Institute of Chartered Accountants Australia

21 September 2012

Mr Patrick Sedgley
Business Tax Working Group Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600

By email: BTWG@treasury.gov.au

Customer Service Centre
1300 137 322

NSW
33 Erskine Street
Sydney NSW 2000

GPO Box 9985
Sydney NSW 2001

Phone 61 2 9290 1344
Fax 61 2 9262 1512

ACT
L10, 60 Marcus Clarke Street
Canberra ACT 2601

GPO Box 9985
Canberra ACT 2601

Phone 61 2 6122 6100
Fax 61 2 6122 6122

Qld
L32, 345 Queen Street,
Brisbane Qld 4000

GPO Box 9985
Brisbane Qld 4001

Phone 61 7 3233 6500
Fax 61 7 3233 6555

SA / NT
L29, 91 King William Street
Adelaide SA 5000

GPO Box 9985
Adelaide SA 5001

Phone 61 8 8113 5500
Fax 61 8 8231 1982

Vic / Tas
L3, 600 Bourke Street
Melbourne Vic 3000

GPO Box 9985
Melbourne Vic 3001

Phone 61 3 9641 7400
Fax 61 3 9670 3143

WA
L11, 2 Mill Street
Perth WA 6000

GPO Box 9985
Perth WA 6848

Phone 61 8 9420 0400
Fax 61 8 9321 5141

Dear Patrick

Discussion Paper 13 August 2012

The Institute of Chartered Accountants Australia (the **Institute**) welcomes the opportunity to comment on the abovementioned Discussion Paper, which is intended to request initial input ahead of a more considered analysis supported by macroeconomic modelling[1].

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world. Representing more than 70,000 current and future professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession's commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

The Discussion Paper outlines, in broad terms, a number of options which the Federal Government may choose to implement to fund a cut to the company tax rate. The Institute reaffirms its previously expressed view that the terms of reference for the Discussion Paper are inappropriate.

If the government does proceed with any of the recommendations of the Business Tax Working Group (the **Working Group**) it is imperative that the timing of cuts to concessions within the business tax system align with cuts to the company tax rate. That is, the commencement date of cuts to concessions must not precede the commencement date of cuts to the company tax rate.

The Institute formulated its view, as to which concessions might be withdrawn, or pared back, from the perspective of the potential likely impact of this action on Australia's economic fundamentals. In particular, would the withdrawal of a particular concession result in an increase, or decrease, to Australia's real GDP? The Institute accordingly commissioned independent expert advice from The Centre for International Economics. A copy of this report is available on request and subject to "in confidence".

[1] Paragraphs 22-24 of the Working Group's Discussion Paper

1. Executive Summary

The Institute makes the following specific comments and recommendations in relation to the Discussion Paper. (References to sections in the submission are indicated in brackets).

Scope of Discussion Paper (Section 2)

- The Working Group when preparing its recommendations to the Federal Government should have regard to the probability that the Discussion Paper's terms of reference have hindered the consultation process. This is due to the terms innate effect of dictating asymmetric outcomes between "who benefits" from the any cut in the company tax rate and "who bears the cost" of that rate cut.

The merits of a reduction in the company tax rate (Section 3)

- As previously articulated in the Institute's submissions to the Henry Review the Institute agrees with the merits of reducing the corporate tax rate to 25 percent over the short to medium term subject to economic and fiscal circumstances.

Base broadening options – Depreciating assets and capital expenditure (Section 4)

- Independent economic research commissioned by the Institute shows that the implementation of Option B.1 to reduce the diminishing value rate for depreciation from 200 percent to 150 percent would result in a decline to Australia's real GDP of 0.08 percent per annum or $1.18bn based on 2011-12 Australian GDP. Accordingly, the Institute does not support this option.

- Independent economic research commissioned by the Institute shows that the implementation of Option B.7 to remove or reduce the first use exploration deduction would also result in a decline to Australia's real GDP of 0.08 percent or $1.18bn based on 2011-12 Australian GDP. Accordingly, the Institute does not support this option.

- Independent economic research commissioned by the Institute shows that the implementation of Options B.3 and B.6 would also result in a material decline to Australia's real GDP. Accordingly, the Institute does not support these options. (Refer section 4).

- Independent economic research commissioned by the Institute shows that the implementation of Options B.4 and B.5 are broadly neutral to pointing to a slight increase in real GDP where the accelerated depreciation is replaced by equivalent cuts in company tax. Accordingly, the Institute considers that these options should be the primary focus for further analysis and investigation. The Institute does not support these options where they are not replaced by equivalent cuts in company tax. In that instance the change will result in a material decline to Australia's real GDP.

Base broadening options – The R&D tax incentive (Section 5)

- The Institute recommends that further work be performed to determine if it still holds true that the stimulatory effect of R&D tax concessions for large companies is low. If that further work confirms this finding the Institute supports a further restriction of the R&D tax concession where there is a reduction in the company tax rate.

Base broadening options – Reduce interest deductibility (Section 6)

- The Institute does not support any measures to limit interest deductibility by reference to EBITDA (Options A.4 and A.5.) The Institute considers the current analysis of the merits of the proposal to be too undeveloped to support the proposal.

- The Institute considers the assertions as to the flaws of the arm's length rule in the Discussion Paper to be unsubstantiated and not to justify the removal of this test. Given the apparent continuing policy basis for an arm's length rule and its evident suitability for investors in the infrastructure and property sectors the Institute does not support any option to remove the arm's length rule (Options A.1, A.4 and A.5).

- The Institute is of the view that given the volatility of global asset movements and currency fluctuations the worldwide gearing ratio should retain "a gearing ratio buffer". That buffer should preferably remain at 20 percent, but no less than 10 percent, thereby resulting in an Australian company having gearing no greater than 120 per cent of the group's worldwide gearing, but no less than 110 percent.

