SUBMISSION - CONSIDERATION OF A CUT TO THE COMPANY TAX RATE

Paragraph 104 of the Discussion Paper states in relation to Options A.4 and A.5 that -

> "The Working Group does not have sufficient information at this point in time to instruct Treasury so that they could reasonably estimate the potential savings from this proposal. Among other things, further detail on how these options were to apply in practice and possible effects on business are needed. Submissions on these aspects would be particularly welcome."

Essentially these two options deal with proposing a cap on interest deductions for all business taxpayers with the possible exclusion of banks.

If we are reading the Discussion Paper correctly, the interest deduction could be by reference to a percentage of net interest expense relative to EBITDA. The international benchmarks outlined in the report indicate that this could be between 25% - 50%.

With that background, we have the following broad observations –

1 This concept is analogous to an interest cover ratio often applied by banks as part of their lending covenants. Thus there are commercial benchmarks which can vary between industries. It is important that the benchmark can change from industry to industry. Thus if a generic benchmark is imposed then this will not be commercial and could severely impact those industries that operate outside that benchmark.

   Once you impose a tax guideline that is inconsistent with equivalent commercial guidelines then the tax system is operating counter to commercial reality and is inappropriate.

2 Consideration also needs to be given to those industries where there might be a lead time between the incurring of the interest expense and the derivation of assessable income. A property developer is a good example in this respect. A substantial development could take two years to complete which might in fact then spread over three financial years. To illustrate, a development might start in February of one year and conclude with sales revenue in the December of the following year. The intervening full financial year might, as a consequence, be a year of low profit and thus low EBITDA whereas the year of completion might be a year of very significant EBITDA.

3 Those groups that operate through trusts might be disadvantaged relative to those that operate through corporate groups. Corporate groups might be significantly advantaged where they are within the corporate tax consolidation regime because, broadly, everything is aggregated and thus the EBITDA of the entire group would seemingly become the basis for the application of the benchmark.

   On the other hand, groups of trusts which are not able to tax consolidate would seemingly be looked at on an entity by entity basis and thus are significantly disadvantaged relative to corporate groups. This same principle applies to corporate groups that operate outside the tax consolidation framework.

4 Further, commercially, the concept has the potential to restrict what might be described as quantum leap investments. By quantum leap, we have in mind that a taxpayer might be undertaking an investment which involves significant gearing but nonetheless positions the taxpayer for a substantial growth in activity. This may

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mean that there is a period of tight cash flow where the interest expense attributable to that quantum leap project is significant and exceeds the benchmark. Denying the interest deduction contributes towards requiring a higher return on the investment in order for it to be economic.

5 This measure is being contemplated at a time when borrowing margins are almost twice what they were 4 – 5 years ago and thus interest is a higher percentage of EBIT than it has been in, broadly, the last decade. It has also been proposed at a time when businesses are not able to achieve the same loan to value ratio from financiers as they have in the past and consequently are resorting to more expensive mezzanine finance.

We should not be imposing non-commercial taxation criteria at a time when it is inconsistent with the business cycle. In that respect, the business cycle we see ourselves in at the moment is likely to last for some years (at best).

6 The concept has the particular potential of impacting start-up businesses (be they large or small) which are more reliant upon debt initially.

7 The thin capitalisation regime was introduced as noted at page 24 of the Discussion Paper to "…limit the capacity of multi-national firms to move profits out of Australia by assigning an excessive amount of debt to their Australian operations".

Essentially that regime is a systemic integrity regime.

Nonetheless, it has been crafted having regard for commercial circumstances.

The crafting having regard for commercial circumstances should not change either in the context of the thin capitalisation regime and/or in the context of the determination of any interest deductibility cap for all business taxpayers.

There is a significant difference between the need for a systemic integrity measure such as the thin capitalisation regime intended to avoid profit shifting to lower tax distributions[1] and a proposed interest deductibility cap that has no material underlying commercial rationale.

In this respect, in the context of thin capitalisation, we note the following extract from paragraph 97 -

> "Thin capitalisation rules must strike the right balance between revenue protection, **on the one hand**, and allowing firms to structure their finances as they see fit, on the other." (Emphasis added)

It is fundamentally inappropriate that there should be a cap on interest deductions that is inconsistent with allowing firms to undertake investments/projects, structuring their finances as they see fit but subject to the overall covenants imposed by their financiers.

8 This concept has the potential to significantly impact businesses when the economy is in a down cycle for reasons including -

[1] Refer paragraph 97 of the Discussion Paper

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8.1 Interest will be a disproportionately high percentage of EBITDA; and

8.2 Business may be more reliant upon borrowings to see themselves through that cycle.

Thus, this cap has the potential to operate at the worst possible time.

9 The implication that such a measure would also incorporate the carry forward of unused EBITDA capacity and denied interest deductions is really only of value for more mature businesses. It does not benefit the types of circumstances identified in paragraphs 2, 4, 6 and 8 above.

10 Paragraph 102 of the Discussion Paper makes the following comment -

> "A more fundamental change would be to limit the scope of all firms (…) to claim interest deductions… This would reduce the corporate tax systems bias in favour of debt (the costs of which are deductible) over equity…, heavily-geared companies would be disproportionately affected by this change."

One of the fundamental reasons why Australia survived the global financial crisis relatively intact was the strength of the regulation of our banking system and the prudence of our banks.

If that system facilitates the provision of commercial debt with the safeguards inherent in the system then, prima facie, there is no excessive bias in favour of debt.

11 Appendix C sets out the principles for business tax reform and in that context the following is noted -

11.1 "One of those principles is economic efficiency which is described as raising (…) revenue in a way that minimises the effect of the tax system, on business decisions except where this is needed to correct for market failure."[2]

To the extent to which this measure is inconsistent with what is happening commercially in Australia then it distorts investment and production decisions.

11.2 A second principle is distributional equity which, among other things, seeks to consider "…where the final incidence falls among capital owners…".[3]

As noted previously, this proposal could well not cause the final incidence of tax to be equally applied across capital owners distinguishing between that capital owned via tax consolidated corporations on the one hand and trusts and non tax consolidated corporations on the other.

11.3 One of the principles is competitiveness though this is looked at in the context of Australia's integration with the global economy.

[2] Refer page 50
[3] Refer page 51

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However, an important consideration is domestic competitiveness whereby the effects of this reform could be disproportionately borne by small and medium sized businesses that are much more debt reliant and/or those larger businesses conducted through trusts structures.

11.4 A further principle is that such reform "…should generally focus on new investment".[4]

This reform is potentially so fundamental that it has the potential to negatively affect projects and structures that have been in place for many years.

[4] Refer page 52

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