Business Council of Australia

SUBMISSION

Submission to the House of Representatives Standing Committee on Economics Inquiry into Tax Deductibility

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Working to achieve economic, social and environmental goals that will benefit Australians now and into the future

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Contents

Executive summary 2
Recommendations 6
Background Information 7
1. Company tax in Australia 7
2. Integrity in the tax system 7
3. Business Tax Working Group 8

The Business Council of Australia (BCA) is a forum for the chief executives of Australia's largest companies to promote economic and social progress in the national interest.

Executive summary

Introduction

The Business Council of Australia welcomes the opportunity to provide a submission to the House of Representatives Standing Committee on Economics Inquiry into Tax Deductibility.

There is very strong evidence from Treasury analysis, and elsewhere, that a lower company tax rate would be beneficial for the Australian economy.[1] However, further changes to the operation of the company tax system should be assessed on their merits, rather than with the narrow view of funding a reduction in the company tax rate. A compelling, evidence-based case for change, that is mindful of the investment and innovation impacts, needs to be made before any changes are considered.

A similar analysis was recently conducted by the Business Tax Working Group and it was unable to recommend a revenue-neutral package, within the company tax system, to fund a lower company tax rate. The process received feedback from many businesses that they would be worse off under the trade-offs canvassed. Some submissions questioned whether there would be a net benefit for the economy from the trade-offs proposed.

The case for retaining interest deductibility for businesses is compelling. Interest deductibility is a longstanding feature of the tax system. Businesses borrow to invest and grow, and interest is a cost incurred in this process. Allowing deductions for expenses incurred in earning income, such as interest, is an important tax principle. Disallowing these deductions would result in double taxation (of both borrower and lender), harm investment and growth, significantly impact committed investment and certain sectors, and risk unintended consequences. Most of our competitor countries allow deductions for interest while imposing lower company tax rates. In addition, Australia has some of the toughest integrity laws in the world, including rules limiting excessive interest deductions.

Company tax reforms should be assessed on their merits, not hypothecation

The Business Council supports the inquiry's objective of a simpler and more competitive tax system, which can better support economic growth. This aim should be pursued for the entire tax system and not confined to self-funded changes within the company tax system.

The tax white paper process should consider all tax bases and tax expenditures. However, hypothecating company tax base changes to a rate reduction is not the best approach for this process. Any considered changes to the company tax system should be assessed on their impact on investment and growth, rather than with respect to funding a reduction in the company tax rate. Furthermore, simplicity is important but should not be

[1] Department of the Treasury, 'Understanding the economy-wide efficiency and incidence of major Australian taxes,' Working Paper 1, L Cao, A Hosking, M Kouparitsas, D Mullaly, X Rimmer, Q Shi, W Stark & Sebastian Wende, Canberra, 2015.

pursued as a goal in itself and risk ignoring the implications for economic efficiency and growth.

Tax reform is vital for lifting competitiveness and growth

The tax white paper process is an opportunity to ensure Australia's tax system remains sufficiently robust and competitive to better support investment, growth and jobs in an increasingly competitive and dynamic global environment.

A competitive corporate tax system is an important element of maintaining a strong economy and lifting living standards. The corporate tax system should encourage investment, risk-taking, innovation and entrepreneurship. In addition, the community needs to have confidence in the integrity of the corporate tax system if it is to support broader tax reform.

There are many elements contributing to the overall competitiveness of the corporate tax system. Business tax expenditures are one element of the system and have recently been rationalised – there are 85 business tax expenditures today, down from 108 the previous year.[2] They seek to counter to some degree the disincentive effects of a high statutory company tax rate and inflation on investing and risk-taking activities which often have very long lead times.

Company tax can influence investment across assets and industries, discourage foreign investment, reduce investment in innovative activities, distort financing decisions, and absorb resources, due to complexity of the tax system. A lower corporate tax rate would encourage investment and facilitate economic growth. As investment increases, capital deepening increases labour productivity, which in turn flows through to higher real wages.

Australian companies pay a large amount of tax

Company tax is the second largest source of national tax revenue, with collections expected to be almost $70 billion in 2015–16.[3] The company tax base is also relatively small, with around 2,000 companies paying approximately two-thirds of company tax in 2011–12.[4] The 12 largest taxpayers paid one-third of company tax in 2012–13, up from around a fifth a decade ago.[5]

Australian companies also pay a large amount of tax compared with international peers. Compared with the OECD average Australia is more than twice as reliant on corporate income tax as a share of all taxes, and corporate tax revenue as a share of GDP is second only to Norway.[6] In part, this reflects the integration of the personal and company

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[2] Department of the Treasury, *Tax expenditures statement 2013*, Commonwealth of Australia, Canberra, 2014 & id., *Tax expenditures statement 2014*, Commonwealth of Australia, Canberra, 2015.

