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Company income tax deductions

3.1 As is the case with individuals, businesses are subject to income tax based on their taxable income. If businesses are sole traders, or consist of partnerships or trusts, their tax liability is that of their owners. In contrast, companies are taxed at the corporate level. Australian shareholders receiving dividend income from the company receive a credit against their tax liability for the tax paid by the company.[1]

3.2 In Australia, business expenditure is tax deductible if it has a valid connection to business activities.[2] Expenses incurred during the course of ordinary business activities are referred to as revenue expenses, which include interest on loans for the business. Revenue expenses are deductible in the same year in which they are incurred. Capital expenses, such as those relating to the purchase of buildings and other assets, are deducted over the longer term and the depreciation amount of an asset can be tax deductible each year over the course of a number of years.[3]

3.3 The committee was asked to examine options to simplify the company income tax system, focussing on broadening the base to fund reductions in marginal rates. Particular reference was made to the deductibility of interest incurred by businesses in deriving their income.

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1 Treasury, *Submission 19*, p. 10.

2 A list of business tax deductions is at Appendix D.

3 Treasury, *Submission 19*, p. 10.

Interest deductibility

3.4 Under Australia's company income tax system, interest expense is tax deductible to the extent it is incurred in gaining or producing assessable income or for the operation of a business. As with other business deductions, the expense cannot be capital, private or domestic in nature.[4]

3.5 The deductibility of interest expense is provided for through the general provision for deductions in section 8-1 of the *Income Tax Assessment Act (1997)* (Cth), rather than a specific section for interest deductibility.[5]

3.6 Evidence provided by the Parliamentary Budget Office (PBO) shows that interest costs vary by company size and industry type, meaning that interest deductibility is more important to some companies than others. Table 3.1 shows company interest expenses by company size, based on annual turnover. In 2014-15, interest expenses claimed by all companies in their tax returns totalled $42 billion, $27 billion of which were claimed by 955 very large companies.[6]

3.7 Table 3.1 illustrates that, for very large companies, around 2.3 per cent of their total expenses claimed were interest deductions. In recent years, this proportion has declined. The PBO suggested this decrease may reflect a range of factors including a general cut in interest rates during this period.[7]

3.8 The PBO stated that in 2012-13, the largest interest expense claims, as a proportion of total claimed expenses, were in the rental, hiring and real estate services industry, and the electricity, gas, water and waste services industry, which were around 6.6 per cent of reported expenses.[8] In absolute terms, the mining and manufacturing industries had the largest interest expenditure, 20 per cent and 15 per cent of total reported interest expenses, respectively.[9]

3.9 In regards to the finance and insurance industries, the PBO explained that these industries have high levels of interest expense, with interest comprising nearly 26 per cent of their total expenses as they 'are in the

4 Treasury, *Submission 19*, p. 10.

5 Law Council of Australia, *Submission 6*, p. 4.

6 Parliamentary Budget Office (PBO), *Submission 3 (25th Parliament)*, p. 2. The category of 'very large' company includes those with an annual company turnover of more than $250 million.

7 PBO, *Submission 25*, p. 22.

8 PBO, *Submission 25*, p. 23.

9 PBO, *Submission 25*, p. 23.

business of borrowing and lending money', as such, interest expense is a 'working expense…rather than being a cost of financing'.[10]

Table 3.1 Company interest deductions by company size (turnover), 2013-14

Company turnover	Number of companies	Total interest expenses ($m)	Percentage of total interest expenses claimed (%)	Total expenses ($m)	Interest as a percentage of total expenses (%)
<$2 million (micro)	676,431	3,494	8.2	189,284	1.8
<$10 million (small)	56,405	2,624	6.2	221.834	1.2
<$100 million (medium)	15,026	5,234	12.3	381,843	1.4
<$250 million (large)	1,174	3,755	8.8	180,719	2.1
>$250 million (very large)	955	27,383	64.4	1,207,601	2.3
Total (excluding finance and insurance)	**749,991**	**42,490**	**100.0**	**2,181,281**	**1.9**

Source Parliamentary Budget Office (PBO), Submission 2 (45th Parliament), p. 2.

