THE TAX INSTITUTE

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Mr Chris Jordan AO
Chair
Business Tax Working Group
c/- The Department of The Treasury
Langton Crescent
PARKES ACT 2600

Email: BTWG@treasury.gov.au

Dear Chris

DISCUSSION PAPER ON CUTTING THE COMPANY TAX RATE

The Tax Institute thanks you for the opportunity to provide this submission in response to the Business Tax Working Group's (the "**Working Group**") Discussion Paper (the "**Discussion Paper**") dated 13 August, 2012, concerning prioritising consideration of a cut to the company tax rate.

The Tax Institute congratulates the Working Group on the release of the Discussion Paper, as well as the related Consultation Guide intended to set out the timeline and process by which consultation in relation to business tax reform will be undertaken.

At this stage, it is broadly our members' view that the Working Group's consultation efforts on the Discussion Paper have been extensive, appropriate and sufficient. As such, we thank Working Group members for their consultation efforts to date.

We acknowledge that the Discussion Paper is based on data available as at the time of its release and is set out as an options paper only, rather than constituting recommendations. We have set out our submission below on that basis.

We also note that the Working Group is due to receive further detail and modelling from Treasury in regards to the expected effect on the economy of a cut to the company tax rate, as well as feedback from the business community in relation to the likely impact of changes to the thin capitalisation regime. We urge the Working Group to release such information publicly when available (subject to any confidentiality requirements) to allow for more informed consultation and debate through this significant reform process.

Our submission has been formulated on the basis of our members' primary concerns and interactions with the tax system (i.e. from a tax design and tax policy perspective) and as such does not seek to address the consequences of the proposed changes on business operations or behaviour. We encourage the Working Group's ongoing consultation with the business community in order to obtain essential feedback on the likely effect of the proposals in the Discussion Paper on business investment and outlook.

We note that the Discussion Paper has been developed in line with the Working Group's Terms of Reference, including the requirement to "identify a range of off-setting budget savings from existing Commonwealth business taxation (or spending) measures" without considering changes to the GST.

We have made our submission in line with these Terms of Reference. However, we note the significant concern within our membership in relation to this restriction. This missed opportunity to lower the overall tax burden on companies and reconsider the appropriateness of Australia's current tax-mix will limit the potential benefits to the Australian economy arising from this reform process.

As a result of these concerns, we have also copied this submission to the Deputy Prime Minister and Treasurer, The Hon Wayne Swan MP.

THE ARGUMENT FOR A COMPANY TAX RATE CUT

We broadly agree with the detailed arguments set out in the Discussion Paper in relation to the potential benefits to the Australian economy of a cut to the company tax rate (currently 30 per cent) in the short term in the order of 2-3 per cent, with a longer term goal of a company tax rate of 25 per cent as recommended in the report of the *Australia's Future Tax System Review*.

The widely accepted likely increase in Australia's attractiveness as a destination for foreign investment, the resulting short term increase in returns on capital, and the longer term projected increase in returns on labour, as well as the multitude of tax administration savings (for example by way of reduction in the incentive to transfer price) are all valid and widely accepted reasons for pursuing a cut in the company tax rate.

We acknowledge that such a cut will first and foremost affect the investment decisions (and returns on investment) of foreign investors, and will largely constitute a timing benefit for domestic investors as a result of Australia's imputation system. Regardless, we consider a cut in the company tax rate to be worthwhile as it will reduce the cost of equity financing for many small to medium enterprises currently operating in a credit constrained environment.

We also note that while a cut in the company tax rate will not immediately benefit the majority of small to medium enterprises that are not currently operating in a company structure, it is our view that the balance of these businesses will nevertheless benefit from the economy-wide benefits that will flow from the cut. In addition, it is our recommendation that the company tax rate should be made available to any separate entity for small business that is developed in due course.

WORKING GROUP TERMS OF REFERENCE

Despite the above, our membership is nevertheless concerned by the limited scope for business tax reform allowed by the Terms of Reference of the Working Group, as extracted above. This is because the full scope of the economy-wide benefits of the company tax rate cut can only result from a lowering of the overall tax burden placed on business, in order to achieve a system that is as close as possible to fully integrated and to maximise the competitiveness of Australian companies in global capital markets.

