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Dear Sir,

**Observations from various clients at KPMG roundtables**

KPMG held a number of client roundtables throughout Australia in the past month on the Business Tax Working Group Discussion Paper.

We have sought to capture the observations made by numerous clients at these roundtables in the attached document which includes approximately 60 comments. No doubt many items will reflect a common theme, but others will not.

These are the various opinions of our clients. They are not necessarily the views of KPMG, nor are they wholly consistent. It is inevitable that different sectors will have different positions.

Further, we have sought to be concise. However, if you would like expansion and clarification on any issue we would be pleased to assist.

Whilst there will inevitably be differences of view, there is one thing we should all share. That is, we need to ensure that the best arguments, observations and nuances are brought to your attention and feed into your evaluation process. In this process a deep understanding is paramount.

Yours faithfully

Grant Wardell-Johnson
Partner

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# Observations from various clients at KPMG client roundtables

**Note: These observations do not reflect a KPMG view. Moreover, the views expressed here do not generally reflect a consensus, but an amalgam of individual client perspectives.**

## 1.0 Overall perspectives

### 1.1 Reflections on the limited scope of the BTWG Review

1.1.1 A number of clients noted that it was unfortunate that the political environment was such that there could not be discussion on funding a reduction in the company tax rate through an increase in the GST rate or the level of exemptions in the GST regime.

1.1.2 It was noted that Australia has a very high level of company tax revenue as a percentage of GDP by international standards. This is acknowledged in the AFTS Report to the Treasurer, but is not understood by the wider community. Australia's reliance on consumption taxes is low by international standards.

1.1.3 Some clients indicated that business needs to speak with a coherent voice on the need for a tax base switch rather than a rate for base trade-off.

1.1.4 Some clients saw the limited scope of the BTWG as potentially difficult for business as it required business to work through the various trade-offs to come to a concluded view.

1.1.5 Others took the view that, while the BTWG project was difficult for business, if the BTWG failed to draw any conclusions then Government was likely to draw its own conclusions and indeed may reverse some perceived concessions to finance non-business related objectives.

1.1.6 Some observations were made concerning the exclusion of shareholder taxation from the scope of review of the BTWG and, in particular, the franking regime. While this would have required greater consideration if the ACE option had been pursued, it was still considered to be relevant. One major financial institution observed that the interaction of a company tax rate deduction and the imputation system meant that there was very little benefit for domestic industry and small to medium business on the basis that any tax benefit at the company level was clawed back at the shareholder level.

1.1.7 One further observation concerned what was termed the current political obsession with balancing the budget. This was perceived to present difficulties for appropriate transitional rules for the offsetting measures on a company tax rate reduction.

### 1.2 Reflections on the overall benefit of a reduction in the company tax rate

1.2.1 There were a number of diverse views on the overall benefits of a reduction in company tax rate. One client questioned whether the right way to address the issue is to ask what the desired target growth rate is and whether the "stimulus" generated by a company tax rate reduction would meet that objective. Overlaying this analysis, it was suggested there should be an analysis of the connection between target growth rates and the stimulus of a company tax reduction in a "patchwork" economy such as ours.

1.2.2 There was acknowledgement by some that a reduction in company tax rate ultimately leads to higher real wages in an open economy such as ours. This was little understood by the broader community.

1.2.3 One participant observed that the company tax rate is only one element on direct foreign investment. In Infrastructure, which receives very considerable foreign investment, the MIT regime is of significantly greater importance than the company tax rate as such.

1.2.4 There was some discussion on whether small reductions in the company tax rate are worth it. Some held the view that it would require a significant reduction - say of the order of 4% to 5% - to make a difference in investment decisions. Others held the view that a small difference would have an impact, but would be modelled as would any concessions and concession denials.

# Observations from various clients at KPMG client roundtables

1.2.5 In the KPMG presentation, it was noted that the improvement in standard of living in the 2000s (as against the 1990s) arose largely from a terms of trade benefit, which may well be absent going forward. This gave rise to a need for further productivity gains and capital deepening if we are to maintain living standards. This gave rise to the question of what form of capital deepening leads to the highest level of productivity gains.

1.2.6 In determining what form of capital deepening gives rise to the highest level of productivity gains, it was observed by some that not all capital deepening arises from plant and equipment productivity gains, but also from "know how" particularly in the software, IT services and business services sectors.