Significance of interest deductibility

3.10 The importance of allowing businesses to deduct their interest expenses for borrowings (including debt funded investments) was emphasised by a range of submitters. For example, the Law Council of Australia referred to interest deductibility as an 'essential component of a neutral tax system',[11] while the Australian Private Equity and Venture Capital Association (AVCAL) asserted that it plays a significant role in assisting business activity and economic growth.[12] Similarly, the Australian Bankers' Association (ABA) outlined the importance of maintaining low cost capital to the Australian economy through the deductibility of interest payments, stating that debt funding 'forms the basis upon which most consumers and businesses invest and grow'.[13]

3.11 AVCAL also explained that the importance of interest deductibility goes beyond financing business operations, stating that:

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10 Mr Colin Brown, First Assistant Parliamentary Budget Officer, PBO, *Committee Hansard*, Canberra, 5 February 2016, p. 25.

11 Law Council of Australia, *Submission 6*, p. 2.

12 Australian Private Equity and Venture Capital Association Limited (AVCAL), *Submission 7*, p. 4.

13 Australian Bankers' Association (ABA), *Submission 4*, p. 1.

> It is also routinely considered within the context of decision-making by investors on the merits of investing in a particular business. The availability of deductions for interest costs is therefore fundamental to the overall competitiveness of the Australian business sector.[14]

3.12 The Treasury noted that interest deductibility is important for new businesses operating with high levels of expenditure, stating that:

> The ability for the business to borrow funds and deduct the interest and other expenditure against assessable income significantly benefits the business, provides an incentive for investment and positively impacts the economy. Without the ability to deduct the cost of expenditure, some profitable investments may happen in other jurisdictions or not at all.[15]

3.13 As the PBO noted, some businesses are more reliant on interest deductibility than others. Submitters asserted that specific sectors, such as financers, property development and investment, and capital intensive industries, rely heavily on debt funding and interest deductibility.[16]

3.14 The Commercial Asset Finance Brokers Association of Australia (CAFBA), representing companies that assist businesses to finance the purchase of equipment, maintained that interest deductibility is a 'major incentive' for companies to invest in capital. It added that, in Australia, 'a significant proportion of all new equipment purchased by businesses is [debt] financed'.[17]

3.15 The Property Council of Australia referred to debt funding as 'critical to financing major property and infrastructure projects'.[18] It argued that 'interest deductibility is a normal cost of business that creates income by encouraging investment'.[19]

3.16 The Minerals Council of Australia emphasised the importance of interest deductibility to the mining sector due to the sheer scale of funding mining

14 AVCAL, *Submission 7*, p. 2.

15 Treasury, *Submission 19*, p. 10.

16 See, for example: Australian Equipment Lessors Association (AELA) and the Australian Fleet Lessors Association (AFLA), *Submission 26*, p. 2; Commercial Asset Finance Brokers Association of Australia (CAFBA), *Submission 8*, p. 1; Property Council of Australia, *Submission 16*, p. 2; Minerals Council of Australia, *Submission 22*, p. 1.

17 CAFBA, *Submission 9*, p. 1.

18 Property Council of Australia, *Submission 16*, p. 1.

19 Property Council of Australia, *Submission 16*, p. 1.

projects require. It stated that Australia's mining industry 'relies heavily on highly mobile foreign capital, including debt funded capital'.[20]

Integrity rules around interest deductibility: thin capitalisation and transfer pricing

3.17 From an international perspective, the rules determining what income is taxed and how tax is assessed varies from country to country. In this global context, to help address the challenges of base erosion and profit shifting (BEPS),[21] most countries have integrity rules that apply to interest expense incurred through international transactions.[22] Australia has comprehensive thin capitalisation rules and transfer pricing rules.[23] Other countries, including the United Kingdom[24] and New Zealand[25] also have integrity rules around these areas.

3.18 Australia's thin capitalisation rules aim to prevent excessive debt funding by disallowing interest deductions if the underlying debt exceeds certain limits.[26] The three tests used to determine the allowable level of debt deductions are:

- the 'arm's length' debt test, which benchmarks commercial or truly independent debt levels for the Australian operations;
- the 'safe harbour test', which sets the rate of debt that an entity can use to fund its Australian operations; and
- the 'worldwide gearing ratio test', which allows gearing of a company's Australian operations to be geared up to the level of the worldwide group.[27]

3.19 The PBO provided an analysis of Australian Taxation Office (ATO) data on the interest expenses of multinational companies (excluding finance

20 Minerals Council of Australia, *Submission 22*, p. 1.

21 Base erosion and profit shifting refers to tax strategies adopted by companies with multinational arms to exploit gaps and mismatches in tax rules to artificially shift profits to low or no tax locations, thereby reducing the overall company tax paid.

