Building a better working world

Ernst & Young
680 George Street
Sydney NSW 2000 Australia
GPO Box 2646 Sydney NSW 2001

Tel: +61 2 9248 5555
Fax: +61 2 9248 5959
ey.com/au

Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
Canberra ACT 2600

15 January 2016

Standing Committee on Economics Inquiry into tax deductibility EY submission

Dear Committee Members

EY makes this submission to the Standing Committee on Economics Inquiry) ("Inquiry"):the terms of reference for which are to "examine some options to simplify the personal and company income tax system, with a particular focus on options to broaden the base of these taxes in order to fund reductions in marginal rates (including)

- The personal tax system as it applies to individual non-business income, with particular reference to the deductibility of expenditure of individuals in earning assessable income, including but not limited to an examination of comparable jurisdictions such as the United Kingdom and New Zealand; and
- The company income tax system, with particular reference to the deductibility of interest incurred by businesses in deriving their business income" discussed in the first part of this summary.

This submission focuses on the company income tax system, rather than the personal non-business income aspects of the terms of reference.

Funding reduced marginal tax rates for companies by broadening the company income tax base does not have regard to options to change Australia's tax mix

The terms of reference request the Inquiry to explore options to fund reduced marginal tax rates for companies and non-business individuals by broadening the base, that is, by presumably taxing more corporate income and income of non-business individuals. The proposition is in essence to determine if there are any simpler ways to reduce marginal tax rates but funded from reductions in existing tax concessions, that is, reducing marginal tax rates without a material net revenue cost.

The terms of reference do not look to how to fund marginal tax rate cuts by changing the tax mix to have greater indirect taxes (notably re-engineering the GST), nor do they consider other potential revenue or Government expenditure options.

Recent analysis by the Productivity Commission (Appendix 2) is consistent with work of the Federal Treasury and other analysts, confirming how Australia's over-reliance on corporate taxes and under-reliance on indirect taxes is out of line with international norms.

The proposals in the terms of reference are challenging propositions.

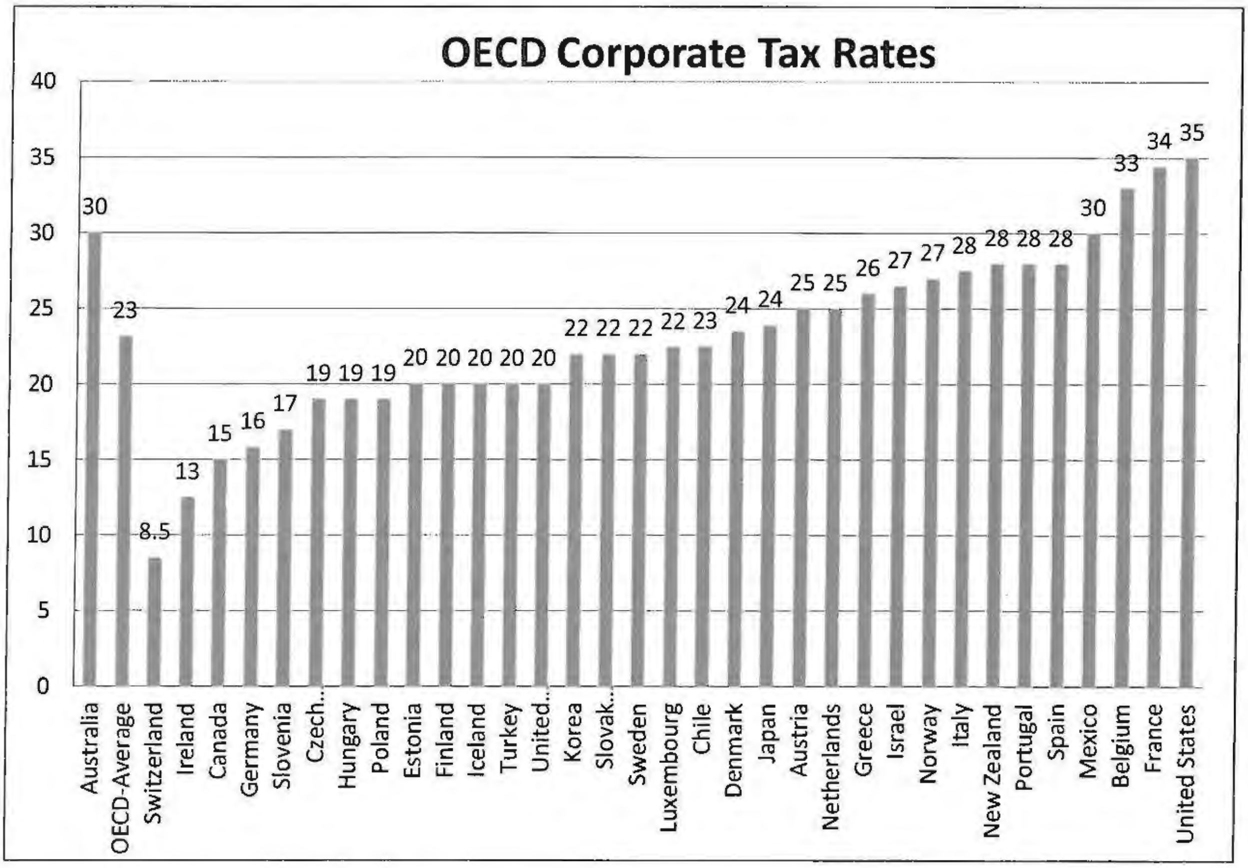
We assume that the Inquiry is framed in this manner because of the challenge of achieving consensus from political stakeholders at the federal level as well as some States and Territories in relation to the need to increase Australia's reliance on indirect taxes, including the GST and State/Territory taxes.

We welcome the opportunity to assist the Inquiry to explore and reinforce that such a proposition is very problematical if not unrealistic.

Lower corporate tax rates would help Australia to be competitive and to attract Investment

1) Australia's tax system needs to be internationally competitive and understandable, at a time of highly volatile global economic conditions, to counter the perception that Australia has a highly complex and unusual tax system. Therefore, we support the need for a lower corporate tax rate, given countries' global competition for capital and business investment.

2) There is a clear international trend to lower corporate tax rates as confirmed in OECD statistics. Australia's corporate tax rates are now higher than the OECD average - even the Scandinavian countries have corporate tax rates in the 20% range[i].



Further, Australia's corporate tax rate is well in excess of countries in our region - even Japan, coming out of a long recessionary period is moving to reduce its corporate tax rates as the overall rate when combined with local taxes affects its competitiveness. Similarly, US politicians are recognising the adverse growth impact of their high corporate tax rates.

3) It is difficult to attract foreign investment if Australia's corporate tax rates are now higher than the OECD and Asia-Pacific averages.

Australia's high "sticker" tax rate is particularly unhelpful for attracting mobile businesses outside those sectors where Australia's immovable assets attract investment (i.e.; investment outside the resources, agribusiness and tourism sectors).

