits associated with a cut in the company tax rate may not be fully realised if the company tax cut is met by corresponding reduction or removal of existing tax concessions within the business tax system.

We would also like to point out that the benefits flowing from the lowering of the business taxes on corporate taxpayers can equally apply to non incorporated businesses. The IPA has been a strong advocate for reducing the business tax burden on all small businesses regardless of the structure they operate their business through. We have already developed a way that this could be achieved in the short term and proposed funding for implementing such a measure which we could elaborate on if given the opportunity.

In relation to issues raised in the discussion paper, we provide the following submission summary.

In broad terms, the main points can be summarised as follows:

- Effectiveness of a revenue neutral mandate – In light of economy wide benefits, the rationale for funding the cut in the corporate tax rate from solely within the business tax system will put at risk the potential benefits from lowering the corporate tax cut. Broadening the tax base to fund company tax rate reduction may have limited impact in terms of making Australia more attractive to entrepreneurs. We also question the need for a cost neutral outcome if a company tax rate reduction improves both the quantity and quality of investments over time. A cut in the corporate tax rate on its own represents a very piecemeal approach to what the government portrays as a genuine initiative which is designed to improve the tax system.
- No GST mandate – Wider changes to the tax mix are required to realize potential benefits from a cut in the corporate tax cut. We believe the terms of reference for the funding options needs to look at a wider mix of taxes as part of the solution for reducing the burden of business taxes. The inclusion of the GST would provide more flexibility with the funding options.
- Concessions affecting non corporate – Some of the proposed funding options under consideration will impact non corporate taxpayers who will not benefit from a cut in the company tax rate. Non corporate entities will not benefit directly from any company tax cuts, but face the prospect of a reduction in some of their existing long standing tax concessions without any offsetting benefits. This appears inequitable to all businesses that do not use a corporate structure. Only a third of the 2.5 million small businesses in Australia are incorporated and therefore the impact of some of the funding options will have an adverse impact on non corporate taxpayers including individuals.
- Accelerated depreciation - The IPA believes that accelerated depreciation rationale still holds true and should be maintained at current levels. The

diminishing value method (DVM) more closely aligns depreciation rates with the actual decline in the value of assets, but we do acknowledge that this alignment can vary across different asset groups.

- Research and Development – The R&D tax rules were recently tighten and the IPA supports genuine productivity enhancing R & D. As the funding options under consideration only involve denying some of the benefits to companies with a turnover greater than $20 million, our submission will not specifically cover this funding option.
- Building Depreciation – The proposition in the discussion paper that buildings do not depreciate is strongly rejected. Buildings have economic lives like other productive assets. Taxpayers would be discouraged to undertake capital improvements if building depreciation were abolished. Initiatives such as the "greening of buildings" to take advantage of technological advances would be discouraged if the tax system penalized taxpayers for undertaking such capital works. Economic lives of buildings are getting shorter, primarily due to technological advancements. The greening of buildings and increased regulations support the need for higher rates of depreciation than currently allowed. Any move to a less generous building depreciation regime can be expected to affect investor sentiment as it will raise effective marginal tax rates (EMTRs) on investments by a range of businesses including residential investors.

Cost Neutral Mandate – overly conservative

The Working Group's terms of reference stipulate that in order to pursue the economic benefits associated with a reduction in the company tax rate, savings should be identified from within the business tax system in order to progress reforms in a cost neutral way.

We question the revenue neutral mandate. The discussion paper makes a strong case for the need to cut the company tax rate and the benefits that will flow from

doing so. If the rate cut spurs further investment which appears well founded, then this additional activity will generate higher tax take, offsetting some of the reduction associated with the tax cut. A cost neutral outcome will therefore appear unnecessary if a company tax rate reduction improves both the quantity and quality of investments. In particular the discussion paper highlights the improved attractiveness of Australia for foreign investment, as the company tax rate represents a sourced based tax on business income. The cost neutral mandate appears overly conservative and therefore the quantum of cost savings from the removal of long standing concessions may not be required to the extent proposed. The economy wide benefits from a lower company tax rate would have greater chance of success and effectiveness if the revenue neutral mandate objective was not part of the terms of reference

Preliminary estimate of the revenue cost of a company tax rate cut

NewTax Rate	2012-13 $M	2013-14 $M	2014-15 $M	2015-16 $M	Total $M
29%	300	1,400	1,800	1,900	5,400
28%	300	2,700	3,600	3,800	10,400
27%	500	4,200	5,300	5,600	15,600
26%	1,000	5,600	7,000	7,300	20,900
25%	1,300	6,900	8,700	9,100	26,000

The above analysis has quantified the potential cost of each incremental one per cent reduction in the company tax rate. No macroeconomic modelling of the long term benefits of company tax reform has similarly been tabled, to quantify the substantial positive impact on gross domestic product. The discussion paper has indicated that this information has been requested from Treasury and will be available at a later date.