22 Treasury, *Submission 19*, p. 11.

23 Treasury, *Submission 19*, p. 11.

24 K Nicholson and D Burn, *United Kingdom – Corporate Deductions*, Price Waterhouse Coopers (PWC) World Wide Tax Summaries, 1 May 2015, <http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/United-Kingdom-Corporate-Deductions>, accessed 20/1/2016.

25 D Lamb, *New Zealand – Corporate Deductions*, PWC World Wide Tax Summaries, 16 June 2015, <http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/New-Zealand-Corporate-Deductions>, accessed 20 January 2016.

26 Treasury, *Submission 19*, p. 11.

27 Treasury, *Submission 19*, p. 11.

and insurance companies). It showed that in 2012-13, $26 billion of interest deductions were subject to thin capitalisation rules (57 per cent of total interest deductions), $20.6 billion of which related to 612 very large companies.[28]

3.20 The PBO noted that companies that were subject to thin capitalisation rules in 2012–13 had, on average, higher relative interest expenses (3.2 per cent) than for all companies (2.3 per cent) and companies not subject to the rules (1.6 per cent).[29]

3.21 It is to be noted that this data is based on the thin capitalisation rules as they were before significant changes were made in 2014, which first applied to companies from 1 July 2014. One of the major changes was the reduction of the statutory safe harbour debt limit for general entities from 75 per cent debt-to-assets to 60 per cent debt-to-assets (or from 3:1 to 1.5:1 on a debt-to-equity basis).[30]

3.22 Australia's transfer pricing rules dictate that pricing for international dealings between related parties reflect what is expected from unrelated parties operating at arm's length. These rules can impact on interest expenses arising from related party transactions, since the interest charged on loans needs to be charged at the rate expected to be charged by unrelated parties (i.e. on an 'arm's length' basis).[31]

3.23 Australia updated its transfer pricing rules in 2012 and 2013 to be more consistent with the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines.[32]

3.24 In April 2017, the Government's Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017 passed both Houses. According to The Treasury, the Bill updates Australia's transfer pricing rules to reference the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, as amended by the BEPS Actions 8-10 (transfer pricing and value creation) recommendations. The update applies from income years commencing on or after 1 July 2016.[33]

3.25 The Treasury stated:

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28 PBO, *Submission 25*, p. 23.

29 PBO, *Submission 25*, p. 23.

30 *Tax and Superannuation Laws Amendment (2014 Measures No. 4) Act 2014* (Cth).

31 Treasury, *Submission 19*, p. 12.

32 Treasury, *Submission 19*, p. 12; Treasury, *Income Tax: cross-border profit allocation – review of transfer pricing rules consultation paper*, February 2016, p. 1.

33 Treasury, *Submission 2 (45th Parliament)*, p. 1.

> Incorporation of the OECD Guidelines update will, amongst other things, ensure the pricing of transactions reflects the economic substance of the transaction rather than just the contractual form. For example, it will ensure the interest rates attributed to related party loans reflect the actual commercial risks assumed.[34]

3.26 A number of submitters acknowledged the importance of existing integrity measures.[35] For example, AVCAL asserted that there is no evidence of excessive leverage as a consequence of interest deductibility and that current safeguards are adequate.[36]

3.27 Similarly, the Business Council of Australia asserted that the thin capitalisation regime aims to 'strike a balance between integrity and flexibility' and that 'the recent changes to Australia's transfer pricing and thin capitalisation laws make these regimes arguably the most robust in the world'.[37]

3.28 While expressing general support for Australia's thin capitalisation and transfer pricing rules, AVCAL stressed the need for business and investor certainty. AVCAL was critical of recent changes made to thin capitalisation rules, arguing that a lack of transitional arrangements had forced some businesses to restructure their financing operations, at significant cost.[38]

3.29 In contrast, the Tax Justice Network Australia (TJN) was critical of Australia's current approach to thin capitalisation, asserting that it allows 'companies to artificially debt load up to the debt-to-equity safe harbour'.[39] The TJN contended that this 'effectively sets a safe limit on the acceptable amount of tax avoidance a multinational enterprise can enter into without facing challenge'.[40] The TJN made several recommendations to restrict artificial debt loading which are outlined later in this chapter.