- The Institute considers there is a case for differentiating within the thin capitalisation rules between foreign owned inbound investors and outbound investors, as occurs currently.

- The Institute considers it important that Treasury costings of proposed changes to the thin capitalisation rules be robustly tested. The Institute has significant concern that the costings will be insufficiently developed, particularly given that the thin capitalisation rules apply not only to large businesses but also to medium and smaller businesses. The Institute recommends that the full costings be released to the business sector for analysis and stress testing.

- Any changes introduced to Australia's thin capitalisation rules must, in the Institute's view, allow for appropriate transitional periods (lead times) for businesses to refinance their activities, where they have medium or long term debt locked in.

Allowance for corporate equity (Section 7)

- The Institute agrees with the Working Group that the allowance for corporate equity (ACE) should be relegated to the "back burner" for the time being.

Compliance costs (Section 8)

- The Institute is concerned that any new law change will result in additional complexity and hence compliance cost for business. It is therefore important that this issue be factored into any recommendations made by the Working Group. The Institute makes a number of specific observations in this regard on certain options.

- The Institute is of the strong view that none of the base broadening measures should commence at a time before any corporate tax reduction applies. The Institute considers that if this were to occur that would be a breach of "the good faith" basis on which consultation occurs. The Institute repeats its earlier observation that participation in this particular consultation process has already been challenged by the Discussion Paper's terms of reference (ie, that any savings to fund a reduction in the company tax rate must be found within the business tax system).

Transitional arrangements (Section 9)

- The Institute is also of the strong view that any changes made to implement any of the options contained in the Discussion Paper should be prospective only, should contain transitional arrangements and allow sufficient implementation time for business.

2. Scope of Discussion Paper

Appendix A to the Discussion Paper contains the Working Group's terms of reference for the Discussion Paper. They *inter alia* require any reforms arising from the Discussion Paper to be "revenue neutral to the business tax system". That is, any savings to fund a reduction in the company tax rate must be found within the business tax system.

The Institute is of the view that the terms of reference are, in the above respect, unduly restrictive. Further, the likely effect of that constrained scope will have been to hinder the extent and quality of the consultation process as well as the level of by-in from external stakeholders.

This is because the cost of any reform measures to fund a company tax rate cut will not be experienced evenly across business but will vary from sector to sector. Moreover, the benefit of any cut in the company tax rate will only directly benefit those businesses which operate through a corporate structure. Accordingly, the businesses which directly benefit from a cut to the company rate of tax will not necessarily be the same businesses which are directly impacted by the changes made to fund the cut. Moreover, the terms of reference exclude consideration of the benefits to labour, which economic theory suggests will be an ultimate beneficiary of a reduction to the company tax rate.

The likely asymmetric outcomes between "who bears the cost" and "who benefits" was apparent to many at the outset of the consultation process. This asymmetry has, in the Institute's view, polarised stakeholders.

As a result the Institute expects that many stakeholders who might have otherwise contributed to the consultation will have not participated, or alternatively done so in muted terms. Alternatively, others may have largely founded their submissions on sectoral interests rather than the public interest. In either case the consultation process is likely *not* to have been as fulsome or as constructive as would have occurred if the terms of reference had been broader. The Institute is of the view that the Working Group should bear this consideration in mind when preparing its recommendations in the draft final report.

3. The merits of a reduction in the company tax rate

The Institute agrees with the Working Group's assessment that Australia should aim to reduce its company tax rate and the case put forward for a lower company tax rate as explained in the Discussion Paper. We also concur with the earlier findings of the *Australia's Future Tax System (AFTS) Review* (the **Henry Review**) which recommended, among other things, that the company tax rate be reduced to 25 percent over the short to medium term subject to economic and fiscal constraints.

The Institute has consistently advocated for a reduction in the company tax rate. Most recently in September 2011, the Institute released a tax policy leadership paper *Tax Reform: Laying the Foundations* which was produced with KPMG. We recommended that the company income tax rate be reduced to 25 percent in the medium-term, with the view to achieving an aspirational 20 percent corporate income tax rate in the longer-term.

Indeed when recognising fiscal constraints, we suggested that consideration should be given to undertaking a review of tax concessions. As has been done here, we thought that such a review would seek to identify potential 'trade-offs' where some existing features of the corporate income tax system could potentially be modified in exchange for achieving a lower headline company tax rate target. In particular, we were cognisant that investment decisions may be distorted as a result of existing policies.
Our views on the benefits of reducing the corporate tax rate were set out in some detail in the earlier joint submission with KPMG to the Henry Review in 2008. Entitled *Thinking beyond*

borders – tax reform for the 21st century, the report explored the link between corporate tax and productivity and the strong evidence that corporate tax is linked to economic growth.

4. Base broadening options – Depreciating assets and capital expenditure

The Working Group notes at paragraph 40 of the Discussion Paper that "[Australia's] productivity growth has slowed over the last decade". A key challenge over the coming decade is stated to be the need "to boost multifactor productivity". The Working Group also notes at paragraphs 7 and 42 of the Discussion Paper that Australia has always been reliant on, or dependent on, international capital to fund investment and that this is not likely to change in the future.

4.1 The constraint of full employment

The Discussion Paper, however, does *not* note that Australia's economy has in recent times been operating at, or near, full employment in economic terms. Moreover, that constraint to productivity and hence economic growth is unlikely to ease in the foreseeable future. Indeed the projected decline in Australia's working age population highlighted at Chart 5 of the Discussion Paper points to a further tightening of this constraint to productivity growth.

This is an important point and one which is directly relevant to the relative economic merit of retaining specific taxation incentives to invest in capital equipment or not. If Australia is, for all intents and purposes, operating at full employment then, subject to a radical change to Australia's immigration policies or reproductive rates, the only meaningful way to boost productivity growth is to institute policies which encourage investment in Australia's capital inventory.