We note that Australia's company tax system has undergone significant bouts of reform over the past few decades, and that as noted in paragraph 61 of the Discussion Paper, a relevant study has estimated that "in 2011 Australia was middle ranking (10th) among G20 countries in terms of a measure of the breadth of the corporate tax base." This is of course as a result of significant base broadening that was undertaken most recently in order to implement the recommendations of the Ralph Report.

As a result, as noted by the Working Group in the Discussion Paper, little further base broadening is possible in order to further lower the company tax rate. Many of the remaining concessions within the business tax system have been intentionally bestowed in order to encourage specific business activity, some quite recently.

A cost-benefit analysis and reconsideration of the basis and merits of these remaining concessions is of course a worthwhile exercise. However, by drawing such narrow Terms of Reference for the Working Group, the Government has missed an opportunity to consider and implement a broader tax reform agenda that would have yielded greater benefits for business and the Australian economy more generally.

Specifically, we note that a broader tax reform agenda encompassing considerations including the following, would have yielded greater benefits to the Australian economy:

- Repeal of inefficient state taxes such as stamp duty;

- Reconsideration of the appropriateness of the current rate and base of the GST;

- Consideration of outstanding recommendations of the Henry Tax Review with respect to the personal tax and transfer system; and

- Consideration of road user charging.

In comparison, the narrow parameters within which the Working Group has been required to consider ways in which to 'fund' a company tax rate cut present a disappointingly limited scope within which to consider business tax reform.

Nevertheless, our comments on the base broadening options set out the Discussion Paper are set out below. We reiterate our view that we consider it worthwhile to explore the ongoing appropriateness of the concessions set out in this section in light of the potential benefits of a company tax rate cut, with an intention to effect such a cut by removing concessions where appropriate.

BASE BROADENING OPTIONS

Interest deductibility and thin capitalisation

The tax treatment of debt and equity funding should not influence an entity's choice of capital structure. As such, any limitation on the deductibility of interest should be approached with caution, as such limitations risk being arbitrary or poorly defined.

Furthermore, the significant variety in the cost of debt funding faced by entities of different sizes and/or in different industries is likely to result in any universal rule limiting debt deductibility affecting funding choices among different taxpayers in vastly different ways.

In the context of this framework, we make the following comments on the options proposed in the Discussion Paper.

We also encourage the Working Group to engage in consultation with those members of the business community that are currently or are likely to (in light of any proposed changes) be subject to the thin capitalisation provisions in order to determine the impact of the proposed changes on business investment and outlook.

Arm's length test

While difficult to administer, it is our view that the arm's length test is a necessary alternative to the safe harbour gearing levels, in order to ensure that the thin capitalisation rules achieve their intended revenue protection function. This is because the ideal arm's length level of gearing differs significantly between industries and entities of various sizes, and the application of a generic safe harbour gearing level can result in arbitrary outcomes (with respect to the extent to which the thin capitalisation rules affect choice of funding mix). That is, we have a significant preference for Option A.2 over Option A.1.

Nevertheless, there remains scope in our view for the simplification of the arm's length test, and further alignment with transfer pricing methodologies that would allow for a decrease in compliance costs of determining this amount. As such, we recommend that the current arm's length debt test be reviewed with a view towards simplification.

Reduction of safe harbour gearing levels – general entities

As noted in the Discussion Paper, Australia's current thin capitalisation regime "could be seen as overly generous" when assessed against the thin capitalisation regimes of other countries. This assertion accords with the experience of our members and prevailing research on this issue.

As such, some tightening of the thin capitalisation rules is unlikely to significantly affect the decisions of marginal foreign investors so long as Australia's thin capitalisation rules are not altered to be overly restrictive when considered in comparison to the regimes of competing foreign investment destinations.

Nevertheless, we recommend that the Working Group via Treasury make available further data in relation to the types of entities (and relevant industries) that are subject to the thin capitalisation rules and have historically been geared to safe harbour levels in order to allow more targeted consultation in relation to the likely effect of such a change on the investment decisions of foreign investors, as well as the extent to which such changes would cause entities to deviate from their ideal funding mix (in the absence of tax considerations).

Cap interest deductions for business taxpayers

The current basis for the application of the safe harbour test (i.e. total assets) is in our view out-dated and significantly favours entities that have a high accounting asset base, while disadvantaging service-providing entities that are likely to have a much higher percentage of their asset base reflected in goodwill that may not have been recognised for accounting purposes. Furthermore, as noted in the Discussion Paper, many other comparable international jurisdictions have in recent years shifted away

from the application of thin capitalisation rules to an asset base towards a model focussed on earnings.

