Law Council
OF AUSTRALIA

Professor (Emeritus) Sally Walker
Secretary-General

24 September 2012

Business Tax Working Group Secretariat
The Treasury
Langton Crescent
PARKES ACT 2600
Via email: BTWG@treasury.gov.au

Dear Sir or Madam

Submission on the Business Tax Working Group (BTWG) Discussion Paper

The Taxation Committee of the Business Law Section of the Law Council of Australia (the Committee) appreciates the opportunity to participate in the Government's consultation process in respect of recommendations for broadening the business tax base to allow for a reduction in the corporate tax rate.

Set out below is the Committee's submission regarding the Discussion Paper.

1. Executive Summary

1.1. The Discussion Paper canvasses a number of possible ways in which a cut to the company tax rate could be funded from within the business tax system. The Committee notes that reform to the GST is outside the terms of reference of the BTWG. The Committee believes that GST reform should at least be considered in any base broadening exercise.

1.2. The Committee's key concerns relate to the proposed changes to interest deductibility and the thin capitalisation regime, the level of forecasting work undertaken to date, and the accuracy of the revenue estimates prepared in respect of the proposed decrease in the company tax rate.

1.3. Finally the Committee is concerned that, as a general proposition, significant changes to Australia's tax system may have a negative impact upon foreign investors' perception of the Australian tax system, particularly in light of changes which reverse recently enacted measures.

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2. The Committee’s submissions

Perception of Australia as a stable and attractive tax jurisdiction

2.1. At paragraph 4 of the Discussion Paper the BTWG states that it believes that Australia should have an ambition to reduce its company tax rate over the medium term and that achieving a materially lower rate is a worthwhile reform objective, consistent with the recommendation by the Australia’s Future Tax System Review, on the grounds that it would help Australia to continue to attract investment and would reduce incentives to shift profits off shore.

2.2. The Committee is concerned, as a general proposition that changes to the business tax system will in fact result in a negative perception of Australia from the perspective of foreign investors, thereby reducing foreign investment into Australia.

2.3. The Committee notes that anecdotal evidence from its members suggests that foreign investors are increasingly regarding Australia as a "medium-high tax risk jurisdiction".

2.4. This has resulted from the various changes which have undermined the stability of the system, for example, the private equity debate, the changes to Part IVA, and transfer pricing changes. There is a risk that changes along the lines of those suggested in the Discussion Paper may further undermine non-resident confidence in Australia as an investment destination.

2.5. The Committee particularly notes the comment at paragraph 85 of the Discussion Paper that some of the suggested options involve a reversal of measures that have only recently been enacted, further adding to the perceived uncertainty of Australia as an investment destination.

Interest deductibility and thin capitalisation proposals

2.6. Options A1 to A5 propose a number of different ways in which interest deductions might be restricted. The Committee is particularly concerned at the proposal that there be a limit for both domestic and foreign entities to claim interest deductions.

2.7. There does not seem to be a clear policy basis for the proposed changes to the thin capitalisation rules, other than as a revenue saving measure to fund the proposed company tax rate cut. This is in contradistinction to the current and previous thin capitalisation rules that existed prior to the changes made pursuant to the *New Business Tax System (Thin Capitalisation) Act 2001*. In the Committee’s view, major changes in tax laws are not recommended without a clear policy basis that taxpayers and advisers could understand.

2.8. Paragraph 102 of the Discussion Paper refers to the corporate tax system's bias in favour of debt over equity referring to this as a distortion. However, it should be borne in mind that debt and equity are fundamentally different, and are not simply readily interchangeable methods of financing a company.

2.9. Equity provides an ownership interest in a company and typically grants rights to dividend returns, rights to vote and rights to surplus capital on winding up of the company. Whilst debt typically provides only a periodic return on the investment and a promise of return of the investment.

2.10. From a cost to capital perspective, debt is cheaper than equity as it typically lacks the features of equity which give rise to the types of rights set out above. Furthermore, debt does not typically bear the same risk profile in terms of fluctuating value.

2.11. In simple terms, debt and equity are quite different both functionally and economically and the tax system recognises this. To the extent that the legal form of an equity instrument can be changed so that it has debt like features, this is recognised in the rules of Division 974.

2.12. The Committee does not support the proposal set out in paragraphs 111 and 112 which proposes a restriction to interest deductions based on a fixed percentage of a taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA), without appropriate costing and analysis being done on the potential impact on taxpayers in the current economic climate. In times of difficult economic circumstance, domestic companies may be doubly disadvantaged in that they experience their business margins contracting, resulting in a reduction in EBITDA which in turn produces a further loss in the deductibility of their interest costs. The Committee therefore considers that this proposal may have the effect of exaggerating the impacts of any downturn in the business cycle. This is contrary to what is sought to be achieved by the Government.