The relevant question becomes will Australia's productivity, and hence economic growth be better boosted by retaining the existing tax based incentives to capital investment, or by lowering the company tax rate?

4.2 *Findings of the CIE Report*

The Institute commissioned the Centre for International Economics (the **CIE**) to perform an independent general equilibrium analysis using a 53-sector model of the Australian economy (CIE-REGIONS) to quantify the relevant benefit to Australia of the proposals (excluding building depreciation). The *Final Report – Background information on accelerated depreciation: a consideration* (the **Report**) is dated 18 September 2012. A copy of the Report can be provide on request and on an "in confidence" basis.

The findings of the research are significant. The authors note at page 10 of the Report:

> *"The Henry and Ralph tax reviews speculate that trading off tax concessions on investments for a broad based reduction in the company tax would reduce distortions in investment thus improving economic efficiency and growth. The results here suggest otherwise, at least for the broad-based accelerated depreciation concession B1. The reason for this result is that with a broad based tax reduction both labour intensive and capital intensive industries are equally advantaged. Increased activity across all sectors drives up demand and prices for all inputs. In a fully employed economy labour constraints limit growth. With tax concessions on investment, growth is concentrated in the capital intensive sectors. With mobile global capital, the supply of capital is virtually unconstrained, meaning growth is less constrained.* ***In short, in an economy at full employment and facing tight labour constraints – and in the absence of specific policies to increase the labour force – tax policies which implicitly favour the least limited resource will tend to lead to growth****".* (***emphasis added***)

The Institute asked the CIE to quantify the relative economic benefit to Australia (as distinct to participants in particular industry sectors) of retaining the following incentives as compared to a reduction in the company tax rate:

- Option B.1 - Reduce the diminishing value of depreciation from 200 percent to 150 percent;
- Option B.3 - Remove the capped effective life provided to certain depreciating assets used in oil and gas extraction and petroleum;
- Option B.4 - Remove the capped effective life provided to depreciating assets used in primary production;
- Option B.5 - Remove the capped effective life provided to water facilities;
- Option B.6 - Remove the capped effective life used in non-specified industries; and
- Option B.7 - Remove or reduce the "first use" exploration deduction.

The Report found that if these six options were implemented it would consistently result in deterioration to Australia's real GDP, with the exception of Options B.4 and B.5 where the change was broadly neutral to pointing to a slight increase in real GDP where the accelerated depreciation is replaced by equivalent cuts in company tax.

It is noted that depending upon the option implemented the deterioration to Australia's real GDP could be material. The two largest modelled declines relate to Option B.1 and B.7 in the amounts of 0.08% per annum or $1.18bn based on 2011-12 Australian GDP.

4.3 Conclusion

The Institute concludes that if it is an economic policy objective of the Federal Government to boost productivity growth in Australia then it appears not to be desirable to implement any of these six options, with the possible exceptions of Option B.4 and B.5, namely the removal of capped effective life provided to depreciating assets used in primary production and for water facilities.

The Institute would be pleased to discuss these issues further and notes the Working Group will release Treasury macroeconomic modelling in October. This would include the corresponding modelling of the effects of a company tax rate reduction on GDP.

5. Base broadening options – The R&D tax incentive

The third tranche of options in the Discussion Paper involve winding back the R&D tax incentives available for large companies in various ways: Options C.1 to C.4.

5.1 Large versus smaller companies

In assessing the relative merit of the four options, the crucial matter to consider is the extent to which larger companies and/or those with bigger R&D spends are actually influenced by the availability of the 40 percent non-refundable R&D tax offset (as opposed to just a normal deduction). That is, in the absence of the tax offset, would the same amount of R&D take place anyway?

The Institute agrees with the Working Group's observations at paragraph 160 that:

> *"Evidence suggests that tax incentives have different impacts on the R&D performed by small relative to large firms. To the extent that the incentive is not, or is unlikely to be, effective in influencing company R&D investments there is an argument that the revenue forgone could be better employed."*

The Institute notes that using the current $20 million threshold to differentiate small firms from large firms is too low for these purposes: the discussion paper itself sets much higher turnover levels for some options. The 2008 Review of the National Innovation System (the 'Cutler Report') which recommended the adoption of a refundable tax offset for smaller companies and a non-refundable tax offset for larger companies used a $50 million turnover threshold.

The comprehensive report by the Productivity Commission of March 2007 entitled *Public Support for Science and Innovation* concluded that the extent to which the (former 125%) basic R&D tax concession stimulates additional R&D is low, particularly for large firms. The arguments put forward in the report are that the basic tax concession is likely to have a relatively low inducement rate because it provides an across-the-board subsidy to eligible expenditure regardless of whether the R&D would have been undertaken anyway. The report went on to recommend that access to the (former) 125 per cent R&D tax concession should be restricted to small firms. While the report did not define small companies it cited studies which noted incentive effects for turnovers over $100 million.

The Cutler Report also made important comments in this respect. For example (p104):

> *"The inducement effects of a concession are likely to differ as between small technology based firms, and larger more mature firms. At one consultation with larger companies, 82 percent of those present indicated, when polled, that the incentive value was marginal or none, and no one said the 175 percent incremental premium scheme influenced their R&D activity."*

More recently the Senate Economics Legislation Committee reported on *Tax Laws Amendment (Research and Development) Bill* 2010 in June 2010. The report includes a discussion of large versus small companies (at page 36). It begins by stating that based on both spillover benefits and additionality "it is generally thought that assistance to smaller companies is more likely to be preferable to assistance to larger companies. Many original ideas start out in small start-ups".