For this reason, countries generally are moving to lower corporate tax rates to ensure they remain competitive.

4) We welcome the attention of the Inquiry to the issue of how a lower corporate tax rate would stimulate growth in the economy and recommend the Inquiry seek modelling of the issues from Treasury or other government agencies. In our view:

i) a lower Australian corporate tax rate would attract investment from overseas, and would allow Australian companies to use the resulting funds to reinvest in growth

ii) that growth would over time lead to enhanced corporate tax revenue, as the investments lead to greater economic activity, and to greater [personal] tax revenue from Australians' earnings from the companies.

The Henry Review into Australia's Future Tax System ("The Henry Review") initiated by Labor in 2009 (discussed below), put it well:

"Reducing taxes on investment, particularly company income tax, would also encourage innovation and entrepreneurial activity. Such reforms would increase income for Australians by building a larger and more productive capital stock, and by generating technology and knowledge spillovers that boost the productivity of Australian businesses. A lower company income tax rate would also reduce incentives for foreign multinationals to shift profits out of Australia."

iii) the "growth dividend" should over time be greater than the initial revenue costs from a lower corporate tax rate. We would submit the Inquiry should ask Treasury to model these impacts.

Australia's corporate tax take is high, and funding corporate tax cuts from broader corporate tax base does not address Australia's structural corporate tax issue

Australia's tax collections from corporates are extremely high as a percentage of total tax revenue, higher than OECD countries (with the exception of Norway), out of line with the trend by countries including OECD countries to reduce their corporate tax rates, and well in excess of rates for our Asia Pacific competitor countries.

A proposal for a "self-funding, zero sum" reduction of corporate tax rates, funded by a broader corporate tax base causing no reduction of overall corporate tax revenues, does not address the over-reliance on corporate tax collections in Australia's tax system caused by an under-reliance on efficient indirect taxes.

There may also be funding options outside the corporate tax system but in our view there are not readily available funding options within the corporate tax system.

That is why a review of a, broadly, similar tax proposal involving revenue neutrality, commissioned by the then Treasurer Wayne Swan from the Business Tax Working Group (BTWG) in 2012 concluded (as explained below and see Appendix 4):

"8. The Working Group has made a number of findings but is unable to recommend a revenue neutral package to lower the company tax rate."

Australia's corporate tax base is already broad

The terms of reference relating to options to simplify the company income tax system, focus on "options to broaden the base of these taxes in order to fund reductions in marginal rates (including) the deductibility of interest incurred by businesses in deriving their business income".

1) **We highlight for the Inquiry that Australia's corporate tax system already has a broad corporate tax base. Australia's corporate tax base was broadened as part of the 1998 Ralph Review, in particular to reduce capital allowances on capital equipment and to eliminate companies' access to capital gains tax indexation.**

   The Henry Review (commissioned by a former Labor government, and which reported in 2009) analysed options for adjusting our corporate tax system and identified a few immediate issues to address the broadening of the corporate tax base.

2) **The BTWG in 2012 highlighted the already broad base of Australia's corporate tax system.**

3) **As well, the BTWG highlighted that the concept of a revenue-neutral cut in the corporate tax rate amounts to, for some taxpayers affected by withdrawal of the relevant tax incentives, to an actual increase in the corporate tax rate for them.**

The BTWG stated (and for convenience we reproduce extracts of its report at Appendix 4) that:

"Finding 4: The Working Group notes that there is considerable debate and uncertainty around the magnitude of the distortion associated with the remaining concessions in the business tax base, including concessions that promote important activity like investment in infrastructure and research and development.

Finding 5: The Working Group received feedback from many individual businesses asserting that they would be worse off as a result of the trade-offs canvassed in the Discussion Paper. Further, some submissions questioned whether there would be a net benefit for the economy as a whole from a combination of some of the base broadening measures canvassed and a cut in the company tax rate of between one and three percentage points. Overall, the Working Group has found there is a lack of agreement in the business community to make such a trade-off."

4) **Using base broadening tax policy measures to fund lower marginal tax rates does not necessarily enhance growth of the economy (whatever their other impacts) and may in fact be detrimental to growth.**

A 2015 study by tax specialists in the US Congressional Research Service[ii] concluded somewhat similarly to the BTWG on this issue:

> *"An inevitable characteristic of a revenue neutral tax reform is a tendency to balance out positive and negative effects on labor supply and growth. Revenue neutral tax reform may have other virtues, but given the inevitable trade-off of such an approach, a major impact on growth may not be one of them."*

That study identified that the withdrawal of tax concessions for certain activity would prima facie have adverse outcomes for taxpayers undertaking those activities, with its own impacts on growth, which might not be offset by economy-wide tax rate concessions, and identified that the trade-offs and net outcomes are a significant factor to be considered in overall tax policymaking.

The US interest in this area flows from the US examination of various recent proposals for implementing corporate tax rate cuts through base-broadening measures, particularly those focused on interest deductibility.

The Quantitative Economics and Statistics (QUEST) group of EY US (Ernst & Young LLP) has performed various studies noting also the risks to growth from such approaches. These are cited below.

5) **Since the 2012 BTWG report, Australia's corporate tax base has been further broadened through the introduction of the broader transfer pricing rules, expanded thin capitalisation rules, and limitation of R&D claims for companies with large turnovers.**

Therefore, in our view, Australia's corporate tax system does not provide potential for a self-funding corporate tax rate cut from withdrawal of corporate tax concessions.

Deductibility of interest

1) **The Inquiry should be aware that for Australian companies with Australian resident shareholders, the dividend imputation system provides a powerful incentive for the use of equity funds from shareholders, rather than interest-bearing debt.**

The dividend imputation system means that, for Australian shareholders, company tax paid gives rise to imputation credits.

Thus, any bias to the use of debt in Australian companies is tempered by the dividend imputation system, as noted in the Henry Review Report:

"Dividend imputation continues to provide benefits such as neutrality around financing and entity choices. It also enhances the integrity of the tax system by reducing the benefits of minimising company income tax. These benefits mean that dividend imputation should be maintained in the short to medium term."

(As it is considering any calculations of potential revenue impacts, the Inquiry should note that lower company tax rates for Australian companies would result in increased tax collections from Australian investors arising from their lower dividend imputation credits on dividends received.)

2) **Interest incurred by businesses is a fundamental business expense. From the perspective of equity and efficiency, a business expense should be recognised for tax purposes.**

3) An issue considered by tax policy thinkers internationally is whether company tax systems encourage the use of interest expenses so as to cause interest-bearing debt to be favoured by companies over the use of shareholder equity.

a) **The 2012 report of the Henry Review, commissioned by Labor, noted the global consideration by economists of whether company tax systems encourage the use of debt. It did not recommend any reduction of deductibility of interest expense and noted the international thinking that company tax bases should be altered to an expenditure tax, further allowance for corporate equity (ACE) or similar measures that better equate the outcomes of debt and equity.**

However, the Henry Review noted that Australia's dividend imputation system does a lot to level the playing field for Australian companies in relation to their use of capital as distinct from debt to fund their growth.