3.30 The ATO indicated in relation to debt, that while every jurisdiction has integrity challenges, it felt it had 'the tools to enforce the policy settings

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34 Treasury, *Submission 2 (45th Parliament)*, p. 1.

35 See, for example: ABA, *Submission 4*, p. 2; Australian Petroleum Production and Exploration Association (APPEA), *Submission 8*, p. ii.

36 AVCAL, *Submission 7*, p. 4.

37 Business Council of Australia, *Submission 21*, p. 6.

38 AVCAL, *Submission 7*, p. 2.

39 Tax Justice Network Australia (TJN), *Submission 18*, p. 13.

40 TJN, *Submission 18*, p. 13.

which are in place'.[41] As an example of the application of these tools, the ATO noted its successful action in relation to transfer pricing against Chevron in the Federal Court in October 2015,[42] as well as its successful action against Orica in the Federal Court in December 2015, where '[P]art IVA [of the *Income Tax Assessment Act 1936* (Cth)]…the general anti-avoidance rule applied… to artificial creation of deductible debt'.[43]

OECD base erosion and profit shifting recommendations

Thin capitalisation rules

3.31 Chartered Accountants Australia and New Zealand (Chartered Accountants ANZ) drew the committee's attention to the G20/OECD BEPS recommendations[44] that were released in October 2015 as part of the BEPS Action Plan, summarising the BEPS recommendation in relation to limiting interest deductions (Action Item 4) as follows:

> Broadly, the OECD recommends a fixed ratio rule which limits an entity's net interest deductions to a fixed percentage of its profits, measured using earnings before interest, taxes, depreciation and [amortisation] (EBITDA) based on tax numbers. The percentage restriction should be set by each jurisdiction at a single benchmark fixed ratio of between 10 [per cent] and 30 [per cent] of EBITDA.[45]

3.32 Chartered Accountants ANZ further described that 'the use of EBITDA reflects policy thinking that links interest deductions to the level of the entity's taxable economic activity and, comparatively speaking, the fixed ratio rule has the advantage of greater simplicity'.[46] However, it noted that 'any decision to link net interest deductions to the level of an entity's EBITDA will need to address volatility in earnings'.[47]

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41 Mr Jeremy Hirschhorn, Deputy Commissioner, ATO, *Committee Hansard*, Canberra, 5 February 2016, p. 32.

42 Mr Jeremy Hirschhorn, ATO, *Committee Hansard*, Canberra, 5 February 2016, p. 31; Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4) [2015] FCA 1092.

43 Mr Jeremy Hirschhorn, ATO, *Committee Hansard*, Canberra, 5 February 2016, p. 31; Orica Limited v Commissioner of Taxation [2015] FCA 1399.

44 The recommendations are available in the report: Organisation for Economic Co-operation and Development (OECD), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Final Report*, October 2015.

45 Chartered Accountants Australia and New Zealand (Chartered Accountants ANZ), *Submission 11*, p. 13.

46 Chartered Accountants Australia and New Zealand (Chartered Accountants ANZ), *Submission 11*, p. 13.

47 Chartered Accountants Australia and New Zealand (Chartered Accountants ANZ), *Submission 11*, p. 14.

3.33 Chartered Accountants ANZ emphasised that if the proposed fixed ratio range was implemented, 87 per cent of the companies studied by the OECD would be able to deduct all of their net third party interest costs. The group suggested that this model, if implemented, could create tax competition between nations, whereby a nation could assume a higher fixed ratio with more lenient interest deductibility rules in order to attract international investment.[48] These potential tactics, Chartered Accountants ANZ noted, highlight the need for 'a multi-lateral approach to implementing the OECD recommendations'.[49]

3.34 The OECD also recommended an optional fall-back rule whereby, according to Chartered Accountants ANZ, 'an entity with net interest expense above a country's fixed ratio [could] deduct interest up to the level of net third party interest/EBITDA ratio of its worldwide group'.[50] This would potentially be subject to a cap of 100 per cent of total group interest; however nations could apply an uplift of up to 10 per cent to prevent double taxation.[51]