The Committee goes on to make some very persuasive arguments which point to the relative ineffectiveness of R&D tax concessions for large companies, for example:

> *"Even if large and small companies were equally innovative in their ideas, it is much easier for large established companies with large retained earnings and easy access to finance to fund their ideas. It is much less of a gamble to undertake a risky project if it only represents a small proportion of a large diversified company's capital than if it puts at risk a large proportion of a small company's capital. There are therefore more good ideas that are not undertaken due to financial constraints by small companies and so assisting them is more likely to result in* ***additional*** *innovation."*

5.2 Consideration of the options

5.2.1 Option C.1 – Abolish the 40 per cent non-refundable tax offset other than for small companies

A $20 million turnover cap would be too low for this option. The Institute considers that this option will put more pressure on companies to keep within the selected turnover as if it is exceeded the 45 percent refundable tax offset would steeply go down to a standard tax deduction. As noted in the discussion paper, this is likely to place more pressure on integrity rules.

5.2.2 Option C.3 – Impose a cap on the amount that can be claimed annually under the 40 per cent non-refundable tax offset

A $100 million expenditure cap is mentioned in Appendix E although not in the body of the Discussion Paper. If the expenditure cap was set at too low a level the Institute has some concern over whether this option would provide the appropriate incentive. This is due to the comments of the Productivity Commission that the design of the (former) expenditure and turnover limits for eligibility to the tax offset created "perverse incentives against undertaking R&D above a certain amount".

5.2.3 Other options

If the R&D concessions were to be considered in the base broadening exercise, the Institute reiterates that the level of support for small and medium sized companies should allow for turnover of up to $50 million (as was originally proposed in the Cutler Report) or $100 million in conjunction with any winding back of incentives available to larger companies. Alternatively, and depending on costings, thought could be given the increasing the refundable tax offset to 50 percent (as was also originally proposed in the Cutler report). Further options may involve various combinations of the options.

5.3 Transitional arrangements

If any of the options are further progressed, it will be important for appropriate transitional arrangements for existing projects, etc, to be put in place and also costed in the final report. (Transitional arrangements are discussed in section 9 of the submission).

5.4 Evidence

The Discussion Paper makes the important comment (albeit as a footnote) that there is only "limited evidence of the effectiveness of the incentive as currently configured". These changes only took effect from 1 July 2011. Given all the studies done were on the former concessions, care will need to be taken in assessing the total effects of any proposed change to the current incentives. This would include risks such as companies relocating R&D activities overseas.

5.5 Conclusion

Previous studies suggest that the extent to which basic R&D tax concessions stimulate additional R&D is low for large firms. The Institute considers that work to assess the effect of the non-refundable 40 percent tax offset on large firms is warranted to see if this still holds true. If so, the Institute considers there would be merit in restricting the R&D tax concession provided any cost savings help fund a reduction in the company tax rate.

6. Base broadening options – Reduce interest deductibility

The Discussion Paper makes a number of brief statements as to perceived problems with Australia's thin capitalisation regime, namely that it is "overly generous"[2], that there are "flaws with particular rules, including the arm's length test"[3] and that the arm's length debt test is redundant for banks because of capital adequacy tests are appropriate for their purposes.[4] The statements are not supported by statistics or further explanation. In the absence of evidence the Institute is not persuaded by these assertions and does not accept them.

The Discussion paper thereafter enumerates five potential reform options which fall into two groups:

(a) Three options to reduce the scope for multinationals to shift profits offshore – that is, reforms focused on cross border activity, and

[2] Para 98
[3] Para 98
[4] Para 100

(b) Two options which cap interest deductibility for both domestic and multinational taxpayers.

6.1 Changes to the thin capitalisation rules

6.1.1 Option A.1 – Remove Arm's Length Test and Reduce Safe Harbour Gearing Levels – General Entities

As already noted the Discussion Paper asserts without evidence that there are "flaws with particular rules, including the arm's length test .... which in its current form could allow significant profit shifting to occur" and the arm's length test "as a discretionary test ... is difficult for the ATO to administer. The large information asymmetry ... raises integrity concerns"[5]. Strong evidence needs to be provided so that the merits of these assertions can be tested.

The Institute observes that the existence of the arm's length test is founded in a legitimate policy basis. This is stated in the Explanatory Memorandum which accompanied the introduction of the test:

> *"2.6 The prescribed safe harbour debt to equity ratio may be exceeded in circumstances where the funding structure could be maintained on an arm's length basis. In such a situation, no deductions will be disallowed. This change recognises that some funding arrangements may be commercially viable notwithstanding that they exceed the prescribed limits. It also makes the rules more consistent with Australia's DTAs."*[6]

In the absence of evidence to the contrary that policy reason still holds true today.

Further, the arm's length test is particularly appropriate for the infrastructure and property sectors and should, as a minimum, be retained for those sectors. This is because the asset characteristics of investments in these sectors are stable long term assets secured by substantial income rights and often government concessions. Given that this "asset quality" is high investments in these sectors can support high gearing ratios in conformity with ordinary international investment practice.

Given that Australian investors in infrastructure and property sectors have the capacity to borrow domestically to a commercial (that is, arm's length) debt amount they should be permitted to continue to apply the arm's length debt test. There is no tax policy reason why foreign investors should be discriminated against in comparison to domestic investors. Accordingly, foreign investors should also be permitted to gear their investments to a similar level. Indeed, retention of the arm's length debt test in relation to infrastructure investment is, in the Institute's view, particularly important to securing debt finance for such investments.

It may be that arm's length debt test requires some fine-tuning, but the abovementioned assertions do not justify such action: For example the Institute questions if there is 'large information asymmetry'[7] in relation to Australian-based outbound investors.