**1.3 Importance of robust modelling**

1.3.1 In all sessions the question for the need for deep and robust modelling was raised. This broadly took the form of one of six (related) observations.

1.3.2 Firstly, it was noted by some clients that a significant amount of work occurred in relation to the 1999 RBT measures on an economy wide level and the industry sector level which had not been duplicated here. Second order benefits and the growth dividends were taken into account in this modelling. It was observed by one client that papers and Senate enquiries were launched into the modelling assumptions and that this assisted the public debate. Put succinctly, it was considered by some that the general level of modelling in the BTWG process was not as comprehensive as in previous exercises.

1.3.3 Secondly, for some, the positions mentioned in the paper did not "look right" based on industry knowledge. This was particularly the case in relation to the removal of statutory life caps in the LNG sector, where it was doubted that any additional revenue would be raised in the period of the forward estimates (while, it was suggested there could be considerable adverse consequences based on longer term impacts). The was also a comment made in relation to the "imputation claw-back" rate of 20% used in the initial modelling.

1.3.4 Thirdly there was concern raised around the failure to *recognise* second order impacts. Thus, it was argued from one LNG provider, that the second level impacts of exploration expenditure are very different if funds are spent on engineering and geological expertise as against simply holding a tenement. This, it was argued, should be taken into account.

1.3.5 Fourthly, and this is related to the second point but was broadly raised, modelling should take into account the different multiplier impacts for different types of foreign investment. This goes to the question of the desirability of certain options based on the economic impacts and how they fit with the needs of the Australian economy. It was noted by one large Energy corporate that an external modeller in 2010, had modelled the impact of the reduction of the corporate tax rate from 30% to 29% and then to 28.5%, including the impact on each of the major sectors. The modelling found that the mining and construction sectors benefited the most with a growth of 0.6%. However, the modelling did not consider the impact of the removal of accelerated depreciation and needs to be extended to take this into account.

1.3.6 Fifthly, modelling should take into account the relative importance of the company tax rate and concessions in attracting foreign investment in different sectors. In the KPMG material provided to the client roundtables, it was noted (based on ABS statistics) that in the four years ending in 2011, there were 1,243 projects from 933 countries with a total investment of $US122b. Greenfield investments accounted for 85% of the projects. The top four categories of projects (by number and not value) were "Software and IT services" (255), Business Services (180), Financial Services (139) and Communications (96). Coal, oil and natural gas had 83 projects (many of which were presumably very large). The question is how sensitive each of these projects were to the company tax rate and industry specific questions. While there was no consensus on this point, many thought that the tax-sensitive sector was the mining and oil and gas sector.

1.3.7 Sixthly, some raised the concern that there was a lack of transparency on the modelling. It was acknowledged that this was a difficult issue, but that the business community could end up as losers based on an over-estimation of the lost revenue from a tax rate reduction and an underestimation of revenue gained from the removal of certain benefits or other trade-offs.

## 2.0 Thin capitalisation and other interest cap rules

### 2.1 General observations including transitional rules

2.1.1 It was generally recognised that the impact of these rules depended on whether the entity was foreign owned and the difference between parent gearing and Australian subsidiary gearing.

2.1.2 The need for appropriate transitional rules was seen to be paramount. This was particularly the case given that debt was often 'locked in' for some considerable period of time. An analysis of various options should be undertaken with the costs associated with each. Possibly could this lead to a conclusion that a gradual tax rate reduction is appropriate.

### 2.2 Arm's length test

2.2.1 Generally, there was strong consensus that the arm's length test should remain. Some acknowledged difficulties in administering the test, while others suggested that such difficulties needed to be better articulated.

2.2.2 A number of participants noted that the arm's length test was of particular importance to the Infrastructure industry and its removal could cause significant damage given Australia was in need of significantly more investment in this sector.

2.2.3 One participant observed that the reason the arm's length test is beneficial is because it is 'flexible', providing appropriate levels of gearing for different industries and sectors and that it is consistent with international norms.

2.2.4 Another participant observed that there should not be a transfer pricing 'overlay' on top of the thin capitalisation rules adopted. That is, there should not be two arm's length rules - one based on certain assumptions outlined in the tax legislation and the other based on general transfer pricing principles.

### 2.3 EBITDA based test

2.3.1 The EBITDA test received mixed responses from clients. Some were comfortable if it was an alternative test. That is, if one failed an assets/liabilities based gearing test, then one could be "saved" by an EBITDA test.