3.35 Whilst Australia's rules are premised on the proportion of debt as compared to the assets of the entity rather than net interest as compared to EBITDA, in evidence to the committee, the Treasury explained that the OECD's final report had made allowance for Australia's rules, where countries 'for their own specific reasons, may decide to continue with a debt-to-asset treatment', as well as the arm's length debt test.[52] These settings are required as Australia's circumstances involve 'relatively high corporate rates internationally, high infrastructure investment needs, resource rich, and [we are] pretty reliant on foreign capital'.[53] AVCAL cited the Board of Taxation's Review of the Arm's Length Debt Test (2014) which had highlighted the importance of the arm's length debt test, particularly for taxpayers that are 'generally of the kind that contributes significant economic activity within the services, resources and infrastructure industries'.[54]

48 Chartered Accountants ANZ, *Submission 11*, p. 13.

49 Chartered Accountants ANZ, *Submission 11*, p. 14.

50 Chartered Accountants ANZ, *Submission 11*, p. 14.

51 Chartered Accountants ANZ, *Submission 11*, p. 14.

52 Mr Rob Heferen, Deputy Secretary, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 33.

53 Mr Rob Heferen, Deputy Secretary, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 33.

54 AVCAL, *Submission 7*, p. 3; Board of Taxation, *Review of the Thin Capitalisation Arm's Length Debt Test*, 2014, pp. 5-6.

3.36 Chartered Accountants ANZ made a similar comparison between Australia's rules and the OECD's approach, stating that overall, 'Australia's current thin capitalisation regime already has many of the hallmarks of the OECD's *flexible* approach to limiting interest deductions'.[55] In addition, it warned that as the current stage in the BEPS process involves monitoring the reactions of governments around the world, 'it would be unwise for Australia to be a "first mover" in implementing the OECD recommendations'.[56]

3.37 The Treasurer responded to the release of the OECD recommendations in October 2015, stating that:

> …the Government will be consulting with stakeholders, foreign governments and the OECD and will pay close attention to ensuring investment activity is not compromised and that Australia remains an economically competitive place to do business.[57]

3.38 The Treasury noted that it is currently considering the recommendations alongside the impact of the 2014 changes to the thin capitalisation rules,[58] and that a process will be undertaken to ensure that Australia's rules 'do not allow companies to have quite a departure from the base of the 30 per cent EBITDA under reasonable assumptions'.[59]

Anti-hybrid rules

3.39 The TJN expressed concern about whether Australia was doing enough to counter hybrid mismatch arrangements.[60] Hybrid mismatch arrangements are arrangements that 'exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral'.[61]

3.40 In 2015, the OECD, as part of the BEPS Action Plan, released its final report on Action Item 2, *Neutralising the Effects of Hybrid Mismatch*

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55 Chartered Accountants ANZ, *Submission 11*, p. 16.

56 Chartered Accountants ANZ, *Submission 11*, p. 17.

57 The Hon. Scott Morrison MP, Treasurer, 'OECD report supports Australian Government action on multinational tax avoidance', *Media Release*, 6 October 2015.

58 Treasury, *Submission 19*, p. 11.

59 Mr Rob Heferen, Deputy Secretary, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 33.

60 Dr Mark Zirnsak, Spokesperson, TJN, *Committee Hansard*, Canberra, 5 February 2016, p. 30.

61 Organisation for Economic Co-operation and Development (OECD), Base Erosion and Profit Shifting Project (BEPS), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - Final Report*, 2015, p. 11.

Arrangements. The report makes recommendations regarding the design of domestic rules and the development of model treaty provisions that would neutralise the tax effects of hybrid mismatch arrangements.[62]

3.41 In the 2017-17 Budget, the Government announced that it will implement the OECD's recommendations. The Treasury explained:

> Under the new rules to neutralise hybrid mismatch outcomes, Australia will deny a tax deduction if the offshore related party receiving the payment is not taxed on the income. Similarly, if a tax deduction is not denied to an offshore related party in relation to a payment to an Australian entity which would otherwise not be taxed in Australia, the income received in Australia will be taxed.[63]

Arguments for retaining interest deductibility

3.42 The importance of retaining interest deductibility within the company income tax system was highlighted by a range of stakeholders, with the main themes being that:

- removing interest deductibility would negatively impact on investment and the Australian economy;
- interest deductibility in Australia is consistent internationally, and its removal would undermine the competitiveness of Australian companies; and
- Australia needs to reduce its corporate tax rate, however the corporate tax system alone cannot fund this reduction.