This reform process presents a unique opportunity to reconsider the appropriateness of the base to which our current thin capitalisation rules are applied, and to alter this base to more accurately reflect the current circumstances of the Australian economy (including an expanding services sector).

However, any such rule should be introduced as a fall-back option to the current assets-based safe harbour rule only rather than a replacement of the same, in order to minimise compliance costs and transitional issues for entities that currently rely on the assets-based safe harbour rules. This should be the case regardless of whether the ratio applicable to the assets-based test is altered. Such a treatment is also comparable to the method employed by comparable international jurisdictions that have moved to an earnings-based model.

However, we caution against the application of a blanket cap on the interest deductions of all taxpayers as canvassed in Options A.4 and A.5 for the following reasons:

- As noted in the Discussion Paper, the thin capitalisation rules were introduced to protect revenue against transfer pricing activities of multinationals via excessive debt deductions. No such justification is relevant in the context of taxpayers that operate domestically only.

- The application of a cap on interest deductions will not result in equality of tax treatment of debt and equity funding. In fact, such a denial of debt deductions will further exacerbate existing differences in the tax treatment of debt and equity funding, as the benefit of any denied interest deductions will either be forfeited or carried forward, but will not constitute a frankable distribution. Furthermore, as the required return on equity will differ significantly across industries and entities of varying sizes, the extent of the distortionary effect of such a limitation will be varied and arbitrary.

- Such a change will encourage taxpayers to rely more heavily on equity funding, especially where the earnings of the relevant entity are not predictable/steady over income years. As such, such a change will actually result in greater distortions to the ideal funding mix (in the absence of tax considerations) for affected businesses.

We also note that implementation issues in relation to such a regime will need to be carefully managed, especially as EBITDA is typically far less predictable or manageable than a company's total assets on a year-to-year basis.

The banking sector

With respect to the application of any changes to the current thin capitalisation regime to the banking sector, regard must be had to the specific nature of interest expense in the context of a banking business.

An earnings-based safe harbour test will not necessarily be appropriate in a banking context. In light of interest expense comprising the most significant cost of doing business for such an entity, an earnings-based test could apply to a bank in the same fashion as a super-profits tax (rather than for the stated purpose of the thin

capitalisation rules i.e. to counter integrity concerns). As such, we strongly recommend that financial institutions continue to have the option of applying an assets-based safe harbour test where considered appropriate by the taxpayer.

In respect of Option A.3, we note that any increase in the safe harbour for the minimum equity requirement should be formulated with regard to the Australian Prudential Regulation Authority's Minimum Tier 1 Capital Ratio requirements. It is our understanding that this requirement may be increased to 6 per cent in light of recent Basel III reforms. In those circumstances, an increase in the safe harbour from 4 per cent to 6 per cent of the risk weighted assets of the Australian operations would seem appropriate. Further input from the banking sector should be obtained before any legislative changes are specifically contemplated.

Transitional rules

We consider that transitional rules would be necessary if any changes are effected to the current thin capitalisation regime, and that the length of the transitional period will need to be commensurate with the extent of the change.

Depreciating assets and capital expenditure

We broadly agree with the comments in the Discussion Paper that tax depreciation should align as closely as possible with economic depreciation in order to ensure that a company's effective tax rate aligns as closely as possible to the company tax rate in any given year.

Nonetheless, we note that any changes in depreciation rates will result in timing differences only in tax payable, and as such will have the greatest effect on companies operating in industries in which the viability of medium to long-term projects is calculated taking the time value of money into account, rather than businesses that have a regular turnover of plant and equipment in the context of an ongoing enterprise.

Reduce the diminishing value rate for depreciation from 200 per cent to 150 per cent

The rationale for this increase in the diminishing value rate (as noted in the Discussion Paper) to "more closely align depreciation rates with the actual rate of decline in the economic value of assets" does not accord with our members' understanding of the effect of this 2006-07 Budget measure.

Our members are broadly of the view that while this change led to a closer alignment in some circumstances and in relation to some assets, the change equally led to tax depreciation being accelerated ahead of accounting and economic depreciation in other circumstances.

As such, the reduction of the diminishing value rate for depreciation from 200% to 150% is likely to affect the alignment of tax and economic depreciation differently across different industries.