The Henry Review concluded that while Australia should monitor and, if appropriate, participate in global moves to change the corporate tax system, Australia should not be a "front-runner".

The Henry Review recommended that:

"B — Investment and entity taxation | B1 — Company and other investment taxes

Recommendation 26: The structure of the company income tax system should be retained in its present form, at least in the short to medium term.

A business level expenditure tax could suit Australia in the future and is worthy of further consideration and public debate. It is possible that other economies will move towards such systems over coming years and it could be in Australia's interest to join this trend at an early stage."

We highlight for the Inquiry, at Appendix 3, the discussion and strong views of the Henry Review, that:

- Australia should not be a front-runner on such moves as this would adversely affect our competitiveness, which is important for a capital importing country like Australia.

- only some countries are using mechanisms that affect the relative attractiveness of corporate interest deductibility for tax purposes.

b) **A 2011 staff study by an IMF staff member explored tax policy issues** relating to the proposition that: [iii]

"Most tax systems today contain a "debt bias", offering a tax advantage for corporations to finance their investments by debt."

The IMF staff study explored the policy challenges involved in such a proposition and summarised the analysis as:

"What can be done to mitigate debt bias in the tax code? In a nutshell, it will require either reducing the tax deductibility of interest or introducing similar deductions for equity returns. A number of countries have already opted to reduce interest deductibility. But such restrictions on deductions do not eliminate debt bias altogether, and they bring considerable new complexities and opportunities for tax avoidance. Abolishing interest deductibility would indeed eliminate debt bias, but it would also introduce new distortions into investment, and implementing it would be very difficult. For these reasons, no country has moved toward eliminating the deduction.

The second option, introducing a deduction for corporate equity, has better prospects. This involves, for example, granting firms a deduction for the normal return on equity equal to the rate of government bonds. Apart from eliminating debt bias, such an allowance would bring other important economic benefits, such as increased investment, higher wages, and higher economic growth. The main obstacle is probably its cost to public revenues, estimated at around 0.5 percent of GDP for an average developed country."

c) **We highlight that the countries which have explored a limitation on interest deductibility (outside the cross-border thin capitalisation rules) or an Allowance for Corporate Equity (ACE), eg Italy, Belgium, are countries that do not have dividend imputation systems like Australia's.** Appendix 5 presents details of some countries' policies.

d) The BTWG created by former Treasurer Wayne Swan reported in 2012 on whether a cut to Australia's corporate tax rate could be introduced, self-funded by reducing other business tax concessions or an ACE, a self-funding corporate tax rate cut which in essence would not reduce the corporate tax contribution to Australia's tax revenues.

   The BTWG, chaired by Chris Jordan, reported that it was unable to find any business consensus on such a self-funding package recommendation for reasons including differences among different sectors of Australia's economy, and the problem of how to manage transitions to any major new measure. Appendix 4 outlines the relevant discussion in the BTWG final report.

e) **US experience is consistent with the BTWG recording concern about such measures.** The US had various tax reform proposals in earlier years involving the use of restrictions on interest deductibility to fund reductions in corporate tax rates:

   - A 2011 proposal limiting the deductibility of corporate interest to its noninflationary (real) component, equivalent to a 25% across-the-board limit on interest deductibility
   - A President Obama 2012 Framework for Business Tax Reform identified reducing the tax bias toward debt financing as one of four key elements for business tax reform

   Various studies by the US Ernst & Young LLP Quantitative Economics and Statistics group examined various proposals using the EY General Equilibrium Model of the US economy[iv]. Some observations from the US-based studies:
   - *"An important issue for a revenue-neutral tax reform is how a lower CIT rate or lower tax rates generally will be paid for. Understanding the potential impacts and tradeoffs associated with using the revenue from specific revenue-raising provisions is an important consideration in designing a pro-growth tax reform plan." (2015)*
   - *"A revenue-neutral reduction in the corporate income tax rate financed by an across-the-board limitation on corporate interest expenses has been found to discourage investment through a higher METR (marginal effective tax rate) – a measure of the additional economic profit needed for a new investment to cover taxes over its life – on investment. The METR is a standard measure used to analyze investment incentives across investment types, by source of financing and on the overall level of investment and is frequently used to inform tax policy discussions.*

"The net effect of the policy change in 2013 would be to increase the marginal effective tax rate (METR) for new investment in the corporate sector by 9.6% and in the business sector as a whole by 6.2%, thus discouraging investment; the METR for a debt-financed investment would rise from 0.4% to 17.7%, but would remain largely unchanged for an equity-financed investment; This policy also further discourages investment in the corporate sector" (2013)

- *"This analysis pairs further limits on the deductibility of interest expenses of inbound companies with offsetting uses of the additional revenue – a revenue-neutral reduction in the CIT rate or a revenue-neutral increase in government spending. This report finds that further limiting the deductibility of interest expenses by inbound companies would reduce US GDP in the long-run, after taking into account the effect of a revenue-neutral reduction in the CIT rate" (2015)*

The submissions confirm the need for the Inquiry or any policymaker to consider the potential effects of any proposals for Australian growth and employment, with economic modelling of the impact on growth and employment.

f) **The G20 global initiative to counter multinational businesses' Base Erosion and Profit Shifting (BEPS) has two specific action items which relate to interest deductions:**

Action 4 seeks to counter inappropriate cross-border use of interest in the context of BEPS. However, this action item has seen an international broad direction to the use of countries' thin capitalisation rules (that is, debt to equity ratios or debt to earnings ratios) and not to outright denial of interest deductions. Australia has strong thin capitalisation rules, modernised in 2014 after a Budget initiative by the then Labor government, and in our view the rules do not require further amendment at this time.

Action 2 seeks to address hybrid financial instruments which might lead on a cross border basis to double tax benefits, but that action does not operate in terms of countries' domestic tax systems. Australia is addressing action 2 as the Board of Taxation is considering the direction to be adopted, to report in March 2016.

4) **We emphasise for the Inquiry that there is no global move in the BEPS agenda, which represents over 80% of global economic activity, to scale back interest deductibility other than in the thin capitalisation and hybrids context.**

Significant transitional and sovereign risk issues involved in policy changes concerning interest

If any change were to be proposed which might affect Australian companies' debt funding structure, it raises transitional issues and would require a significant lead time to enable companies to adjust their capital structures, in addition to impacting Australia's international competitiveness.

On the competitiveness issue, if Australia's tax rules changed to reduce Australian companies' tax deductibility from using debt, then those Australian companies would have higher taxes paid unless and until they replaced that debt with equity. The current debt-using companies would have a commercial disadvantage compared with Australian competitors using less debt (e.g.; more mature companies with greater financial resources) and also foreign-owned competitor companies, which have interest deductibility in their home countries.