2.3.2 An observation was made that the US rules provide an alternative test (to 1.5 to 1 gearing) insofar as they only apply if the 1.5 to 1 rule is breached.

2.3.3 The primary criticism of the EBITDA test concerned P&L volatility. One large corporate indicated that they had a large stamp duty liability one year related to an acquisition which would have significantly damaged their ability to claim deductions for interest in that year.

2.3.4 The ability to carry-forward denied deductions and unused EBITDA only partially addressed this problem. The solution, it was said, lay in having an alternative assets based test.

2.3.5 Some service industry based clients liked the EBITDA concept, however, there was not a widespread understanding of how the rules operated internationally.

2.3.6 One client in the Energy sector perceived a potential "double whammy" for that sector if there was a reduction in accelerated depreciation and the introduction of an EBITDA based test (without the alternative gearing test).

**2.4 Modelling savings from changes to thin capitalisation rules**

2.4.1 There was a widespread view that previous estimates of revenue saved from changes to the thin capitalisation rules 'understated' the true impact. It was acknowledged that the BTWG was aware of this.

## 3.0 Depreciating assets and capital expenditure

**3.1 General vs specific trade-offs**

3.1.1 Some clients divided the various options in relation to depreciating assets and capital expenditure into general reductions in benefits and specific industry reductions in benefits. The argument made was that a general benefit, being the reduction in the income tax rate, should be offset by a reduction in a general concession first. The general trade-offs were considered to be the movement of the diminishing value method from 200% to 150% and the various options concerning building depreciation and amortisation. The specific areas were considered to be statutory effective life caps and exploration and prospecting rules.

3.1.2 The logic underlying the proposition that the general benefit should be offset by general detriment was, in part that the rules establishing the specific benefits were established for sound economic reasons and that the underlying rationale for those reasons had not dissipated. In particular following the base broadening- rate reduction trade-off under the Ralph Review a review undertaken concluded that it was appropriate for effective life caps to be put in place for specific industries, each with a very specific and well thought out rationale.

**3.2 Reduction in the Diminishing Value method from 200% to 150%**

3.2.1 There were a variety of views in relation to the importance of the 200% DV methodology. In a number of cases the methodology was seen as very important, if not decisive, in an Australian company choosing to embrace projects in Australia and not offshore. These were large oil and gas projects located in Queensland and Western Australia.

3.2.2 It was noted by a number of clients that where the trade-off is accelerated depreciation for a tax rate cut then the difference is a permanent, rather than a timing difference, for accounting purposes. Different clients had different views as to whether this was important. An impression is that the larger projects were modelled on a NPV-cash basis. For general businesses without large projects, the benefit of the permanent difference assumed greater importance.

3.2.3 A number of clients indicated the importance of modelling the economic impacts of this trade-off and whether this would have a positive or negative impact on GDP including various sector effects.

**3.3 Removal of effective life caps**

3.3.1 It was argued by some clients following from the above that considerable work had been undertaken 10 years ago establishing the importance of effective life caps in particular industries. The arguments then raised and accepted by Government are still relevant today. The effective life statutory caps should therefore be left unchanged.

3.3.2 The LNG sector noted the importance of the statutory effective life caps for long term projects. As modelling was undertaken on an NPV-cashflow basis, it was argued that statutory effective life caps were critical to the project economics and removal could render some projects sub-economic. It was argued that Australia's depreciation regime without effective life caps would be a disadvantage to the regimes in Canada and US in particular. One client indicated that for upstream assets generally the Australian rate is 13.33% pa compared to 25% pa for Canada and 28.57% for the US.

# Observations from various clients at KPMG client roundtables

3.3.3 It was observed that the revenue to be raised from the removal of effective life capping in the period to 2015-16 of $330m, appeared to overstate the position, but in any event were small in the near term. In this regard it was noted that there was a significant time lag between a Final Investment Decision and the first use of an asset. It was said this could be of period of 5 years or so. From there the project could be for a period in excess of 30 years. The essential point being raised is that there is a significant risk that long term projects may not go ahead if the statutory cap is removed causing significant detriment, for a very short term gain (if one exists at all in the near term).

3.3.4 There was considerable concern raised over any transitional rules which might apply in relation to the removal of effective life caps. It was suggested that if removal were to take place, which it was argued should be strongly resisted, then the transitional rule should taken into account when the final investment decision was made and not be grounded in first use of the asset.