The second aspect of Option A.1 is to alter the debt-equity test downwards. In this regard the Institute considers the Working Group should distinguish between *Australian-based outbound investors* and non-resident inbound investors. This distinction recognises that Australian-based outbound investors will typically have higher quality assets and better borrowing capacity than downstream subsidiary companies (which may often be recently-established, with more variable trading conditions). Therefore the Australian parent company will typically

[5] Para 98
[6] New Business Tax System (Thin Capitalisation) Bill 2001
[7] Para 98

have better credit spreads and lower funding costs, providing some commercial imperatives to borrow in the Australian parent company to a slightly greater extent.

The merits of this distinction are recognised in the New Zealand thin capitalisation rules. These provide a more favourable method for New Zealand outbound investors (that is, businesses located in New Zealand which invest internationally) than applies to inbound investors.

Under the New Zealand rules, broadly:

- Inbound investors have a 60 percent debt or 110 percent of worldwide gearing rule but
- Outbound investors retain the previous 75 percent debt or 110 percent of worldwide gearing rule.

The Institute does not support an option to cut the worldwide gearing ratio for general entities and non bank financial entities from the current 120 percent of the group's overall global gearing ratio to 100 percent. This option appears to envisage reducing the ratio for the Australian entity in worldwide group to 100 percent of the group's overall global gearing ratio – that is, identical to the global gearing ratio of the group.

It is important to retain a "gearing ratio buffer" which is implicit in the 120 percent ratio. The reason for the buffer is that the global gearing rule will always be subject to the volatility of global asset movements and currency fluctuations. It is difficult for a global group to be precisely hedged globally in relation to its borrowings and assets. Currency movements and asset valuation movements might easily cause an individual country company (in this case the Australian company in the global group) to have its gearing ratio vary by up to 10 percent, or more, in one year as compared with the global gearing ratio. This risk is particularly acute in the current global economic environment. The Institute notes that the New Zealand application of the global gearing test is to have an optional 110 percent of global gearing test for both inbound and outbound investors.

6.1.2 Option A.2 – Remove Arm's Length Test and Reducing Safe Harbour Gearing Levels – General Entities

Unlike Option A.1, this option involves maintaining the arm's length test. The Institute supports that proposition.

In relation to the proposal to change the debt to equity ratio, the Institute's comments in relation to Option A.1 are equally applicable. In particular the Working Group should consider:

(a) a more favourable ratio for Australian outbound investors than downstream inbound Australian investments; and

(b) the worldwide gearing test should be retained at 120 percent, but in the alternative not be varied down beyond 110 percent (not 100 percent) of worldwide gearing.

6.1.3 Option A.3 — Reducing safe harbours for financial institutions

This option relates to financial institutions and contains a number of specific proposals. The Institute is not in a position to provide in-depth comment on this highly industry-specific option.

6.1.4 Option A.4 — Cap interest deductions for all business taxpayers (excluding banks)

This option would involve replacing the thin capitalisation rules with a cap on interest deductibility set by reference to "'earnings before interest, taxes, depreciation and amortisation' (EBITDA) for all taxpayers, excluding banks"[8]. The Discussion Paper refers to certain international experience in respect of EBITDA, including France, the United States of America and New Zealand.

The Institute notes that the analysis of EBITDA in the Discussion Paper is undeveloped. For example, it refers to the EBITDA benchmark rate for the US as being 50 percent,[9] but the US earnings-stripping test is not a standalone test and is subject to a threshold debt-equity ratio of 1.5:1. In Germany the EBITDA test is surrounded with a range of concessions, such as a sizeable *de minimis* rule. The primary test in New Zealand is the debt-equity ratio. As well, the context of the introduction of the EBIDTA rules in Italy and Spain is of economies with their budgets in crisis, and Italy followed its EBITDA rule with an ACE. The summary table in Appendix F is very abbreviated and does not develop these differences. Accordingly, it has the potential to be misleading.

Additionally, the Institute does not agree that the thin capitalisation or EBITDA test should apply to businesses which operate domestically. The European countries' modification of their thin capitalisation rules to domestic transactions, as well as cross-border transactions, arises from the European Community (EC) treaty obligations related to freedom of establishment and capital movement within the EC. A 2002 European Court of Justice decision[10] prevented Germany from applying its cross-border thin capitalisation regime to a German company borrowing from its Dutch ultimate holding company. This resulted in Germany replacing its thin capitalisation regime in 2004 with EBITDA tests with numerous concessions: this influenced the other abovementioned European countries. This EBITDA approach is not followed outside the EC, other than for the New Zealand 'saving rule' introduced in 2012.

The Institute also notes that an EBITDA rule has the potential to be extremely volatile in its outcomes. For example, consider a company with the following profiles:

- depressed circumstances in one year which reduce its earnings for that year; or
- accounting-driven write downs in one year; or
- significant bad debts experience causing a bad debt write-off of debts previously recorded as income.

In all of these scenarios the company might fail an EBITDA test. Indeed, the volatility of corporate earnings, which is greater than the volatility of corporate asset and gearing values, raises questions about the merits of EBITDA as a basis to restrict interest deductibility.
The Institute is of the view that a full and formal and extensive analysis of such potential effects flowing from the adoption of an EBITDA would need to be performed before the Institute could support its adoption in Australia. The EC treaty is not in our view the driver for Australian tax policy. We reiterate that New Zealand introduced EBITDA this year as an alternative for companies which failed the primary debt-equity ratio.

6.1.5 Option A.5 — Cap interest deductions for all business taxpayers

The Institute's reservations in relation to Option A.4 apply equally here.

[8] Para 111
[9] Para 112
[10] The Lankhorst-Hohorst case (2002) C-324/00 concerned a German subsidiary which borrowed from a Dutch upper-tier company. The German thin capitalisation rules which focused on debts to non-residents were held to be incompatible with the freedom of establishment principle under Art. 43 of the EC Treaty applicable to EU residents.