The above estimates have assumed that around 20% of the cost of any company tax rate will be clawed back through higher personal tax receipts due to lower franking credit tax offsets. This assumption also appears overly conservative.

Terms of Reference - No GST mandate

The terms of reference also expressly restrict the Working Group from considering changes to the goods and services tax (GST). The exclusion of the GST as part of the options restricts the funding choices that will be available. The IPA, like most other Associations believe the GST is part of the solution for restructuring our tax system. There is almost unanimous agreement among mainstream economists, tax experts, Treasury and business, that the Goods and Services Tax will have to be increased and broadened. Australia's GST compared to many other countries has a narrower base and in terms of the absolute tax burden that it raises, is substantially below the OECD average. The current tax mix is unlikely to support future spending demands, especially as the population ages. Wider changes to the tax mix are required, such as company tax cuts alongside a higher GST. Both the OECD and the International Monetary Fund have thrown their weight behind the need for wider changes to Australia’s tax mix. They also advocate for company tax cuts alongside a higher GST.

Funding the cost of the company tax reduction from within the business tax system may reduce the expected resultant economy wide benefits and therefore reduce the effectiveness of such a measure. If what is being proposed is largely intended to be tax neutral, then it clearly can't be as attractive as a set of proposals that over time reflect a change in the tax mix. A cut in the company tax rate, offset by reduction in tax concessions amounts to “tinkering” and will do little to lower the high tax burden placed on businesses in Australia. What is being proposed does not amount to a reduction in the overall tax burden. A ppiecemeal approach to tax reform as proposed, will not be as effective as a holistic approach as detailed in the Henry Review.

Concessions applying to all Taxpayers

Some of the options to broaden the tax base to fund the reduction in the company tax rate are concessions that apply across all taxpayers and are not restricted to

corporate entities. Non corporate entities will not benefit directly from any company tax cuts, but face the prospect of a reduction in some of their existing long standing tax concessions, without any offsetting benefits. This appears inequitable to all businesses that do not use a corporate structure. Only a third of the 2.5 million small businesses in Australia are incorporated, and therefore the impact of some of the funding options will have an adverse impact on non corporate taxpayers.

One of the funding options is reducing or eliminating accelerated depreciation allowances. The economic rationale for this is to align allowances with economic rates of depreciation. The argument being that the business tax system should be neutral and should not seek to favour certain types of investments or activities over others. The benchmark for the neutral treatment of capital expenditure is that tax depreciation should be aligned as closely as possible with economic depreciation. As stated in the discussion paper, the Australian tax system has moved closer to this benchmark, principally through the adoption in 2001 of the uniform capital allowances regime. However, the system retains a number of departures from the benchmark which are now under consideration as part of broadening the tax base.

The discussion paper lists the following areas may merit consideration for reform with the objective in broadening the tax base:

1. Thin capitalisation changes
2. The diminishing value method of depreciation;
3. Statutory effective life caps;
4. The immediate deductibility for exploration or prospecting expenditure; and
5. Building depreciation
6. Research and Development

We wish to restrict our comments to 2 and 5 above which have specific implications for the small business sector.

Diminishing value method of depreciation

Existing depreciation tax rules allow taxpayers the choice of two methods of calculating the decline in value of a depreciating asset, namely the prime cost (straight line) method and the diminishing value method. Under the diminishing value method, the decline in value of a depreciating asset is assumed to be greatest in the first year and smaller in each following year. The lower the diminishing value rate, the lower the deduction in the early years of an asset's life (although total depreciation over time remains unchanged) In the 2006-07 Budget, the Government increased the diminishing value rate for determining depreciation deductions from 150 per cent to 200 per cent of the corresponding prime cost rate for all eligible assets. It equated to a 33 per cent increase in the allowable depreciation rate for all eligible assets in the first year. The effect of the measure was to increase depreciation deductions in the early years of an asset's life. The stated purpose of the change was to better align depreciation deductions with the actual rate at which assets decline in value.