3.3.5 Specific industries pointed to specific benefits of statutory effective life caps. Clients from the trucking industry highlighted certain secondary benefits, including safety and environmental factors, in having a younger fleet.

3.3.6 It is understood that some members of the airline industry were concerned about competitive issues given the high depreciation rates applied to aircraft in competitor jurisdictions. It was asserted that this was not a fair playing field and that statutory caps at least provide some assistance to redress this.

3.3.7 One client noted the potential difficulty in removing the statutory life caps for some industries and not for others. In this context it was suggested that removal of statutory caps in the agricultural sector would be politically difficult.

**3.4 Exploration and prospecting expenditure**

3.4.1 A comment made by a number of participants is that the BTWG Discussion Paper perceives the current treatment of exploration and prospecting expenditure as "concessionary". It was suggested that this is not the case and the current treatment reflects the position that would occur under general principles of deductibility. On this argument a change to the rules provides a detriment to the industry as against general taxpayers, which is inappropriate.

3.4.2 Another observation made concerns the need to differentiate between different types of exploration expenditure. Exploration expenditure on geological and engineering services is quite different in nature from expenditure on the purchase of tenements. This links to the discussion above on second order impacts.

3.4.3 A number of participants observed that the current rules provide neutrality on farm-in, farm-out arrangements. This ensures that tax does not act as an impediment to ensuring that the most economically efficient joint venture holds the economic interest. In the absence of a deduction for the purchase of an interest in an exploration right, there would be an exit charge on one side of the transaction and a spread deduction on the other.

3.4.4 It is not uncommon for there to be swaps of joint venture interests. If the current rules were to be changed, some clients indicated there was a need for the establishment of rollover rules as occurs in the US and Canada.

3.4.5 It was argued by a number of participants that the level of risk involved in exploration expenditure was significant (and not fully appreciated). Given the significant economic benefits which flow from successful exploration expenditure, it was said to be inappropriate to defer deductions and thus put that expenditure at risk, by imposing upon it an additional tax burden. This is the original *raison d'etre* for the upfront deduction in its legislative form and the rationale for such a deduction continues to apply.

3.4.6 One client raised an issue in relation to the determination of 'effective life' for an exploration deduction. The suggestion was that by its very nature it would be practically difficult to ascertain the effective life

when a project was in an exploration or feasibility phase.

**3.5 Building depreciation**

3.5.1 A number of clients observed that changes to the building depreciation rules raised little revenue in the period to 2016 and wondered it was worth the cost of change.

3.5.2 It was noted that there were secondary impacts in relation to the conversion of a building write-off into building depreciation in relation to trust distributions. A question was raised as to how these secondary impacts had been costed.

3.5.3 A number of clients commented on the potential complexity in determining the effective life of a building.

**3.6 Research & Development concessions**

3.6.1 A large number of clients expressed concern at eliminating the R&D offset for companies with a turnover for a year greater than $20m. Again these concerns were grounded in the general benefits to the economy of R&D expenditure. It was considered that a significant portion of this expenditure may not occur if the 40% non-refundable tax offset was abolished. It was suggested that at this time of increasing global economic stress and in view of the tremendous internal pressures for structural change and adjustment, it was an inopportune time to change the concession at all.

3.6.2 Some clients also highlighted the significant spillover benefits that occur as a result of R&D expenditure. This comment also feeds into the question of taking into account second order implications as outlined above.

3.6.3 It was also noted that in an increasingly global world, R&D can be relocated elsewhere. One client thought that the potential relocation of R&D offshore should be factored into the modelling.

3.6.4 It was noted by several clients that the R&D tax incentive was only introduced with effect from the 2012 year of income after four years of consultation between government and industry following on from a review of that National Innovation System in 2008. Given the introduction of the new R&D incentive has occurred after more than 3 years of consultation it seems premature to change the system at this early stage. The new system has not been properly evaluated.

3.6.5 Some participants expressed concern at the use of turnover thresholds to determine the cut off for the R&D concession. It was observed that such threshholds often give rise to practical issues.

3.6.6 While many considered that the R&D concession should not be changed at all, some participants indicated that if there was change, the $100m cap was likely to cause the least amount of detriment. Some suggested that at that level of R&D, the expenditure was likely to be incurred regardless of the concession. However, this was not accepted by some participants.