6.2 Conclusion

In summary the Institute:

- does not support any measures to apply limit interest deductibility by reference to EBITDA (Options A.4 and A.5.) The Institute considers the current analysis of the merits of the proposal to be too undeveloped to support the proposal;
- the assertions as to the flaws of the arm's length rule are unsubstantiated. Given the apparent continuing policy basis for an arm's length rule and its evident suitability for investors in the infrastructure and property sectors the Institute does not support any option to remove the arm's length rule (Options A.1, A.4 and A.5);
- given the volatility of global asset movements and currency fluctuations the worldwide gearing ratio should retain "a gearing ratio buffer". That buffer should preferably be 20 percent, but no less than 10 percent, thereby resulting in a worldwide gearing ratio of preferably 120 percent, but no less than 110 percent;
- considers there is a case for differentiating within the thin capitalisation rules between foreign owned inbound investors and outbound investors, as occurs currently;
- considers it important that Treasury costings of proposed changes to the thin capitalisation rules be robustly tested, preferably by an independent body. The Institute has significant concern that the costings will be insufficiently developed, particularly given that the thin capitalisation rules apply not only to large businesses but also to medium and smaller businesses.[11] The Institute recommends that the full costings be released to the business sector for analysis and stress testing; and
- any changes introduced to Australia's thin capitalisation rules must allow for appropriate transitional periods (lead times) for businesses to refinance their activities, where they have medium or long term debt locked in. If, for example, the government were to make changes to the rules in the May 2013 budget which is implied in the Discussion Paper, in our view the changes should operate from the commencement of the 2014/15 financial year, that is, 1 July 2014 – 15 months after the announcement in the budget. This is because any substantial change in the thin capitalisation ratio will require Australian businesses to raise new equity. For example, moving the thin capitalisation ratio from 75% debt to equity to a 60% ratio will involve businesses locating and raising a 15% equity injection into the Australian businesses.

7. Allowance for corporate equity (ACE)

The Institute agrees with the Working Group's assessment that full implementation of an ACE is not advisable at this time due to concerns about revenue neutrality, implementation risks, shortcomings of key design features and other uncertainties (including as a result of operating in a global economy).

Although the Institute thinks that the ACE should be relegated to the "back burner" for the time being, we concur with the Working Group that the ACE may be worthy of further consideration and public debate in the longer term.

8. Compliance costs

Efficient decisions by businesses require that the tax law that governs a particular transaction be as simple to understand as possible and the processes necessary to comply are not unduly complex.[12] This benefits both business in complying with the new laws and the ATO in administering the provisions. The Henry Report noted that considerations about the equity of a

[11] Subject to a carve-out where total debt deductions of the taxpayer and its associate entities are $250,000 or less (section 820-35)
[12] Appendix C, page 52.

tax system need to take into account exposure to complexity and the distribution of compliance costs and risk.[13] The Institute endorses these views.

New law or change creates additional complexity and/or uncertainty as to its interpretation and application – the greater the change, the more likely it is that complexities will arise. Taxpayers will need to assess the impact of the change or new measure on current projects and future investment decisions. They will also need to determine the impact of the change or new measure on existing reporting systems and data collection processes for tax compliance and disclosure purposes. For those taxpayers who were not previously affected by a particular measure but will now be affected by the new law, this will have a particularly onerous impact.

Complexity, uncertainty, changes to processes and systems and assessing how new law affects the taxpayer's business decisions will have a direct effect on the cost of tax compliance. For large businesses and multinationals, increased compliance costs may create a disincentive to invest. For small to medium enterprises increased compliance costs may be difficult to sustain.

To the extent that the Working Group makes recommendations to change existing provisions or introduce new law to implement a new policy outcome, it is submitted that careful consideration should be given to costs associated with the implementation, compliance and ongoing administration of any change.

8.1 Specific compliance cost issues

The Institute makes the following specific observations in relation to compliance costs that are likely to arise should particular options be implemented.

8.1.1 Specific compliance cost issues – Depreciation and R&D changes

The Institute notes with regard to the options for reform associated with changes to depreciating assets and capital expenditure (Options B.1 to B.14) and to the R&D provisions (Options C.1 to C.4), complexity, and therefore increased compliance costs will arise in applying required transitional rules to a particular asset acquisition or expenditure.

There may also be an increase in compliance costs arising where taxpayers are required to determine the effective lives for assets for which there is currently a statutory effective life cap (Options B.2 – B.6) and for buildings (Option B.12). To the extent that the particular reform would require a taxpayer to segregate particular expenditure where such delineation does not exist currently, some compliance costs may be incurred in capturing and disclosing the relevant amount (e.g. Option B.11 – exclude feasibility studies from exploration expenditure).

8.1.2 Specific compliance cost issues – Thin capitalisation changes

The Institute notes with regard to proposed changes to the thin capitalisation rules, Option A.1 proposes the removal of the arm's length test (for general entities and non-bank financial entities) and the arm's length minimum capital amount (for banks). To the extent that taxpayers do currently rely on these tests, there may be compliance costs involved in them applying one of the other thin capitalisation thresholds, although these costs are not likely to be as significant as those associated with the introduction of a new measure (as outlined above). To the extent that there are changes simply to the thin capitalisation safe harbour or world-wide gearing ratios (Option A.2 and Option A.3) this is unlikely to change compliance costs. However, increased compliance costs may arise to the extent that transitional rules are

[13] The Henry Report, Chapter 2, Box 2.1: Design principles for the tax and transfer system),

complex or other changes are required to the existing provisions to incorporate the changes or there are additional reporting disclosures required by the ATO.