On the transitional issue, Australian companies could only replace their debt by:

a) selling assets, which might have economic implications particularly in the low growth global economy, with current concerns about global financial stability which are causing lower asset prices for assets of many sectors. Asset sales would in essence, downsize the Australian companies,

b) raising new capital, which we suggest is challenging given the highly volatile capital markets, or

c) implementing cost reduction programs to free up cash flow, involving not just marketing campaigns but also addressing staff and capital efficiency and cost structures, with consequences in this challenging economic environment.

For some corporate entities, for example those with long term debt programs in place involving third party lenders, the costs of winding back those debt programs may be significant.

All of these actions take time and would add to volatility, so the transitional issues are significant.

We submit that the Inquiry should very carefully consider the economic impact of any proposals put forward for wide-ranging interest deductibility reductions. In our view the starting position (if any such measures were ever considered) would be to provide significant grandfathering for entities with current debt structures and significant lead times for introduction of any new rules.

Targeted tax incentives including targeted lower corporate tax rates

We note a global trend, in addition to general lower corporate tax rates, to use targeted company tax rate cuts or concessions to grow new investment – tax incentives to drive growth in the same way as investment allowance deductions and similar incentives. For example:

- the UK introduced a 10% tax rate (the 'patent box') to allow basing patents and resulting income and employment in the UK: this was found in its original form to constitute 'harmful tax competition' so the UK is adjusting the 10% concession to encourage substantial business activity. Other countries are following that UK approach.
- Singapore has a tax incentive policy targeted at creating new employment, whereby companies establishing particular businesses in Singapore with commitments to new specified employment levels receive tax incentives – the incentives appear geared to growing employment. Other countries are adopting low-rate incentives to attract specific substantial business activity.

The G20 and OECD global BEPS agenda allows legitimate tax competition using significant business incentives.

These incentives-based approaches are different to the trend of recent years to economy-wide "broad base low rate" company tax settings. The incentives are geared to specific committed activity.

We do not necessarily advocate such targeted tax rate reductions as compared with economy-wide reductions as they involve government targeting and supervision and raise issues for sectors not covered. However, we do note that where governments see their revenues as constrained, then targeted tax rate reductions are one way of reducing the temporary adverse outcomes of economy-wide corporate tax rate reductions.

Personal Tax and non-business deductions

In relation to the personal tax system the Inquiry focuses on individual **non-business income,** that is, not the income of self-employed business people, and the related deductions. The terms of reference do not look to business deductions:

1) We support the need to address Australian personal tax rates as in our view they affect incentives to work Australian personal tax rates also affect the attractiveness of remaining in Australia for talented mobile Australians.

2) The Productivity Commission issued a 2015 Working Paper on "Tax and Transfer Incidence in Australia"[v] discussing the interaction of Australia's personal income and social welfare tax benefits, where it confirmed that:

> Australia's tax personal tax rates and social welfare expenditure are highly progressive in that higher income taxpayers pay the overwhelming bulk of personal taxes and have low social welfare expenditures offsetting their contribution to the tax mix.

"While Australia's level of transfers is well below the OECD average (and below that of other OECD 10 countries), its level of in kind services is slightly above the OECD average (figure 3.4)."

3) The expenditure of individuals in earning assessable income involves not just "work-related expenses" that relate to the paid employment of an individual. The deductions also relate to the derivation of assessable income other than employment income, and we highlight in particular, income from dividends, interest and capital assets such as rent-producing property. The different classes of assessable income and related deductions require careful consideration.

4) We could suggest many options for simplifying the treatment of individuals carrying on businesses, but that is outside the scope of the Inquiry's terms of reference.

If the Committee requires further information please contact in the first instance

Yours sincerely

Attachments

Appendix 1 – Inquiry into tax deductibility - terms of reference

http://www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Tax_deductibility

On Tuesday 1 December 2015 the Treasurer, the Hon Scott Morrison MP, asked the Committee to undertake an inquiry into the simplification of the personal and company income tax system.

The Committee invites interested persons and organisations to make submissions addressing the terms of reference by **Friday, 15 January 2016**. Online submissions can be made on this page.

For information on how to make a submission, go to our Making a submission to a Committee Inquiry page.

terms of reference

The Committee will examine some options to simplify the personal and company income tax system, with a particular focus on options to broaden the base of these taxes in order to fund reductions in marginal rates. Matters to be examined include:

- The personal tax system as it applies to individual non-business income, with particular reference to the **deductibility of expenditure of individuals in earning assessable income, including but not limited to an examination of comparable jurisdictions such as the United Kingdom and New Zealand; and**
- The **company income tax system, with particular reference to the deductibility of interest incurred by businesses in deriving their business income.**

Committee Secretariat contact:

Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
Canberra ACT 2600

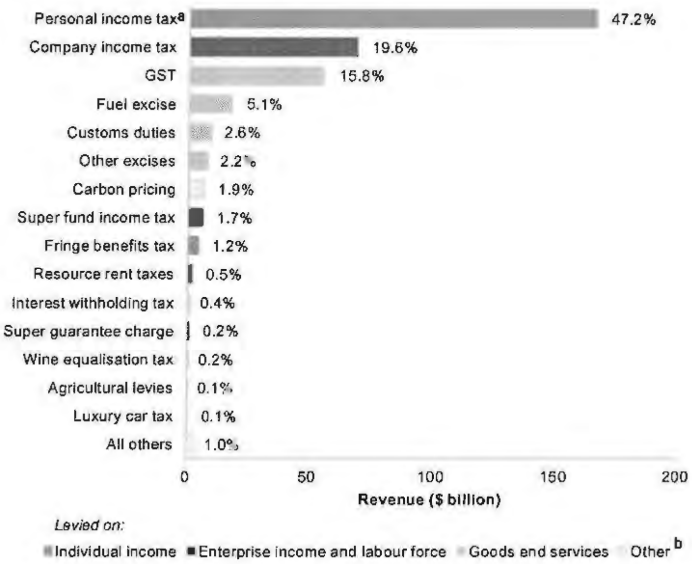
Phone: (02) 6277 4587
Fax: (02) 6277 4774
economics.reps@aph.gov.au

Appendix 2 – Productivity Commission - tax mix in Australia

Source: Productivity Commission "Tax and Transfer Incidence in Australia" October 2015
http://www.pc.gov.au/research/completed/tax-and-transfer-incidence

"In 2013-14, the Australian Government raised $352 billion in taxation revenue, equivalent to 23 per cent of Australia's GDP (ABS 2015a). Eight out of every ten dollars in tax revenue raised came from just three taxes: personal income tax, company income tax and the GST. Personal income tax is by far the largest tax, accounting for almost half of all Australian Government tax revenue (figure 2.1)"