The IPA believes that the accelerated depreciation rationale still holds true and should be maintained at current levels. The DVM more closely aligns depreciation rates with the actual decline in the value of assets, but we do acknowledge that this alignment can vary across different asset groups. The faster depreciation allowance also provides valuable cash flow benefits assisting small businesses with managing capital outlays associated with asset replacements.

We strongly support the continuation of the DVM at its current 200% rate. The Prime Minister's manufacturing taskforce in its recent report dated August 2012, acknowledged the role that accelerated depreciation played in reducing tax burdens to encourage investment and reduce the costs of doing business and represents a key way that governments can assist business.

Building depreciation

Current rules allow all taxpayers the ability to claim a deduction for expenditure incurred in constructing capital works, including buildings and structural

National Office
Level 6, 555 Lonsdale Street, Melbourne VIC 3000 Australia | GPO Box 1637 Melbourne VIC 3001 Australia
t +61 3 8665 3100 f +61 3 8665 3130 e natoffice@publicaccountant.org.au w publicaccountants.org.au ABN 81 004 130 643

improvements. These expenses can be depreciated over 40 years at a rate of 2.5 per cent each year. For short-term traveller accommodation, more generous rules apply (25 years, 4 per cent) apply.

We acknowledge that the use of fixed rates of depreciation for capital works deductions, are calculated without regard to a structure's effective or economic life. The discussion paper considers three options as follows:

- option 1- basing the depreciation rate on an estimate of effective life;
- option 2 - dispensing with depreciation entirely and instead factoring construction expenses into the cost base for capital gains tax ;
- option 3 – allow a uniform rate of depreciation of 2.5%

Under all approaches, the cost of repairs would continue to be the subject of an immediate deduction.

Option 1 would require the determination of the effective life which will vary depending on the type of construction, the nature of the building itself, and the use to which it is put. The adoption of an effective life regime for buildings would raise policy design and implementation challenges as noted in the discussion paper. For example, the value of a purchased building would have to be established separately from the land and this process may be difficult, costly, and open to manipulation. By contrast, deductions under the current building depreciation regime are relatively straight forward as they are based on the original cost of construction.

Option 2 justifies the removal for scaling back existing building allowances because the tax system recognises depreciation in other ways, for example, by providing a deduction for costs of insurance, maintenance and repairs and reflects the actual depreciation (or appreciation) as a capital loss (or gain) on disposal.

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Option 3 involves retaining the existing system but imposing a uniform rate of deduction for all capital works at the current rate of 2.5%.

Any move to a less generous building depreciation regime can be expected to affect investor sentiment as it will raise effective marginal tax rates (EMTRs) on investments by a range of businesses including residential investors. Building depreciation also provides a valuable cash flow benefit to investors especially those who negatively gear such investments. Tinkering with building depreciation may also have adverse implications on residential investors, who factor into their returns the cash flow benefits of building depreciation. The discussion paper does not specifically exclude residential buildings. To the extent that residential construction is brought within scope, investment in this area may be adversely affected with implications for housing affordability.

IPA supports the continuation of deductions for expenditure in constructing capital works including buildings and structural improvements. Option 1, whilst it tries to bring buildings and structural improvements within the current capital allowance regime, raises unnecessary compliance issues. Option 2 is strongly rejected as it does not recognise that buildings like other productive assets decline in value while generating taxable income. A buildings economic life is dependant on a number of drivers. These drivers include physical deterioration, economic, functional obsolescence not to mention aesthetic or social and corporate obsolescence. Taxpayers would be penalised for investing in state-of-the-art buildings if the tax system provided no incentives for undertaking capital works improvements. If anything, technological advances are reducing the economic lives of buildings which justifies higher rates of deductions than currently allowed.

Our overriding response to the discussion paper is that it should be possible to approach important reviews of the tax system with more flexibility than the current 'revenue neutral' mandate. A more effective and manageable tax system would inevitably result, if the restrictive terms of reference where broadened. Business tax reform is something which is in the interests of our long term national prosperity

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Level 6, 555 Lonsdale Street, Melbourne VIC 3000 Australia | GPO Box 1637 Melbourne VIC 3001 Australia
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for all Australians. Restricting the terms of reference for tax reform will limit the potential benefits that would otherwise flow to the community through growth.

The IPA welcomes the opportunity to discuss further any of the matters we have put forward in our submission. Please address all further enquires to myself (tony.greco@publicaccountants.org.au or 0419 369 038).

Yours sincerely

Tony Greco FIPA

Senior Tax Adviser

Institute of Public Accountants