SUBMISSION BY THE

Housing Industry Association

to the

Business Tax Working Group

on the

Business Tax Reform Discussion Paper

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HIA is the leading industry association in the Australian residential building sector, supporting the businesses and interests of over 40,000 builders, contractors, manufacturers, suppliers, building professionals and business partners.

HIA members include businesses of all sizes, ranging from individuals working as independent contractors and home based small businesses, to large publicly listed companies. 85% of all new home building work in Australia is performed by HIA members.

1 Executive Summary

1.1.1 The Housing Industry Association Limited (HIA) welcomes the opportunity to comment on the Discussion paper released by the Business Tax Working Group on August 18th 2012.

1.2 Terms of reference

1.2.1 HIA wishes to highlight three key concerns regarding the terms of reference.

1.2.2 Firstly, the basic premise of the terms of reference and therefore the Business Tax Working Group discussion paper is that business needs to find a way to fund its own company tax cut. This premise immediately mitigates the prospect of an outcome which is of net benefit to the business community and therefore the wider Australian economy.

1.2.3 Secondly and directly related to the first point, this premise and the subsequent options put forward in the discussion paper ignore the fact that the majority of small businesses are not incorporated. This means that many businesses in the residential building industry would experience two negative impacts - they would firstly experience a negative impact from a majority of the changes proposed in the discussion paper, while secondly also missing out on any benefit from a cut in the corporate tax rate.

1.2.4 Thirdly, while HIA appreciates the exclusion of the GST was beyond the Working Group's control, the efficacy of any taxation reforms countenanced when GST cannot be considered is severely diluted. This is especially the case given the mandated focus on outcomes that are budget neutral.

1.2.5 In developing the discussion paper the Working Group focussed on options pertaining to three broad categories:

- interest deductibility (including thin capitalisation);
- capital allowances and the treatment of capital expenditures; and
- the R&D tax incentive.

The first two of these categories contain proposals which threaten the viable operation of businesses within the residential building industry and therefore are of major concern to HIA.

1.3 About HIA

1.3.1 HIA is the peak body for residential builders in Australia with over 40,000 members across Australia. HIA members include builders, contractors, manufacturers, suppliers, building professionals and business partners. Members' businesses range from self-employed independent contractors and home based small businesses, to large publicly listed companies.

1.3.2 Given this diversity of membership, HIA is in a highly informed position to comment on the impact that tax changes proposed by the Working Group would have on businesses operating directly or indirectly in the residential construction industry.

2 The Residential Construction Industry in Australia

2.1.1 The residential construction industry in Australia is worth around $70 billion a year.

2.1.2 Due to the considerable flow-through impact that residential construction has to the wider domestic economy, primarily but not solely through the manufacturing and retail sectors, the health of the industry affects tens of thousands of Australian businesses and in excess of 1 million labour market participants.

2.1.3 The new home building sector of the industry is currently experiencing recessionary conditions for the second time in four years. The renovations sector of the industry contracted over four consecutive quarters to June 2012.

2.1.4 Irrespective of contemporary conditions for new home building, which are unequivocally very weak, this sector of the Australian economy is excessively taxed and therefore already operating in a business environment of distinct disadvantage relative to the existing residential property market and most other sectors of the Australian economy. Independent research finds that on virtually any basis of measurement the taxation burden borne by Australia's new home building sector is disproportionately large. Among Australia's 111 sectors, new home building is the 11th most heavily taxed in terms of total tax burden on the production and use of products. Among Australia's largest industrial sectors (defined as those with a value added of more than $10 billion, of which there are 27), the new home building sector is the second most heavily taxed in relative terms.

2.1.5 Against this backdrop, any taxation changes that are detrimental to residential building activity and to businesses related to the industry will not represent a net positive for the Australian economy. It is HIA's view that some of the options provided by the Business Tax Working Group would further disadvantage businesses operating directly and indirectly in the residential construction industry.

3 BTWG proposals

3.1 Introduction

3.1.1 As noted above, the Business Tax Working Group discussion paper ignores the fact that the majority of small businesses are not incorporated. This means that many businesses in the residential building industry will lose from the changes being proposed, while also missing out on any benefit from a cut in the corporate tax rate. This is a fundamental flaw in the process of taxation policy changes pursued in the discussion paper.

3.1.2 A number of the savings options, if implemented, would represent a major blow to the residential building industry. HIA focuses here on aspects of the first two categories canvassed in the discussion paper, and makes brief comment on the third.