We encourage the Working Group to undertake further consultation with affected taxpayers to determine whether a reduction in the diminishing value rate should be seriously considered as an offsetting measure to fund a cut in the company tax rate.

Capped effective life provided to certain depreciating assets

Where the tax laws allow for a capped effective life over which to depreciate certain assets, the rationale for retaining the effective life should be explored, and if found wanting, should result in a removal of the capped effective life. When evaluating such a rationale, consideration should also be given to the relative merits of other concessions that may be afforded within the business tax system instead.

The Report of the Ralph Review of Business Taxation relevantly noted:

> *The effective life of a mining or resource project will be self-assessed by taxpayers in accordance with guidelines which it is recommended should be developed in consultation with the industry and published by the Commissioner of Taxation.*
>
> *Submissions received from the mining industry argued that, in recognition of the higher risks often associated with mining projects, a limit ought to be placed on the period of write-off of expenditure on developing and operating mining projects. This particular concern is addressed more generally through Recommendation 8.6, which would allow taxpayers to reassess effective lives - and hence write-off rates - during the life of a project should economic circumstances change.*

Following the implementation of this recommendation, accelerated depreciation was removed in most contexts.

However, the Government made the following announcement in the 2002-03 Budget:

> *The Government will introduce statutory effective life caps for depreciation purposes in relation to the taxation treatment of a number of asset classes. As part of its business tax reforms, the Government decided to move to a depreciation system based on effective life. The Commissioner of Taxation is progressively updating the current safe harbour effective lives that taxpayers may use to depreciate assets.*
>
> *In a small number of cases, the Commissioner of Taxation's technical studies indicated that a substantial increase in effective life was in prospect. In these cases the Government has decided to place statutory caps on the effective lives of the assets, in recognition of broader policy considerations. The capped effective lives apply to aeroplanes and helicopters, gas transmission and distribution assets, oil and gas production assets, and assets used to manufacture condensate, crude oil, domestic gas, liquid natural gas (LNG) and liquid petroleum gas (LPG).*
>
> *The effect of this measure is to limit the revenue gain arising from the Commissioner of Taxation's determinations in excess of the statutory caps to around $150 million over the forward estimates period.*

Relevantly, the then Assistant Treasurer's press release of 14 May 2002 in relation to this announcement noted:

> *The industries affected, and the Government, have been aware for some time that significant increases in the effective lives of these assets was in prospect, based solely on tax integrity criteria.*
>
> *"The Government has taken these considerations and other broader national interest concerns, into account in deciding on the appropriate effective life", Senator Coonan said.*
>
> *The new statutory effective life caps will provide certainty for the industries concerned, and provide an appropriate balance between meeting the needs of those industries as well as maintaining the integrity of the effective life depreciation system.*

Consideration of whether the “broader national interest concerns” that drove the introduction of these capped effective lives still remain relevant, or whether there are other current reasons for retaining these effective lives should be considered in light of the economy-wide benefits that are expected to be bestowed via a company tax rate cut.

In considering these matters, we encourage the Working Group to engage in consultation with those members of the business community that are likely to be affected in order to determine the impact of the proposed changes on business investment and outlook, especially within the resources sector.

Transitional rules

As many of the assets to which the statutory effective lives apply are significant assets acquired for long term projects (especially in the oil and gas sector), consideration needs to be given to the manner in which changes in the current depreciation rules will affect the commercial viability of projects that have already commenced.

This is especially the case in light of current concerns over policy risk and the negative effects on foreign investment of continuous changes in the tax system.

Exploration and prospecting

As noted in the Discussion Paper, the immediately deductibility of expenditure on exploration and prospecting is an intentionally favourable tax treatment bestowed on taxpayers operating in the resources industry. This concession is intended to incentivise new mining projects in Australia.

The degree to which this concession affects marginal investment decisions in the resources industry will differ between various taxpayers, the scope and nature of their existing activities and their size.

Some members have noted that the time at which the deduction for depreciating assets “first used” in exploration or prospecting is available is confusing and may be misapplied. However, we note that the relevant concepts in section 40-80(1) of the *Income Tax Assessment Act 1997* are in the process of being tested by the courts[1]. Therefore, it is likely that the way in which the first use exploration deduction is to apply will be clarified via that process.

[1] A taxpayer has made an application to the Administrative Appeals Tribunal in relation to the deductibility of expenditure under section 40-80(1).