[3] Department of the Treasury, *Mid-year economic and fiscal outlook 2015–16*, Commonwealth of Australia, Canberra, 2015.

[4] Department of the Treasury, *Re:think tax discussion paper*, Commonwealth of Australia, Canberra, 2015.

[5] Department of the Treasury, 'Looking forward 100 years: Where to for income tax?', Presentation by R Heferen at the Looking Forward at 100 Years Conference, Australian National University, 27 April 2015.

[6] OECD, *Revenue statistics 2015* – Australia, OECD, Paris, 2015.

tax systems through the imputation system. As a result, company tax acts as a withholding tax on Australian shareholders, and is essentially a tax on foreign investment.

Corporate tax competition is increasing

Australia's 30 per cent corporate tax rate is high relative to the OECD average and our competitors in Asia. In 2006 the 30 per cent rate was a little above the averages of the OECD and our competitors in Asia – about 28 and 29 per cent, respectively. Since then, these averages have fallen to about 25 and 22 per cent respectively, while Australia's corporate tax rate has remained unchanged.[7]

Continued competition for highly mobile capital means that global competitive pressure is more likely to drive reductions in corporate tax rates, and convergence and harmonisation of tax systems. If Australia is a price taker in global capital markets, which would seem to be the case for many investments, the implications are stark – if our company tax rate is out of line with global rates, we will forgo investment. To illustrate, the UK and Spain have lowered their corporate tax rates, to 20 per cent and 25 per cent respectively, to boost investment and growth. The UK has announced a further reduction to 18 per cent by 2020.

Both major political parties in Australia have recognised this challenge and support a lowering of Australia's corporate tax rate over time as fiscal circumstances permit.

Business Tax Working Group

In 2012, the Business Tax Working Group (BTWG) was asked to prioritise consideration of a cut in the company tax rate accompanied by measures which fully offset the cost by broadening the company tax base – similar to the work of this committee's inquiry.

The task of the BTWG was to assess whether this would deliver net benefits to the Australian economy. It consulted widely and was unable to recommend a revenue-neutral package to lower the company tax rate. It observed that it was difficult to find support for base broadening measures beyond the extensive reforms of previous decades.

The Business Council, through consultation with members, did not consider there to be a positive net benefit for the economy from the BTWG options proposed. The BTWG considered that a two to three percentage point cut in the company tax rate would be needed to drive a significant investment response. However, there were far greater risks than benefits in terms of business confidence and investment patterns from the trade-offs under consideration.

Any changes to the tax base, deductions or allowances may increase effective rates and not necessarily improve the efficiency of investment decisions. As a result, some base broadening and lower rate options may have a negative impact on growth, with concentrated negative impacts on the competitiveness of certain sectors. For example, if the responsiveness of capital to the removal of existing tax concessions is greater than

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[7] KPMG, *KPMG's Corporate tax rate survey,* KPMG, United Kingdom, 2006 & KPMG, 'Corporate tax rates table', KPMG, 2015, https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html.

the responsiveness of capital to a reduction in the company tax rate, then the package may not represent a net benefit to the economy.

Ralph Review

The previous major review of business taxation, the Ralph Review, led to a lower company tax rate of 30 per cent and significant base broadening measures. It recommended that general deductibility of interest be retained. It recommended 'that interest expenditure be viewed as the cost of maintaining access to the capital funds underlying a business and hence be deductible in calculating taxable income in the year incurred.' [8] As a result of the Ralph Review and previous company tax reform exercises, the BTWG 'found that the business tax base is broader than it was in the 1980s and 1990s and significant savings are now more difficult to identify and reach consensus on.'

Expenses incurred in running a business are tax deductible

Most expenses incurred in running a business are tax deductible, with those directly related to earning assessable income generally allowed. By allowing deductions for the costs incurred in producing income, income is treated in net terms, which recognises net inputs vary across business activities. Put another way, this approach ensures neutral treatment as it recognises that two companies may incur different costs in attaining the same level of income.

If tax deductions were not provided for expenses such as costs of goods sold or interest paid, this would result in the income from those expenses being taxed twice as income earned by suppliers and expenses paid by the recipients.

Interest expenses are costs of running a business

In Australia, interest is a deductible expense for the borrower, as it is an expense necessarily incurred in running a business. This treatment should not change. Most company tax systems around the world allow deductions for interest payments. In the hands of the lender, interest received is generally taxed as income at their marginal rate.