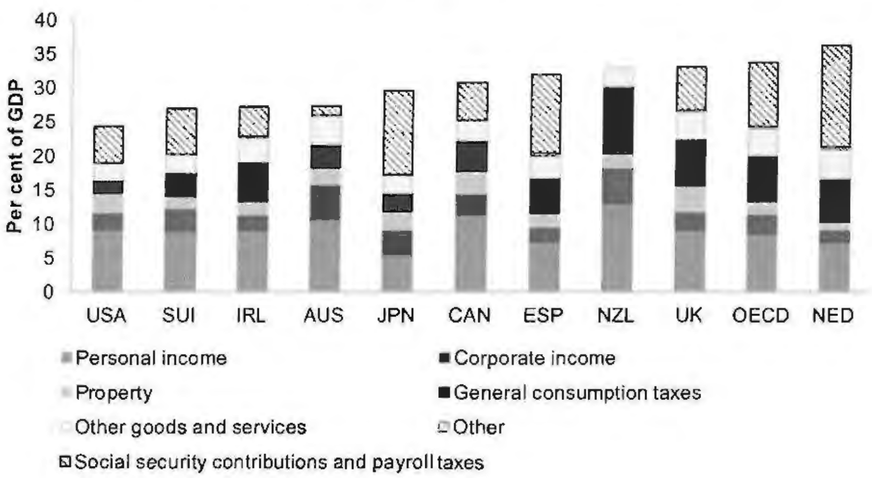
Figure 2.1 **Revenue from Australian Government taxes 2013-14**



[a] Includes the Medicare levy and Medicare levy surcharge. [b] Includes taxes levied on property, non-resident income, the use of goods and the performance of activities.

Sources: ABS (*Taxation Revenue, Australia, 2013-14*, Cat. no. 5506.0); Treasury (2015a).

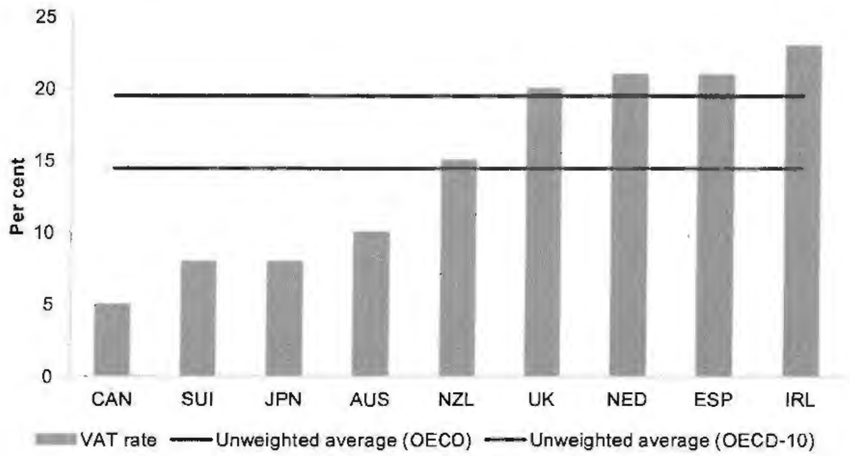
Figure 3.1 **Taxes as a share of GDP in OECD-10 countries[a,b,c] 2012**



[a] Includes state and local government taxes. [b] The OECD amount is an unweighted average for all 34 countries in the OECD (not only those presented in the figure). [c] Other taxes include EU customs duties. Payroll taxes also includes other workforce taxes. General consumption taxes include value added tax and sales taxes. Other goods and services taxes include taxes such as excises and levies.

Source: OECD (2014c).

Figure 3.2 **Value added tax rates in OECD-10 countries**[a,b]
As at 1 January 2014



[a] The United States is not included because it does not have a value added tax (VAT). However, there are retail sales taxes in most states. Some Canadian provinces also apply a sales tax in addition to the VAT. [b] The rate for Japan increased from 5 per cent to 8 per cent on 1 April 2014.

Source: OECD (2014a).

Appendix 3 – 2009 Report of Australia's Future Tax System Review, focusing on comments about interest deductibility tax base and company tax system

Source: Australia's future tax system Report to the Treasurer, December 2009
http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm

(highlighting added by EY)

"Key Directions

"Maintain the company income tax rate towards the lower end of the small to medium OECD economy average, with a reduction to 25 per cent over the medium term. This aims particularly to increase the level of business investment in Australia across all sectors, including foreign direct investment; promote more entrepreneurial activity; and reduce incentives for profit-shifting offshore.

- A business-level expenditure tax could suit Australia in the future and is worthy of further consideration and debate, along with a reconsideration of dividend imputation's place in an internationally integrated economy."

"5.1 A company income tax system for the future

The increasing globalisation of the Australian economy raises questions about the long-term appropriateness of the existing company income tax system and the dividend imputation system.

Australia, in the future, should consider moving the company income tax system towards a business level expenditure tax, such as an allowance for corporate equity, subject to further international development of tax models.[1] A business level expenditure tax would reduce source-based taxes on the normal return to investment in Australia, provide greater neutrality between debt and equity and reduce tax biases across different investments, improving the stability and productivity of domestic business and investment. It may also provide opportunities for wide-ranging simplification of the company income tax system.

Such a system would provide a more effective mechanism for company and personal tax integration in a world of increased capital mobility.

However, in contemplating the replacement of company income tax with an expenditure tax, a significant concern for the Review is that there has been limited or no practical use of such taxes for this purpose. Replacing the current company income tax system with one of these alternatives would therefore involve considerable risks. For example, the practical implications from a tax administration and compliance perspective are unknown. There may also be opportunities for tax arbitrage if Australia is one of only a few countries using such a system.

In light of the potential benefits of business level expenditure taxes, there is likely to be increased interest internationally in them as replacements for company income taxes. Such a system may suit Australia and is worthy of further consideration and public debate. It is possible that other economies will move towards such systems over coming years and it could be in Australia's interest to join this trend at an early stage. An example of a blueprint for the reform of Australia's company income tax system, based on the allowance for corporate equity, is presented in S 0rensen and Johnson (2009).

Moving to a business level expenditure tax could be complemented with improved taxation of savings income. This could include moving to a broader-based dual income tax that includes dividends and greater use of accrual recognition or deeming to measure savings income. Such a move could provide a more equitable and efficient basis for the taxation of savings, and be designed to reduce income conversion problems.

---

1 The case for these systems was outlined for the Review in the Australia's Future Tax System Conference Papers (Sorensen and Johnson 2010 & Auerbach 2010).

B — Investment and entity taxation | B1 — Company and other investment taxes

Recommendation 26: The structure of the company income tax system should be retained in its present form, at least in the short to medium term.

A business level expenditure tax could suit Australia in the future and is worthy of further consideration and public debate. It is possible that other economies will move towards such systems over coming years and it could be in Australia's interest to join this trend at an early stage.