We also note our concerns in relation to Option B.10 as follows:

- The denial of favourable tax treatment over a certain cap risks being arbitrary and affecting different taxpayers in vastly different ways;
- This option will place significant stress on integrity provisions designed to limit the benefit of the concession to its intended recipients; and
- This option will create incentives for taxpayers to limit growth at the margin to retain access to the concession.

In determining whether the immediate deduction for assets first used in exploration should be removed or reduced, we encourage the Working Group to engage in consultation with those members of the business community that are likely to be affected in order to determine the impact of the proposed changes on business investment and outlook.

Transitional rules

In formulating transitional rules, we urge the Working Group to consider the manner in which changes in the current rules will affect the commercial viability of projects that have already commenced.

This is especially the case in light of current concerns over policy risk and the negative effects on foreign investment of continuous changes in the tax system.

Building depreciation

We recognise that the tax treatment of buildings has evolved over time and in response to changes in other, related parts of the tax system (such as the introduction of the capital gains tax regime). While we broadly agree that the existing rules should be reviewed in light of their original rationale and ongoing relevance, it remains our view that tax depreciation rules should broadly align economic and tax depreciation.

As such, in order to recognise the wear and tear suffered by buildings over time, and provide an incentive to owners to undertake improvements (rather than simply repairs) to ageing buildings, we discourage the Working Group from recommending Option B.13 (i.e. the removal of building depreciation deductions).

We recognise the trade-off between the certainty offered by Option B.14 and the flexibility offered by Option B.12. In order to determine which (if any) reform option is most appropriate in the circumstances, we encourage the Working Group to engage in consultation with those members of the business community that are likely to be affected.

Transitional rules

In formulating transitional rules, we urge the Working Group to consider the manner in which changes in the current rules will affect the commercial viability of existing building investments.

This is especially the case in light of current concerns over policy risk and the negative effects on foreign investment of continuous changes in the tax system.

The R&D Tax Incentive

A research and development (R&D) concession should be maintained in Australia in order to support and encourage innovation, most especially in the growing sectors of the economy. It has been the experience of our members that such a concession broadly encourages R&D activity at a relatively low compliance cost impost.

However, the effect of the concession on taxpayers of various sizes and in various industries should be carefully considered in comparison to the cost of the measure.

In determining whether changes should be made to the existing R&D concessions, we encourage the Working Group to engage in consultation with those members of the business community that are likely to be affected in order to determine the impact of the proposed changes on business investment and outlook.

In regard to the tax system and policy issues raised in the Discussion Paper, it has been our members' experience that:

- companies undertaking research and development for the first time or at an early stage are likely to be more influenced to undertake the activity by the availability of a tax concession;

- companies for whom research and development is a non-core part of their business are more likely to be influenced to undertake the activity by the availability of a tax concession; and

- companies that fall into either or both of these categories are typically smaller in size and undertake a narrower range of business activities.

As such, some paring back of the existing R&D concession to the extent that the concession does not incentivise or drive R&D activity in order to finance a company tax rate cut is worthy of consideration.

Our comments on the options canvassed in the Discussion Paper are as follows.

It is our view that Option C.4 is most preferable, because:

- Options C.1 and C.2 will both place significant stress on integrity provisions designed to limit the benefit of the concession to its intended recipients (resulting in increased compliance costs for taxpayers and the ATO) and will also create incentives for taxpayers to limit growth at the margin to retain access to the concession.

- Due to the vastly different amounts spent on R&D by companies in differing industries with an aggregated annual group turnover of greater than $20 million, the imposition of a dollar value cap risks being arbitrary and affecting the spending and investment decisions of taxpayers in vastly different ways. In comparison, the paring back of the allowable offset on a percentage basis (i.e. Option C.4) is more likely to minimise the distortionary effect on spending and investment decisions among taxpayers.

Transitional rules

Any transitional rules should be designed to take into account the potential effect of the wind-back of the R&D concession on the commercial viability of projects that have already commenced.

This is especially the case in light of current concerns over policy risk and the negative effects on foreign investment of continuous changes in the tax system.

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Should you wish to discuss any of the above, please do not hesitate to contact either me or Senior Tax Counsel, Robert Jeremenko on 02 8223 0011.

Yours sincerely

Ken Schurgott
President

CC: The Hon Wayne Swan MP, Deputy Prime Minister and Treasurer