8.1.3 Specific compliance cost issues – EBITDA based restriction to interest deductibility

The Institute at 6.1.4 and 6.1.5 of this submission notes its reservations with Options A.4 and A.5 which propose to restrict interest deductibility by reference to EBITDA. If these options were to be progressed, the Institute notes some particular compliance costs which would likely arise in relation to these options, namely:

- Interpretation and application of new provisions, transitional rules and key concepts to be defined for the purposes of the new rules. The concepts of "interest income" and "interest expense" in the context of the range of transactions entered into by a business would be an example. Although the concept of "interest" is one which is familiar and has been considered for many years for the purposes of the tax law, the new law would no doubt need to have regard to the interaction of the debt/equity and taxation of financial arrangements rules (both sets of rules already regarded as being complex) in determining the nature of the "interest expense" which will be subject to the new limitation.

- Calculation of the EBITDA. It is to be expected that the new provisions would specify how to calculate the EBITDA to ensure consistency of approach for all taxpayers. If EBITDA is based on tax concepts such as tax earnings before interest, tax depreciation and amortisation, a separate tax calculation would need to be prepared; if EBITDA is based on accounting concepts, there would be potential costs associated with calculating total EBITDA for tax consolidated groups that do not produce one set of financial statements (e.g. multiple-entry consolidated groups, including whether or not the gross profits of non-resident entities should be included in the calculation). Using accounting concepts also raises the question of how entities who do not prepare accounts or who do not prepare accounts in accordance with accounting standards will be treated. For example, there will be additional compliance costs for trusts that are held within a group that may not prepare standalone accounts (some stapled groups have the head trust holding a range of other trusts).

- Additional compliance costs are likely to arise for small and medium enterprises (where their net interest expense exceeds perhaps a *de minimis* threshold). These businesses may only prepare management accounts, but would be required to calculate their EBITDA in order to claim a deduction for interest which is a common business expense. Given that the calculation of EBITDA is not required under the accounting standards (but is simply a reporting metric), it is possible that some small and medium enterprises do not already undertake that calculation but will need to do so under an EBITDA approach to the deductibility of interest.

- Data capture and tax reporting and disclosure of carry forward excess (non-deductible) net interest amounts and excess EBITDA amount (depending on the design of law), including:
    - Maintaining appropriate records to satisfy tax disclosure requirements
    - Apportionment calculations (or other integrity measures which may be introduced) where an entity joins or leaves a tax consolidated group
    - Potential testing for continuity of ownership, business or assets (similar to carry forward loss recoupment rules).

9. Transitional issues

Although mindful of concerns with complexity, the Institute also recognises the importance of having appropriate transitional provisions.

The Institute agrees with the Working Group's comment[14] that the timing of commencement of reforms and the nature of transitional arrangements are important considerations and are significant factors in determining the viability of proceeding with any broadening of the tax base proposals.

The Institute would be highly alarmed if base broadening measures commenced at a time before any corporate tax reduction applies.

The Institute submits that the following key transitional issues should be addressed by the Working Group in its recommendations to government:

1. Sufficient implementation time
2. Prospective changes only, and
3. Transitional arrangements including, where appropriate, grandfathering of existing provisions.

9.1 Sufficient implementation time

The Institute acknowledges that the time at which any corporate rate reduction or base broadening measures commence is a matter for government, we observe that the materials provided in the Discussion Paper assume a start date of 1 July 2013, which is less than nine months away.

Any change to the tax base must be introduced with sufficient lead time to allow businesses to:

- appropriately respond to the changing tax landscape
- incorporate the changes into financial modelling for proposed investment, and
- be involved in the consultation process in the development of the new laws.

In this respect, regard should be given to the trade-off between the speed with which measures are introduced (to increase taxpayer certainty) and the quality of the outcome, as highlighted by the Board of Taxation in its recently published report of the *Post-Implementation Review of the Tax Design Review Panel Recommendations* and subsequently agreed by Government[15]. The Institute would be happy to provide specific comments on an appropriate implementation time of any base broadening options which are ultimately recommended.

9.2 Prospective changes only

In many cases, investment decisions for large capital intensive projects were made based on financial modelling using the applicable tax laws at that time.

Accordingly a key principle that should be maintained in considering any tax base broadening change is that taxpayers who acted on the basis of the current law should be protected. This is particularly important given the nature of the proposed measures – i.e., when considered individually these measures will be unfavourable to taxpayers. This can be achieved by ensuring that:

[14] Paragraph 94 of the Working Group's Discussion Paper
[15] Recommendation 1 in Board of Taxation's report, December 2011

- any recommendations made by the Working Group should be for *prospective changes to the law only*; and
- there are *appropriate transitional arrangements* including, where appropriate, grandfathering of existing provisions in respect of investment or financing decisions already made.

There has been of late an increasing number of tax law amendments that are retrospective in nature and/or contain little or no transitional provisions to accommodate pre-existing arrangements including, the recent consolidation “rights-to-future-income” and residual tax cost setting provisions, changes to the interaction of the consolidation provisions with the Taxation of Financial Arrangements provisions in Division 230 of the *Income Tax Assessment Act 1997*, changes to the transfer pricing provisions which apply from 1 July 2004, and doubling of the rate of withholding tax on certain distributions from Managed Investment Trusts. Changes of this nature (i.e., retrospective or containing no transitional relief) increase taxpayer uncertainty and discourage investment. This is particularly true for multinational companies employing mobile capital and inbound investment into Australia.

Some of the base broadening options considered in the Discussion Paper, which if implemented, would best apply by taking effect from the start of the taxpayer’s relevant income year (e.g. income years commencing on or after 1 July of a target year). For instance, any changes to the thin capitalisation regime or the R&D tax incentive would be easier to apply from a compliance and administrative perspective, from the beginning of an income year, rather than an announcement date. On the other hand, capital allowance reform measures are more readily capable of having a hard start date that does not coincide with the commencement of the income year. In any event, if any change is to apply from the date of announcement, in the absence of legislative detail, sufficient detail of the extent of the reform should be provided at that time.