Impact on investment and the Australian economy

3.43 One of the more common criticisms of the idea of removing interest deductibility was that it would have far-reaching, negative consequences for investment and the Australian economy as a whole due to the increase in the cost of obtaining debt funding. For example, the Law Council of Australia argued that removing the existing tax deductibility for businesses 'would result in a reduction in investment, job creation and economic growth'[64] and KPMG argued it would 'create its own distortions and detrimental disincentives'.[65]

62 OECD, BEPS, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - Final Report*, 2015, p. 11.

63 Treasury, *Submission 2 (45th Parliament)*, p. 1.

64 Law Council of Australia, *Submission 6*, p. 2.

65 KPMG, *Submission 10*, p. 4.

3.44 The ABA was concerned that removing interest deductibility would undermine the competitiveness of Australian banks, and carry wide-ranging risks to the Australian economy.[66] It stressed that 'Australia has traditionally been a net importer of capital and this capital has been used to help fund the development of the Australian economy', and argued that if interest deductibility was removed, and companies could not claim deductions on debt funding, 'it could act as a brake on domestic investment and adversely affect economic growth'.[67]

3.45 Similarly, CSL Limited warned that such a change would 'further disincentivise growth and productivity by increasing the cost of debt financed investment and reducing the incentive for investment by Australian companies'.[68]

3.46 AVCAL argued that removing interest deductibility would be bad for investment and the Australian economy, because it would result in higher borrowing costs for Australian companies and 'hinder their capacity to fund further expansion, innovation and job creation'.[69] AVCAL stressed that debt funding helps companies to attract capital and invest in new technologies, and that removing interest deductibility would have a 'negative effect on the ability of start-ups to attract funding'.[70] To support its arguments, it noted modelling by Ernst and Young for the United States economy, which showed that limiting interest deductions to fund corporate tax reductions would reduce net economic growth in the long term.[71]

3.47 CAFBA reiterated this argument, observing that it would be difficult for Australia to encourage new start-ups and the growth of existing businesses if 'borrowing costs and equipment financing is more expensive'.[72] It added that lowering tax rates would be meaningless for start-up businesses as they rarely produce sufficient income in the first few years. As a result denying interest deductibility 'would be a huge disincentive to start a new business, in many cases making it not viable'.[73]

3.48 Concerns about removing interest deductibility were raised by representatives across diverse industries. The Housing Industry

66 ABA, *Submission 4*, p. 2.
67 ABA, *Submission 4*, p. 1.
68 CSL Limited, *Submission 5*, p. 1.
69 AVCAL, *Submission 7*, p. 2.
70 AVCAL, *Submission 7*, p. 2.
71 AVCAL, *Submission 7*, p. 2.
72 CAFBA, *Submission 9*, p. 2.
73 CAFBA, *Submission 9*, p. 2.

Association argued that removing tax deductibility would have a negative effect on the housing industry, and warned that it would increase the cost of capital and 'force a reduction in the supply of new housing'.[74]

3.49 The Minerals Council of Australia argued that removing interest deductibility would:

> …reduce the rate of return for investments in Australia and impact on the attractiveness of Australia as a destination for investment for capital intensive resource and infrastructure projects. Fewer resource investment projects would be profitable at the margin and there would be a corresponding decline in investment. Lower investment would in turn reduce productivity and wages and economic growth. The effective rate of tax would increase for many investments in capital intensive industries, even if the headline corporate rate was reduced.[75]

3.50 CAFBA envisaged negative consequences on equipment purchases by businesses if interest deductibility was removed, with the flow-on effects being 'clearly enormous, as it affects not only the businesses that need the equipment, but also those who supply and service it'.[76] It outlined that:

- businesses would lose their interest deductions in borrowing to purchase equipment;
- it would require lenders to 'substantially increase' interest rates to customers to compensate for the removal of their interest deductions; and
- it would increase the cost of equipment because equipment suppliers would 'also be denied interest deductions on the borrowing to hold stock and finance inventory'.[77]

International consistency and competitiveness

3.51 A range of submitters highlighted that interest deductibility was common internationally, and that Australian companies would be disadvantaged if the deduction was removed. For example, the Law Council of Australia noted that the deductibility of interest by businesses in Australia is consistent with similar jurisdictions, and asserted that any reform 'would carry significant risks such as costly restructuring for companies'.[78]

74 Housing Industry Association, *Submission 13*, p. 3.
75 Minerals Council of Australia, *Submission 22*, p. 8.
76 CAFBA, *Submission 9*, p. 1.
77 CAFBA, *Submission 9*, p. 1.
78 Law Council of Australia, *Submission 6*, p. 4.