3.2 Interest rate deductibility options

3.2.1 Under the heading of interest rate deductibility, the Working Group canvasses the view that there is merit in reducing interest-related deductions to all businesses, arguing that the tax system currently has a bias in favour of debt (the costs of which are deductible) over equity (where the returns are taxed). The Working Group notes that the options would "involve a fundamental shift in Australia's approach to the deductibility of interest expenses". Given the enormity such a change would represent, HIA regards this description as something of an understatement.

3.2.2 The issue of most concern to HIA is the proposal to place a cap on the deductibility of interest. This would be done by limiting the business's net interest expense to a set percentage of earnings before interest and taxes, depreciation and amortisation. HIA recognises that this proposal means there would be no cap on interest deductibility up to the amount of interest income earned. However, the reality is that many geared businesses don't receive large amounts of interest income.

3.2.3 This option would undoubtedly reduce the effectiveness of being highly or negatively geared, of which a large number of business are. An additional concern and complication arises from the fact that it is unclear what precisely the definition of what or who is a business would be. How wide would the boundaries be, in other words? Would these measures extend to personal taxpayers with investment properties? This is another sector in addition to unincorpated entities who would not benefit from a company tax cut.

3.2.4 A further concern is that the proposal will cause additional hardship for businesses in 'lean years'. In times of challenging business conditions earnings will be down, but interest expenses still need to be repaid. The current business climate faced by the residential construction industry is a case in point.

3.3 Capital allowances options (depreciation for tax purposes)

3.3.1 There are a number of proposals put forward by the Working Group which will diminish the depreciation benefits currently available to a range of taxpayers. The proposal to significantly reduce, or completely remove, depreciation deductions for buildings is especially concerning.

3.3.2 At present taxpayers can claim a deduction for expenditure incurred in constructing capital works, including buildings and structural improvements. These expenses can generally be depreciated over 40 years, equivalent to a straight-line depreciation rate of 2.5 per cent each year.

3.3.3 Proposed changes are to either base the depreciation rate on an estimate of effective life, or dispense with depreciation entirely and instead factor construction expenses into the cost base for capital gains tax.

3.3.4 HIA notes that the Working Group acknowledges the likely negative implications for residential investment from a less generous building depreciation regime, and the obvious negative flow- on this would have to housing affordability. However, it is erroneous for the Working Group to suggest, as it does, that the impact would be 'marginal as the impact of the additional tax would be widely distributed'.

3.3.5 Adopting a less generous building depreciation regime would unequivocally cause significant damage to the residential construction industry, for a number of reasons.

3.3.6 Firstly, the adoption of slower or zero depreciation for buildings owned by businesses would flow through to personal taxpayers quite quickly - capital allowances apply across asset classes, not business type.

3.3.7 Secondly, the cost of removing building depreciation for businesses is estimated at $170 million. However, the cost in terms of removing depreciation for new housing from all taxpayers is likely to be considerably higher than that figure.

3.3.8 Thirdly, the existing depreciation arrangements provide well in excess of $50,000 worth of benefit in terms of net present value to the purchase of an average new home. The Working Group is erroneous in suggesting this option would have only minimal impact on home building – removal of depreciation benefits would swing investor preferences strongly in favor of established housing.

3.3.9 Fourthly, the new housing sector is already excessively taxed in both relative and absolute terms, as exemplified in section 2.1.4. Making existing tax arrangements even less favourable would exacerbate the cost of housing, reduce supply, and worsen already poor housing affordability and have a detrimental flow on impact on rental stock.

3.4 The R&D Tax Incentive

3.4.1 The Working Group proposes a number of options to reduce the current R&D tax offsets. These proposals, including creating a turnover limit above which no claim can be made and abolishing the 40 per cent offset for companies with turnover above $20 million per annum, appear counter-productive.

3.4.2 Technological advances are a primary method of boosting productivity. It is an undisputed fact that Australia needs to lift its rate of productivity growth.

3.4.3 Furthermore, R&D can have an important role to play in improving housing affordability, through improved construction techniques and product development of building materials, for example. R&D also has the capacity to generate improvements in the flexibility of the housing stock to cater for the requirements of an aging population and therefore ameliorate (budgetary) pressure on the healthcare system.

3.4.4 Any proposal that may act as a disincentive for business to engage in R&D represents a case of false economy irrespective of what the reduction is being used to fund.