Recommendation 27: The company income tax rate should be reduced to 25 per cent over the short to medium term with the timing subject to economic and fiscal circumstances. Improved arrangements for charging for the use of non-renewable resources should be introduced at the same time."

And (later)

"11.2 Macroeconomic stability and national savings

Elements of the tax system can affect macroeconomic stability. For example, tax distortions such as the asymmetric treatment of debt and equity can encourage excessive leveraging and other financial market problems, which have been evident in the recent global financial crisis (IMF 2009b). While reductions in the company income tax rate would reduce this bias, the business level expenditure tax (identified by the Review as meriting further consideration) would substantially reduce it or eliminate it altogether.

The existing tax system is also likely to encourage excessive leveraging in pursuit of tax-preferred income. Where capital inflow is used to finance less productive assets, this can also affect long-term macroeconomic stability. In this regard, recommendations to provide a more neutral tax treatment of savings, to reduce the benefits from negative gearing and eventually abolish stamp duties on housing would also help improve macroeconomic stability.

B1-4 Refining the business income tax base

Reducing financing distortions

Financing choices of business can be distorted

Most company income tax systems, including Australia's, tax the full return to equity only, with interest payments deductible from the company income tax base. This provides companies with a tax incentive to finance investment with debt rather than equity capital. The debt-equity distortion may, however, be reduced where companies are unable to use deductions for interest payments, such as where a company is in a loss situation.

Over reliance on debt makes companies more vulnerable to insolvency and to economic shocks, and may have implications for macroeconomic stability. Providing a deduction for debt and not for equity financing may also discriminate against smaller businesses, and knowledge-based industries that invest more heavily in intangibles. Such businesses may have more difficulty borrowing.

The treatment of debt and equity for tax purposes is complex and creates opportunities for tax avoidance. This has been compounded over recent years with the increased innovation in financial products, often devised to exploit the difference in the tax treatment of debt and equity. As a result of this innovation, the traditional distinction between debt and equity has become even less clear. Increased globalisation has also increased opportunities for tax arbitrage, particularly where countries take different views as to whether a particular instrument qualifies as debt or equity.

The implications of the tax treatment of debt and equity depend in part on the source of finance for specific businesses. The following sections consider the implications for businesses with and without direct access to foreign capital.

Businesses that rely on domestic finance

To the extent that capital is not perfectly mobile, as may be the case particularly for small unlisted domestic firms, financing decisions may be influenced by taxes on capital income (dividends, capital gains, interest) at the personal level.

Where businesses do not have access to international capital — that is, they may effectively operate in a closed economy — the tax preference in favour of debt relative to equity at the company level may be offset by Australia's dividend imputation system. However, even with dividend imputation and with a closed economy assumption, investments financed by retained earnings are likely to be favoured over new equity, because of the concessional taxation of capital gains.

When earnings that would otherwise have been used to pay dividends (and been taxed in the hands of the recipient) are retained in the company, the value of equity increases and shareholders are rewarded with an accrued capital gain which is taxed preferentially on realisation at reduced rates. The shareholder can therefore delay paying tax until the share is sold and the gain realised.

As dividends and interest income are taxed at full marginal rates for domestic savers, investments financed by new equity and debt need to earn a higher return relative to investments funded by retained earnings. This higher return is required to compensate for the tax penalty they face relative to concessionally taxed capital gains.

However, while smaller companies and businesses may not have direct access to foreign capital, much foreign debt capital is raised by Australian banks or financial institutions who then on-lend to the business sector generally. The cost of equity capital for larger firms, to the extent that it is set by access to international equity, will also influence the cost of equity for smaller firms. Hence, even for this sector or group of businesses, the biases outlined for businesses with access to international finance will still be relevant.

Businesses with access to international finance

Where the marginal source of finance is the international capital market, the deductibility of interest from the business income tax base would appear to favour higher levels of debt, driven by the company or relevant income tax rate.

Interest deductibility biases the capital structure of a business towards higher levels of debt — increasing its risk exposure. Distorting these choices may discourage businesses from adopting the best approach to managing other factors associated with their capital structure. To the extent that interest withholding tax applies on the payment of interest to the non-resident investor, it may moderate the bias against equity.

For a multinational company investing in Australia through an Australian subsidiary, the allocation of debt or equity capital to that subsidiary may be motivated in part by tax planning considerations, and not directly affect risk exposure given parent guarantees over any debts of the subsidiary.

Australia's thin capitalisation and transfer pricing rules aim to safeguard against excessive interest charges being allocated to the Australian subsidiary, either by restricting deductibility for businesses that operate at above a specified level of gearing or by policing the interest rate. In this regard, the thin capitalisation rules can be seen as placing a limit on the degree to which the normal, risk-adjusted, return from an investment in Australia can be excluded from Australian tax (by being characterised as a return on debt) and the extent to which it is taxable (as the return on equity). The transfer pricing rules can be seen as a means of restricting the ability of firms to avoid tax on supernormal returns. Together, these rules play a role in ensuring what is judged to be the appropriate level of tax is collected from investment in Australia.

At an economy wide level, the overall bias in favour of debt — together with the incentive provided by dividend imputation and the capital gains tax discounting rules for domestic residents to hold domestic equity — might be reflected in a relatively high share of debt finance in the capital account of the balance of payments. For an individual firm, debt financing can exacerbate vulnerability in the profit and loss statement when revenue falls, as the debt servicing costs are essentially unavoidable, short of default — unlike dividend payments. The increased vulnerability of firms would be expected to magnify the impact of financial shocks and other sources of macroeconomic instability.

Tax-induced distortions to financing decisions should be reduced to avoid encouraging firms to rely excessively on debt finance and to avoid biasing other financial decisions, such as dividend payouts. However, outside of the business level expenditure taxes outlined previously, it is difficult to reduce distortions to financing decisions.

Principle
Thin capitalisation and transfer pricing rules should continue to be used as mechanisms to ensure that what is judged to be the appropriate level of tax is collected from investments in Australia."

EY highlights that, since the Henry Review, Australia has in fact:
a) Replaced our transfer pricing rules and
b) Tightened the thin capitalisation rules

Thus in our view the action seen as appropriate by the Henry Review has been taken.

Appendix 4 – Business Tax Working Group Review for previous Labor Government re lower corporate income tax, Nov.2012

Source: Business Tax Working Group, Final Report to the Labor Government, 1 November 2012
http://www.treasury.gov.au/PublicationsAndMedia/Publications/2012/BTWG-Final-Report

(highlighting added by EY)

"Executive Summary

1. The Business Tax Working Group (Working Group) was established following the Tax Forum in October 2011...

2. The Government asked the Working Group to prioritise consideration of a cut to the company tax rate accompanied by measures that fully offset the cost.[2] The Working Group released a Discussion Paper in August 2012 that sought views from stakeholders about some specific base broadening options to offset the cost to revenue of a cut to the company tax rate.