3.52 Similarly, the ABA stressed that most OECD countries allow interest deductibility and that if Australia removed the deduction, it would mean inconsistency amongst OECD countries and uncertainty for businesses.[79] The ABA took the view that 'taking unilateral action to deny interest deductions would be contrary to global best practice and mean that Australia's tax policy direction would become isolated from that of most other countries'.[80]

3.53 Ernst and Young argued that changes of this nature to Australia's tax rules would make Australian companies uncompetitive because they would have to pay higher taxes unless they were able to replace their debt with equity. It warned that companies that currently used debt would be disadvantaged in comparison to domestic competitors using less debt, such as those with larger financial resources, and companies overseas who are advantaged by interest deductibility in their home countries.[81]

3.54 Ernst and Young added that Australian companies would need to undergo significant transitional arrangements to remain competitive, and could only replace their debt by selling assets, raising new capital or implementing 'cost reduction programs to free up cash flow'.[82] It warned that such transitional arrangements would be significant in terms of the costs of winding back debt programs, would 'take time and would add to volatility'.[83]

Corporate tax system alone cannot fund corporate tax cuts

3.55 As outlined in Chapter One, the 2012 Business Tax Working Group concluded that although Australia should continue the trend from the late 1980s to lower the company tax rate, there was a lack of support in the business community for measures to broaden the business tax base to fund a company tax rate reduction.[84]

3.56 This view that the corporate tax system was not capable of self-funding a corporate tax cut was reiterated among roundtable participants and submitters.[85] In arguing this point, Ernst and Young noted that Australia's

79 ABA, *Submission 4*, p. 2.

80 ABA, *Submission 4*, p. 2.

81 Ernst and Young, *Submission 12*, p. 7.

82 Ernst and Young, *Submission 12*, pp. 7-8.

83 Ernst and Young, *Submission 12*, p. 8.

84 Business Tax Working Group, *Final Report*, November 2012, p. iii; See also, Mr Rob Heferen, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 29.

85 See for example, Mr Tony Pearson, Chief Economist and Executive Director, ABA, *Committee Hansard*, Canberra, 5 February 2016, p. 28; Mr Alf Capito, Partner, Ernst and Young, *Committee Hansard*, Canberra, 5 February 2016,p. 29; Ernst and Young, *Submission 12*, p. 4.

corporate tax base has been broadened since 2012 through more extensive transfer pricing and thin capitalisation rules, and restrictions on research and development claims for companies with large turnovers.[86]

3.57 Similarly, CSL Limited questioned the value of broadening the base of company income taxes in this way, asserting that 'headline reductions funded by increases elsewhere to the same parties would likely result in a nil net benefit to the nation'.[87]

3.58 This sentiment was supported by KPMG, who asserted that any benefits from any trade-off between base broadening and rate cuts would be 'impressionistic only, with a lower headline rate for company tax, but the same effective tax rate'.[88]

3.59 The Minerals Council of Australia argued that a revenue neutral cut to the corporate tax rate, funded by removing interest deductibility, would not reduce effective tax rates:

> Whilst the impact on the overall revenue might be neutral, a change of this nature would effectively result in the redistribution of the incidence of company taxation to industries which rely more heavily on debt funding such as capital-intensive industries. Such a proposal would not represent tax reform and would be counter to Australia's tax policy imperatives to increase investment and growth.[89]

3.60 INPEX emphasised that while there has been a global trend in reducing corporate tax rates, many of the countries that have reduced their rates have not undertaken a 'base-rate trade off'. INPEX argued that consideration be given 'as to whether base broadening to fund a cut will actually help competitiveness given the tax regimes of competitor countries still include a number of concessional treatments'.[90]

3.61 While not commenting specifically on the Australian system, the United Kingdom's (UK) Office of Tax Simplification noted some of its preliminary findings on changes to the tax system in the UK, including that, following the reduction of corporation tax rates in the UK, the value of many business deductions (tax reliefs) has reduced.[91]

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86 Ernst and Young, *Submission 12*, p. 4.