9.3 Transitional arrangements

As noted in the Discussion Paper[16], base broadening measures can be tailored to provide a smoother withdrawal of a concession or staged introduction of new rules. Most significant tax law changes are accompanied by transitional arrangements. This is consistent with the principle outlined above, i.e. that taxpayers who acted based on the current law should be protected.

In the view of the Institute, taxpayers who made commitments to significant transactions should be eligible for transitional relief, so the transitional rules should have appropriate regard to contractual commitments.

Transitional arrangements may take different forms including:

- transitional provisions that modify the application of the new law in respect of certain (generally pre-existing) assets / arrangements
- grandfathering of existing provisions in respect of certain (generally pre-existing) assets / arrangements, and
- delayed application of new laws to allow taxpayers to make changes to existing arrangements to comply with the new law.

[16] Paragraph 63 of the Working Group’s Discussion Paper

Many examples of appropriate transitional provisions in relation to capital allowances can be found in previous measures. The Uniform Capital Allowances (UCA) regime, introduced in 2001, was drafted so as to generally apply prospectively to:

- depreciating assets that commenced to be held under a contract entered into after 30 June 2001
- depreciating assets that are constructed where the construction commenced after 30 June 2001
- depreciating assets that a taxpayer started to hold in some other way after 30 June 2001, and
- expenditure that does not form part of the cost of a depreciating asset incurred after 30 June 2001.

Where a depreciating asset began to be held after 30 June 2001, transitional rules were included to protect the existing treatment of the asset even where the new rules applied. For example, in respect of accelerated depreciation, the transitional rules provided that where acquisition of plant occurred on or after 1 July 2001 (such that the UCA regime applied), but the taxpayer entered into a contract to acquire an item of plant before 21 September 1999, or started to construct the plant before 21 September 1999, the accelerated rates of depreciation were preserved by substituting the accelerated rate into Division 40 of the *Income Tax Assessment Act 1997*.

The concept of “investment commitment time”, relevant to the determination of an entitlement to the investment allowance which was introduced during 2008/09, is a further example of a transitional rule which limited a new provision of the tax law to decisions made after a certain time. The “investment commitment time” was defined as the point in time that the taxpayer entered into a contract under which they held the asset or started to hold at some point in time, started to construct the asset or started to hold the asset in some other way (similar to the rules for the application of the UCA regime).

Similar arrangements were in place for the commencement of the provisions in Division 250 of the *Income Tax Assessment Act 1997* in relation to assets put to a tax preferred use. Division 250 applies to all arrangements where the tax preferred use of an asset started on or after 1 July 2007 under a legally enforceable arrangement that was entered into on or after that date. Taxpayers had the option to elect to apply Division 250 instead of s51AD or Division 16D of the *Income Tax Assessment Act 1936* (which broadly applied prior to Division 250) to pre-existing arrangements, and material alterations to pre-existing arrangements could bring them within the scope of Division 250.

The use of transitional provisions such as those noted above has historically given rise to other interpretation issues that should be considered. Some of these include:

- when does a taxpayer enter into a contract / legally enforceable arrangement?
  This was dealt with by statutory interpretation and considered by the Australian Taxation Office (ATO) in a Tax Ruling[17].
- when does construction of an asset start?
  For the purposes of the investment allowance introduced in 2008/09, the time when a taxpayer “started to construct an asset” was legislatively defined as when the taxpayer first incurred expenditure in respect of the construction of the asset. This was an amendment to the *Tax Laws Amendment (Small Business and General Business Tax Break) Bill 2009* introduced by the Government before it was passed by the House of Representatives.

[17] IT 2158 *Investment Allowance: Contract for acquisition or construction of eligible property entered into prior to 1 July 1985 (former investment allowance)*

- when is expenditure in respect of the construction of an asset? This was considered by the ATO[18].
- how will the transitional provisions deal with splitting or merging of depreciating assets?

To address this type of uncertainty, matters such as this should be made clear as part of the policy and in the legislative drafting.

Transitional issues are not limited to any changes to capital allowances.

Changes to thin capitalisation/interest deductions and R&D tax incentives to fund a corporate tax rate reduction will have similar, and considerably more complex, transitional issues that must be dealt with.

It is likely to be practically difficult to have a transitional rule which would apply the existing thin capitalisation provisions to some concept of an "existing arrangement". Difficulties would arise in defining an "existing arrangement" – for example, existing financial arrangements, existing projects, existing entities – without providing opportunities to exploit the use of these existing arrangements. Without any transitional provisions, taxpayers would not be protected in respect of decisions made based on the current law at the time the decision was made. An alternative option would be to delay the application of the new laws for a sufficient period to allow taxpayers to adjust their existing arrangements to comply with the new provisions. An example of this is the three-year transitional period on the introduction of the debt/equity rules in Division 974 of the *Income Tax Assessment Act 1997*. Under this transitional rule, a company that had issued an interest before 1 July 2001 could make a written election for the previous law to continue to apply for an additional three years (until 1 July 2004). This optional transitional rule provided "continuity in private-sector decision making" and allowed "issuers sufficient time to redeem issued instruments in an orderly manner" (refer to paragraph 2.212 of the Explanatory Memorandum to the *New Business Tax System (Debt and Equity) Bill 2001*).

Given the difficulties and complexities associated with transitional provisions, it is imperative that the consequences of changing the current rules on thin capitalisation/interest deductions and R&D tax incentives are carefully considered before any recommendations are made to government.

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If you would like to discuss any aspect of our comments, please contact me on 02 9290 5609.

Yours sincerely

Paul Stacey
Tax Counsel
Institute of Chartered Accountants Australia

[18] ATO Interpretive Decision ATO ID 2009/113 *Capital allowances: tax break - expenditure in respect of the construction*