3. The Discussion Paper outlined the Working Group's view that a lower company tax rate would lead to greater investment in Australia, which would contribute to improved productivity and higher incomes for Australians. Australia is a relatively small, somewhat open economy that is increasingly integrated with international capital markets and reliant on highly mobile international capital to fund new investment. In this context, a lower statutory corporate tax rate would increase Australia's ability to attract foreign investment and increase the quantity of the capital stock for greater productivity. Over time, it would generally be expected that the economic benefits of greater productivity will be distributed between capital owners, labour and consumers, through higher profits and real wages and through lower prices.

4. The Discussion Paper also outlined a set of principles for business tax reform that have guided the Working Group's thinking and which would be relevant for future consideration of business taxation reform.

5. The Working Group's preliminary view was that a lower company tax rate funded by business tax base broadening could deliver net benefits to the economy. The Working Group's discussion paper canvassed base broadening options in the areas of interest deductibility, capital allowances and research and development expenditure, which, if adopted, could fund a company tax rate cut of two to three percentage points.

6. Following the release of the Discussion Paper, the Working Group met with 20 stakeholder groups and received more than 80 written submissions.

7. The Working Group also asked Treasury to undertake modelling of the potential long-run economic impacts of a lower company tax rate. The modelling, while preliminary, suggests that a one percentage point cut in the company tax rate, depending on how it was funded, could have a positive economic impact in the long run, raising GDP and real wages by around 0.2 per cent, and increasing household consumption. While modelling on the base broadening options was not completed and so could not be determinative for the Working Group's findings, the tentative and preliminary results reinforced some questions raised in consultations and submissions about whether, in theory, some combinations of base broadening and rate cutting could deliver a net economic benefit overall.

8. The Working Group has made a number of findings but is unable to recommend a revenue neutral package to lower the company tax rate. Several factors have been important to the Working Group in reaching this conclusion.

9. First, changes to depreciation arrangements could have a significant impact on the after-tax return on investment, particularly where there is a long lead time before income is produced (for instance, gas pipelines). Australia is currently experiencing an unprecedented level of investment, planned or underway, in the resources sector underpinned by strong demand from Asia. There are a number of significant investment decisions relating to resource projects that have recently been committed or will be considered in the near future. The sheer scale of capital investment in individual projects and the long lead times before production commences mean that changes

2 Hon. Julia Gillard MP, Prime Minister, Closing remarks at the Prime Minister's Economic Forum, 13 June 2012.

made now to depreciation arrangements can have significant impacts on their expected returns.

10. Second, reductions in the company tax rate during the 1980s and 1990s were paid for by making the business tax base broader. As a consequence, the Working Group has found it difficult to identify support for measures that would further broaden the business tax base. As noted in the Discussion Paper, further broadening of the business tax base would involve a reversal of measures that have recently been enacted, the removal of longstanding taxation treatments that were not changed in previous base broadening exercises, or would significantly affect small groups of taxpayers.

11. Third, the economic benefits from a reduction in the company tax rate from the current rate are likely to be smaller than when the rate was much higher in the 1980s and 1990s, notwithstanding that capital may have become more mobile since then. The Working Group considers that a cut of two to three percentage points would be required to drive a significant investment response.

12. These factors have underpinned the lack of support in the business community for pursuing a lower rate/broader base reform of business taxation in Australia at this time. Many businesses that were particularly affected by the base broadening options asserted that they would have been worse off under the trade-offs canvassed. Further, some submissions questioned whether there would be a net benefit for the economy as a whole from a combination of some of the base broadening measures canvassed and a cut in the company tax rate of between one and three percentage points.

13. Nevertheless, the Working Group considers that there are benefits from a lower company tax rate and therefore Australia should have an ambition to continue the trend from the late 1980s to reduce its company tax rate as economic and fiscal circumstances and other budget priorities permit. A reduced rate would result in greater foreign investment flows into Australia by increasing the after-tax return on investment. Greater investment would enhance the capital to labour ratio, a process known as 'capital deepening', which could increase the marginal product of labour, resulting not only in higher economic growth but also higher wages in the long term.

14. This finding is consistent with the direction proposed by the Australia's Future Tax System (AFTS) Review, which recommended a tax mix switch and the introduction of improved charging arrangements for non-renewable resources as the precursor to a rate reduction.[3]

15. The Working Group's terms of reference also required it to consider the merits of a business expenditure tax, including an allowance for corporate equity (ACE). In its Discussion Paper, the Working Group set out its consideration of an ACE and expressed its initial view that an ACE should not be pursued in the short to medium term but may be worthy of further consideration and public debate in the longer term. The Working Group remains of this view following public consultation.

16. Tax reform should be seen as a continual process. The most recent conversation about tax reform in Australia began with the AFTS Review and continued at the Tax Forum last October. Following the Tax Forum, the Working Group was established to focus initially on the tax treatment of losses...This Report fulfils the second phase of the Working Group's task, which was to consider reducing the corporate tax rate further or moving to a business expenditure tax system, funded from within the business tax system.

17. The Working Group commends the principles for business tax reform it has identified as a useful framework that articulates the range of relevant considerations. The Working Group also supports the continuation of a consultative approach to business tax reform.

18. The Working Group would like to thank all of those organisations and individuals who made submissions and attended meetings during the Working Group's deliberations. The Working Group would also like to thank Alf Capito of Ernst & Young, Matt Cowgill of the Australian Council of Trade Unions, and Peter Crone of the Business Council of Australia, who assisted the Working Group. Finally, the Working Group would like to acknowledge the Treasury staff that assisted throughout this process.

Findings of the Business Tax Working Group

Finding 1: The Working Group believes there could be economic benefits associated with a cut in the company tax rate. A reduced rate would lead to greater investment in Australia in the longer term,

3 AFTS Review (2009), *Final Report to the Treasurer*, Treasury, Canberra (recommendation 27).

which would contribute to improved productivity and higher wages for Australians.

Finding 2: The Working Group considers that a cut in the company tax rate of two to three percentage points would be needed to drive a significant investment response.

Finding 3: The Working Group has 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.

Finding 4: The Working Group notes that there is considerable debate and uncertainty around the magnitude of the distortion associated with the remaining concessions in the business tax base, including concessions that promote important activity like investment in infrastructure and research and development.

Finding 5: The Working Group received feedback from many individual businesses asserting that they would be worse off as a result of the trade-offs canvassed in the Discussion Paper. Further, some submissions questioned whether there would be a net benefit for the economy as a whole from a combination of some of the base broadening measures canvassed and a cut in the company tax rate of between one and three percentage points. Overall, the Working Group has found there is a lack of agreement in the business community to make such a trade-off.

Finding 6: The Working Group considers that Australia should have an ambition to reduce its company tax rate as economic and fiscal circumstances permit. This would need to be considered against other budget priorities and should take into account the overall mix of business taxation.