87 CSL Limited, *Submission 5*, p. 1.

88 KPMG, *Submission 10*, p. 5.

89 Minerals Council of Australia, *Submission 22*, p. 1; See also Mr James Sorahan, Director, Tax, Minerals Council of Australia, *Committee Hansard*, Canberra, 5 February 2016, p. 35.

90 INPEX, *Submission 17*, p. 4.

91 Office of Tax Simplification, *Submission 3*, p. 4.

Arguments for reforming company income tax deductions

3.62 In evidence to the committee, most stakeholders argued against the need to reform company income tax deductions. However the Australian Council of Social Service (ACOSS) asserted that some business tax concessions could be removed,[92] and the TJN recommended that integrity rules be strengthened.[93]

3.63 ACOSS was generally critical of current business tax concessions, asserting that concessions should be removed in favour of cuts to company tax rates. It stated that:

> Business tax concessions distort investment decisions between different industries or activities in economically harmful ways and, their removal should make room for lower company tax rates and an improvement in economic efficiency, without loss of public revenue.[94]

3.64 The TJN put forward the view that deductions for interest repayments, 'especially in relation to interest repayments made to another part of the same corporation located overseas, should be curtailed'.[95] It argued that Australia's current rules in relation to thin capitalisation were being exploited through 'aggressive tax structures' that allow profits to be shifted.[96]

3.65 The TJN argued that there were a number of ways that rules could be tightened to address profit shifting through the use of interest deductibility,[97] for example:

- in relation to the thin capitalisation rules, replacing the current arm's length and safe harbour tests with solely a worldwide gearing ratio test;
- introducing legislation to disallow 'deductions for transactions with resident entities of a jurisdiction that does not effectively exchange information with the ATO'; and
- introducing legislation giving effect to the anti-hybrid rules.[98]

3.66 In response to this, the Treasury highlighted the recent tightening of Australia's thin capitalisation rules as well as the work currently being

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92 Australian Council of Social Service (ACOSS), *Submission 24*, p. 3.

93 TJN, *Submission 18*, p. 1.

94 ACOSS, *Submission 24*, p. 3.

95 TJN, *Submission 18*, p. 1.

96 TJN, *Submission 18*, p. 4.

97 Dr Mark Zirnsak, Spokesperson, TJN, *Committee Hansard*, Canberra, 5 February 2016, p. 30.

98 TJN, *Submission 18*, p. 1.

undertaken by the Government regarding the G20/OECD BEPS recommendations, which includes consultation on aligning Australia's transfer pricing rules more closely to the OECD recommendations and on implementation of anti-hybrid rules (as discussed above).[99]

Conclusions

3.67 In reviewing the evidence on options to simplify the company income tax system, specifically to broaden the base to fund reductions in marginal tax rates, it was clear to the committee that there is no appetite for change, particularly in relation to the deductibility of interest incurred by businesses in deriving their income.

3.68 Given the importance of interest deductibility to Australian businesses, and the potentially significant negative effects that may result from change to deductibility arrangements, particularly in relation to investment and the Australian economy, the committee is strongly of the view that current arrangements should be retained.

3.69 The committee notes the findings of the Business Tax Working Group in regards to the difficulty of identifying measures to further broaden the company tax base since reductions in the company tax rate during the 1980s and 1990s were already funded by a range of measures broadening the company tax base.[100]

3.70 The committee also notes the significant work currently being undertaken by the Government on the implementation of the G20/OECD BEPS recommendations. This work will assist to strengthen Australia's already robust rules addressing tax integrity.

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99 Ms Kathryn Davy, Principal Adviser, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 30; Mr Rob Heferen, Treasury, *Committee Hansard*, Canberra, 5 February 2016, p. 30.

100 Business Tax Working Group, *Final Report*, November 2012, p.10.

Recommendation 6

3.71 **The committee recommends that the Government maintain the current company income tax framework that allows the deductibility of interest incurred by businesses in deriving their income.**

Recommendation 7

3.72 **The committee recommends that the Government continue its important work on the implementation of the G20/OECD Base Erosion and Profit Shifting (BEPS) recommendations to further strengthen Australia's rules addressing tax integrity.**

David Coleman MP

Chair

14 June 2017