Businesses require finance, in the form of debt or equity, to invest and grow. An advantage of debt over equity is that it allows those raising debt to retain managerial control of their companies. There are numerous examples where debt is a critical financing option for companies. They include large infrastructure and resources projects with long lead times, and industries with seasonality in earnings, such as agriculture. Debt is also an important source of finance and operating capital for small business.[9]

There are safeguards to ensure interest deductions are not excessive

Australia's thin capitalisation regime is an integrity measure designed to ensure that multinationals do not allocate an excessive amount of debt to their Australian operations

[8] Department of the Treasury, *Ralph Review: Review of business taxation*, recommendation 4.15, Canberra, 1999.

[9] M Matić, A Gorajek & C Stewart, 'Small business funding in Australia', paper presented at the Small Business Finance Roundtable, Sydney, 2012.

to circumvent company tax. The regime limits the extent to which a company may claim deductions for interest paid on debt, and aims to strike a balance between integrity and flexibility. The recent changes to Australia's transfer pricing and thin capitalisation laws make these regimes arguably the most robust in the world.

There are large risks in disallowing interest deductibility

There are large risks in Australia acting alone in disallowing interest deductibility, particularly with its reliance on foreign investment. With interest deductibility generally allowable across the world, unilateral action would encourage firms to raise debt where deductions are allowed, at the cost of those unable to do so. The disruptions to existing projects (especially those with long investment lead times), contracts and financial markets would be enormous, and borrowing costs would likely rise. The finance sector would be greatly affected if lenders were taxed on both the interest paid on debt, as well as deposits.

The Henry review noted that if interest deductibility was disallowed, 'as a significant amount of debt is currently untaxed, this option would also increase the cost of debt financed investment. There would also be significant transitional issues for highly leveraged businesses.'[10] It did not make any recommendations to change the rules around interest deductibility.

The bias towards debt is mitigated

It is argued that allowing deductions for debt and not equity creates a bias towards debt. However, the interaction between the company tax system and dividend imputation highlights the importance of assessing the tax system holistically. Any bias is partially offset for domestic equity investors by imputation credits. Interest withholding taxes have a similar effect, however the Henry review recommended they be abolished for financial institutions. Australian companies have been observed to be leveraged less than their overseas counterparts.[11]

Furthermore, as corporate tax rates have fallen around the world, any bias towards debt has also reduced.

Recommendations

1. Assess measures based on their impacts on investment and growth rather than narrowly consider the company tax system as self-funding.

2. Maintain the treatment of interest deductibility, recognising the risks of acting unilaterally and that interest income is taxed in the hands of lenders.

[10] Department of the Treasury, *Australia's future tax system: final report*, Commonwealth of Australia, Canberra, 2010.

[11] JPH Fan, S Titman & G Twite, 'An International Comparison of Capital Structure and Debt Maturity Choices', *Journal of Financial and Quantitative Analysis 47(1),* 2012, pp. 23–56.

Background Information

1. Company tax in Australia

How does corporate tax work?

Corporate tax is a profits tax levied on a company's taxable income at a rate of 30 per cent.[12] It is calculated as assessable income minus allowable deductions. Assessable income includes income from selling goods and services, while allowable deductions include expenses incurred in carrying on the business, such as employee wages and salaries, costs of goods sold, investment, advertising, utilities and interest.

Why allow deductions?

Most expenses incurred in running a business are tax deductible, with those directly related to earning assessable income generally allowed. Allowable deductions also include the cost of managing tax affairs, which recognises compliance costs imposed on businesses.

By allowing deductions for the costs incurred in producing income, income is treated on net terms, recognising net inputs vary across business activities. This approach ensures neutral treatment as it understands that two companies may incur different costs in attaining the same level of income.

2. Integrity in the tax system

Australia has strong tax integrity measures

Australia has 'some of the strongest tax integrity rules in the world'.[13] Successive governments, through bipartisan support, have sought to maintain this integrity by updating measures such as transfer pricing rules, the foreign source income anti-tax-deferral regime, general anti-avoidance rule and thin capitalisation rules. These measures complement each other and provide Australia with a robust and holistic set of integrity measures.

In response to the release of the OECD's Final Report on the Base Erosion and Profit Shifting Action Plan, the Treasurer noted that there should be no major implementation issues in Australia. This is because Australia either already meets the OECD's recommendations, or is already considering their adoption. The OECD did not recommend any changes to the general principle of interest deductibility.