2.13. The Committee would support the adoption of an EBITDA test as a backup to the safe harbour debt test. Clearly it will be important to set the testing proportion at an appropriate rate. The Committee understands that informally a 30% rate has been suggested. This appears low. For example, in the US where there is a similar test, the rate is set at 50% of EBITDA.

2.14. The other critical design feature is the issue of whether the rules should focus on total debt or only related party debt. The thin capitalisation rules as they applied until 2001 had a related party debt focus. The move to a total debt focus was made on the basis that taxpayers were to be granted a more generous safe harbour debt to equity ratio (the previous ratio of 2:1 moved to the current 3:1 ratio). The rationale behind that change would be severely compromised were there to be a restriction of the safe harbour debt to equity ratio test to 1.5:1 while retaining a total debt focus.

2.15. In the event that the safe harbour gearing ratio is reduced, reverting to a related party debt focus has significant advantages. It means that taxpayers have significantly greater flexibility to rearrange their affairs in order to reduce the amount of debt. This same flexibility does not exist with unrelated party debt. It is particularly the case where long term debt has been borrowed or debt has been raised through the capital markets that prepayment can result in significant penalties. Further, many projects (in particular infrastructure projects) which have been financed through such arm's length borrowings will have assumed a certain debt profile – the alteration of which would certainly add to cost of capital and reduce economic viability through the need to access more expensive equity funding sources.

2.16. The Committee notes that there is apparently a concern that an all-inclusive debt test should be used otherwise foreign investors will simply reallocate third party debt to Australia in order to reduce taxes here. This is not easily done in the absence of parent company support. Even if a related party test is re-introduced, we believe it would be possible to preserve the integrity of the rules by tests which identify parent company supported debt arrangements. Such rules did exist under the former thin capitalisation rules.

2.17. Finally the Committee is concerned that any changes made to the thin capitalisation rules will need appropriate grandfathering and transitional rules being put in place.

Revenue implications

2.18. The Committee considers that the integrity of the costing of any reduction in tax rate [and any base broadening measure] is critical. The key criteria for the BTWG in evaluating the possibility of a reduction in the company tax rate is that any base broadening measures which accompany the reduction in rate should fully offset the cost of the reduction. If estimated costs are inaccurate and policy decisions are made on the basis of these estimated costs, this may lead to a non-revenue neutral outcome.

2.19. Increases in productivity and investment levels are included as particular benefits of a lower tax rate, as set out in Chapter 3 of the Discussion Paper. Against this background paragraph 91 of the Discussion Paper notes that the revenue estimates do not consider behavioural effects or dynamic gains to investment, wages, productivity and growth that will flow from a lower company tax rate.

2.20. The Committee is concerned that the primary reasons for lowering the tax rate, as cited in the Discussion Paper, are then not being taken into account in the revenue estimates upon which the cost recovery measures are based. This would seem counter-intuitive.

2.21. The Committee encourages priority to be given to the survey which is mentioned at paragraph 105 which is directed to gaining a better understanding of potential revenue gains.

Other base broadening proposals

2.22. The Committee makes no specific comments in respect of the proposals as they relate to a reduction or elimination of accelerated depreciation allowances, as set out in paragraphs 114 to 157 of the Discussion Paper (options B1-B14), nor in respect of the proposals as they relate to changes to the R&D tax incentive, as set out in paragraphs 158 to 169 of the Discussion Paper (options C1 to C4).

ACE Proposal

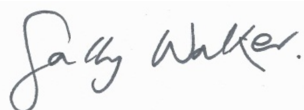
2.23. The Committee notes that the BTWG has also considered the merits of a business expenditure tax, including an allowance for corporate equity (ACE), discussed at paragraphs 25 to 29 of the Discussion Paper.

2.24. The Committee makes no comment on the proposal for an ACE, on the basis that this does not appear to be a realistic option at the present time, and the BTWG feels that an ACE should not be pursued in the short-to-medium term, see paragraph 29 of the Discussion Paper.

The Committee would be happy to discuss any aspects of the submission above. Further enquiries should be directed to Mr Mark Friezer (02) 9353 4227 or Ms Rosalind Myint (02) 9322 7144.

Due to time constraints this submission has not been considered by the Directors of the Law Council of Australia.

Yours faithfully



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