Finding 7: The Working Group commends the principles for business tax reform it has identified as a useful framework that articulates the range of relevant considerations. The Working Group also supports the continuation of a consultative approach to business tax reform.

Finding 8: The Working Group considers that an ACE should not be pursued in the short to medium term but may be worthy of further consideration and public debate in the longer term."

Appendix 5 – selected countries with Allowance for Corporate Equity

Belgium:
Belgian companies and foreign companies with a Belgian permanent establishment or real estate in Belgium may benefit from a tax deduction equal to a percentage of the "risk capital." This deduction is not reflected in the financial accounts. The "risk capital" equals the total equity, including retained earnings, as reported in the non-consolidated closing balance sheet of the financial year preceding the tax year (upward or downward adjustments of the risk capital are taken into account on a pro rata basis), excluding the net tax value of the company's own shares and several tax exempt items and tax credits.

The tax deduction is computed by multiplying the risk capital by the average interest rate applicable for a risk-free, long-term Belgian government bond (the 10-year obligations linéaires – lineaire obligaties, or OLO) for the third quarter of the penultimate year before the tax year. The notional interest deduction rate is capped at 3% (3.5% for small companies) if the above calculation method would result in a higher percentage. The deduction may not be carried forward in the event of a loss.

http://www.ey.com/GL/en/Services/Tax/Worldwide-Corporate-Tax-Guide---XMLQS?preview&XmlUrl=/ec1mages/taxguides/WCTG-2015/WCTG-BE.xml

Brazil:
A Brazilian company may calculate notional interest on the net equity value (adjusted by the deduction of certain accounts) paid to both resident and non-resident shareholders. Notional interest on equity is a hybrid mechanism to remunerate capital to the extent that amounts paid are treated as deductible expenses for corporate tax purposes (similar to financial expenses) while shareholders are remunerated for their investment in capital.

Interest on equity is calculated on the adjusted net equity by applying the official long-term interest rate (TJLP) but subject to limitation established by law, specifically, 50% of current earnings or accumulated profits. It should be noted, however, that in December 2007 the Brazilian accounting regulations were amended to determine, among other things, that the accumulated profits account was extinguished. Despite the fact that the accounting rules have changed, still the relating tax consequences for the Notional Interest on Equity were not yet defined by the tax authorities.

Interest on equity paid to foreign shareholders is subject to withholding tax in Brazil charged at a general 15% rate (or 25% if of payment is made to a low-tax jurisdiction). Interest on equity payments generates tax-deductible expenses. If a Brazilian legal entity is a shareholder, gross revenue taxes (PIS and COFINS) also apply on interest on equity received.

http://www.ey.com/Publication/vwLUAssets/Doing_business_in_Brazil_2011/$FILE/Doing%20Business%20in%20Brazil%202011.pdf

Italy (reintroduced in 2011)
The notional interest deduction (allowance for corporate equity, or ACE) grants Italian enterprises (including Italian branches of foreign businesses) a deduction from taxable income corresponding to an assumed "notional return" on qualifying equity increases contributed after the 2010 fiscal year. Italian resident companies are permitted to deduct from their net taxable income (after applying any tax loss carry-forward) an amount corresponding to a notional return on the increase in equity as compared to the equity as of the end of the 2010 fiscal year (New Equity). The ACE deduction may offset the net tax base but it cannot generate a tax loss. Any excess ACE can be carried forward or converted into tax credits for IRAP purposes. For 2014, 2015 and 2016, the rate of the notional return is fixed at 4%, 4.5% and 4.75% respectively. For subsequent years, the Ministry of Finance will determine the percentage annually on the basis of the average return on Italian public debt securities. Newly listed companies benefit from a 40% increase in the basis on which the benefit is computed with reference to any equity increase occurring in the year of the listing and in the following two years.

http://www.ey.com/GL/en/Services/Tax/Worldwide-Corporate-Tax-Guide---XMLQS?preview&XmlUrl=/ec1mages/taxguides/WCTG-2015/WCTG-IT.xml

Endnotes

[i] http://stats.oecd.org//Index.aspx?QueryId=58204

[ii] The Effect of Base-Broadening Measures on Labor Supply and Investment: Considerations for Tax Reform (Gravelle and Marples) October 22, 2015, Congressional Research Service, https://fas.org/sgp/crs/misc/R44242.pdf

[iii] IMF Staff Discussion Note SDN/11/11,Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions (de Mooij), 2011 https://www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf

[iv] The authors were Doctors Robert J Carroll and Thomas Neubig of the EY US LLP Quantitative Economics and Statistics (QUEST) group.

Robert J. Carroll is the National Director of Ernst & Young LLP's Quantitative Economics and Statistics group, based in Washington DC. Before joining EY, he was the Deputy Assistant Secretary for Tax Analysis of the US Treasury Department, the Department's top economist working on tax policy issues.

Thomas Neubig was appointed in 2014 as Deputy Head of the OECD Centre for Tax Policy and Administration Tax Policy and Statistics Division. Before that he spent 20 years at EY and was EY's Director of Quantitative Economics and Statistics. From 1980 to 1990, Mr. Neubig was with the U.S. Treasury Department Office of Tax Analysis, as Director and Chief Economist with earlier roles as Deputy Director for domestic taxation and Financial Economist.

Three publicly available studies are:

- A 2012 report for the Private Equity Growth Council, "Proposed limits to deductibility of interest to finance corporate rate" - http://www.pegcc.org/ey-report-proposed-limits-to-deductibility-of-interest-to-finance-corporate-rate-reduction/

- A 2013 "Macroeconomic analysis of a revenue-neutral reduction in the corporate income tax rate financed by an across-the-board limitation on corporate interest expenses" prepared for the BUILD Coalition - http://buildcoalition.org/wp-content/uploads/2013/07/EY-Build-Study-July-2013.pdf

- A 2015 report prepared on behalf of the Organization for International Investment, "Macroeconomic impacts of limiting the tax deductibility of interest expenses of inbound companies"
  http://ofii.org/sites/default/files/EY%20Report%20for%20OFII%20on%20macroeconomic%20impact%20of%20interest%20limitation%20June%202015.pdf
  which found, broadly:
  "An important issue for a revenue-neutral tax reform is how a lower CIT rate or lower tax rates generally will be paid for. Understanding the potential impacts and tradeoffs associated with using the revenue from specific revenue-raising provisions is an important consideration in designing a pro-growth tax reform plan. This analysis pairs further limits on the deductibility of interest expenses of inbound companies with offsetting uses of the additional revenue – a revenue-neutral reduction in the CIT rate or a revenue-neutral increase in government spending. This report finds that further limiting the deductibility of interest expenses by inbound companies would reduce US GDP in the long-run, after taking into account the effect of a revenue-neutral reduction in the CIT rate"

[v] http://www.pc.gov.au/research/completed/tax-and-transfer-incidence