Importantly, the government will consult in the implementation of the OECD's recommendations to ensure 'investment activity is not compromised and that Australia remains an economically competitive place to do business', noting also that the 'intricate and sensitive nature of international taxation demands precise and targeted responses to

[12] It is levied at a rate of 28.5 per cent for companies with annual turnover less than $2 million.
[13] See http://sjm.ministers.treasury.gov.au/media-release/003-2015/.

policy challenges, responses that are developed in consultation with our international partners to maximise their effectiveness'.[14]

Australia has robust interest deductibility laws

Australia's thin capitalisation regime is an integrity measure designed to ensure that multinationals do not allocate an excessive amount of debt to their Australian operations. The laws limit the extent to which a company can claim deductions for interest paid on debt, and aim to strike a balance between integrity and flexibility for firms to conduct activities. The recent changes to Australia's transfer pricing and thin capitalisation laws make these regimes arguably the most robust in the world.

The regime operates by allowing firms to apply one of three tests:

- **debt-to-equity ratio**, which restricts most investors to holding $1.50 of debt for every $1 of equity. Non-bank financial entities are restricted to $15 of debt for every $1 of equity. This test was tightened from 1 July 2014.
- **arm's length debt test**, which is a detailed assessment of a company's debt to show that the borrowing can be supported on an arm's length basis and is commercially justifiable. It was recently reviewed by The Board of Taxation, which concluded that it 'is an important integrity measure within the thin capitalisation rules' and that improvements could be made to 'reduce compliance costs and relieve the administrative burden for taxpayers and the ATO'.[15]
- **worldwide gearing ratio**, which is the taxpayer's gearing across the world. This test was also tightened from 1 July 2014.

In response to the recent tightening of interest deductibility rules, Rob Heferen, Executive Director, Revenue Group, Treasury, noted that 'this is probably the sensible limit of integrity measures. In particular, we need to recognise further changes come at a cost, through increased complexity and compliance costs.'[16]

There have been calls for the three tests to be replaced by the worldwide gearing ratio. Pascal Saint-Amans, Director of the Centre for Tax Policy and Administration at the OECD, remarked that this sort of unilateral action would deter investment. He stated that 'if you introduce such legislation and your partners do not do so, then you face the risk of shifting the capital to other countries.'[17]

3. Business Tax Working Group

The Business Tax Working Group (BTWG) was established in October 2011 following the Tax Forum. In June 2012 it was asked to prioritise consideration of a cut in the company tax rate accompanied by measures which fully offset the cost by broadening the company tax base – similar to the work of this inquiry.

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[14] See http://sjm.ministers.treasury.gov.au/media-release/003-2015/.

[15] Board of Taxation, *Review of the thin capitalisation arm's length debt test*, 2014.

[16] Department of the Treasury, 'Implications of digitisation for the Australian tax system', Presentation by R Heferen at the 2014 Economic and Social Outlook Conference, Melbourne Institute, 4 July 2014.

[17] Commonwealth of Australia, *Proof Committee Hansard, Senate Economics References Committee – Corporate tax avoidance*, *9 April 2015*.

The task of the BTWG was to assess whether this would deliver net-benefits to the Australian economy. It consulted widely but was unable to recommend a revenue-neutral package to lower the company tax rate. It observed that it was difficult to find support for base broadening measures beyond the reforms of previous decades. The proposals would change recently introduced measures, remove longstanding measures or have a significant impact on a few taxpayers. For example, changes to depreciation could have a significant impact on the after-tax return on investment, particularly where there is a long lead time before income is produced. Many businesses noted they would be worse off under the trade-offs canvassed.

The BTWG's conclusions were based on key factors as to why a trade-off would not be beneficial. These issues remain prevalent today, and include:

- uncertainty in the economy from structural change
- lesser benefits from removing remaining concessions compared with those removed in the past
- the benefits of a further cut would not be as large as previous cuts.

The BTWG considered a number of options on interest deductibility, including reducing the debt-to-equity and worldwide gearing ratios for general entities and financial institutions. As discussed, these options were eventually adopted outside this process.

Other BTWG observations

The BTWG noted that a comprehensive tax base with minimal exemptions can result in a more productive mix, but that there were circumstances where a departure from a uniform tax base can be justified on economic grounds, such as encouraging activities that give rise to positive social benefits.

The BTWG observed that the business tax base is already broad as a result of tax reform exercises over the past 30 years, and that it was 'not arguing that neutrality is an end in itself.' Some types of capital expenditure may be favoured as they correct for a significant market failure, and economic depreciation can also be difficult to measure and differ by assets and industries, so departures from neutral treatment reflect that.

Statutory effective life caps were introduced over concerns that removing accelerated depreciation would adversely affect investment in certain sectors. Changes would, in the short term, threaten a number of investment projects, including some very large ones. The relative attraction of investing in Australia over other countries would also be affected in some cases.

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