

Business Tax Working Group

Discussion Paper

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DISCLAIMER

This is a discussion paper whose purpose is to stimulate discussion, debate and feedback to the Business Tax Working Group. It is not a position paper and the options canvassed are not recommendations. The Business Tax Working Group recognises that costs would necessarily be imposed on some taxpayers in adopting any of the options canvassed. To date the Working Group has not finalised an assessment of the costs and the benefits of the options canvassed. In releasing this discussion paper the Working Group is seeking information to assist in an evaluation of the balance of costs and benefits.

ACKNOWLEDGEMENTS

The members of the Working Group gratefully acknowledge the work of Treasury Officials in the preparation of this discussion paper.

1. EXECUTIVE SUMMARY

1. The Business Tax Working Group (Working Group) was established following the Tax Forum in October 2011. In June 2012, the Government asked the Working Group to prioritise consideration of a cut to the company tax rate accompanied by measures which fully offset the cost by broadening the business tax base. The Working Group's terms of reference are set out at Appendix A.

2. This discussion paper has been prepared to enable consultation with interested parties. As such, it is designed to elicit the issues raised by the Group's terms of reference and to facilitate feedback on options. It does not necessarily represent the concluded views of the individual members of the Group, their organisations, or the Government.

3. The terms of reference ask the Working Group to make recommendations on how the business tax system can be improved to make the most of the challenges and opportunities arising from transformations in the broader economy, including the patchwork economy, and that aim to increase productivity while delivering relief to struggling businesses.

4. The Working Group believes that Australia should have an ambition to reduce its company tax rate over the medium term and that achieving a materially lower rate is a worthwhile reform objective. This is consistent with the direction recommended by the Australia's Future Tax System (AFTS) Review which recommended, among other things, that the company tax rate be reduced to 25 per cent over the short to medium term with the timing subject to economic and fiscal circumstances¹ and that 'improved arrangements for charging for the use of non-renewable resources should be introduced at the same time.'² This was on the grounds that it would help Australia to continue to attract investment and would reduce incentives to shift profits off-shore.³

5. The terms of reference require the Working Group, in the first instance, to determine whether it is possible to fully fund a reduction in the company tax rate by further broadening of the business tax base. The Working Group supports the principle of a business tax system characterised by a low rate and broad base, subject to other considerations. However, the Group notes that while there may be some scope to examine base broadening options, this needs to be done cautiously. It is vital that the net effects — especially on particular sectors and on investment decisions — of removing existing concessions are examined carefully.

Improving productivity through tax reform

6. In the long term, improving productivity is crucial to ensuring Australia's future prosperity. The company tax rate impacts on productivity through its effects on both the quantity and quality of 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 and labour through higher real wages.

¹ AFTS Review (2009), *Final Report to the Treasurer*, Treasury, Canberra (recommendation 27).

² *Ibid.* Specifically, a 40 per cent resource rent tax on a range of non-renewable resources (recommendation 45).

³ *Ibid.*, p. xix.

7. 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. A sourced-based tax on business income, such as Australia's corporate income tax, increases the before-tax return required before businesses can justify new investment. While dividend imputation relieves domestic shareholders of the impost of corporate income tax, the marginal investor in Australia is likely to be a foreign investor that does not have access to imputation credits. In this context, the statutory corporate tax rate matters for Australia's ability to attract foreign investment and thus the quantity of investment.

8. A by-product of a lower corporate tax rate is that it also reduces the potential distortions that can arise from approaches to measuring business income that are not neutral across all types of investments. For example, differences in the deductibility of debt and equity financing and accelerated depreciation and concessional write-off arrangements. To the extent that these distortions are reduced by a lower corporate tax rate, this can lead to improvements in the quality of investment across the economy (as well as the quantity of investment).

Meeting new challenges and opportunities

9. The case for a lower corporate tax rate is even more compelling against the backdrop of an economy undergoing structural change, the increasing importance of intangible business inputs, continuing volatility in the global economy, increasing globalisation and the rise of Asia.

10. The resources boom is fuelling growth in the mining and mining-related sectors of the Australian economy, but contributing to adjustment pressures elsewhere. Our high terms of trade and sustained high Australian dollar have affected the competitiveness of Australian exporters in non-mining sectors such as manufacturing, tourism, education and import competing industries. Some industries are also facing increased competition for skilled labour. Meanwhile, ongoing consumer caution, changes in expenditure patterns and sector-specific structural changes present further challenges to sectors that are already struggling with difficult international economic conditions.

11. In this context, businesses across the economy are taking steps to become more productive and competitive through adopting new business models, sourcing new plant and equipment, investing in their workforce and exploring new markets and product lines. New investment is needed to meet these challenges. The Working Group's first set of recommendations to introduce loss carry-back, now being implemented by the Government, was proposed in this context.⁴ But a lower company tax rate could also play an important role in supporting the adjustment process.

12. The Working Group is also mindful of the growing importance of intangible assets in the generation of corporate profit. Intangible assets include brands, intellectual property, customer lists, internal processes, and copyrights which are often the result of investments such as R&D and marketing. As intangible assets have no physical form, there is a heightened risk that businesses relocate intangible assets into low-tax jurisdictions. To combat this risk, and others, governments around the world placed increasing focus on ensuring that transfer pricing rules require that such asset transfers (and subsequent payments as between jurisdictions) are valued appropriately for tax purposes.

⁴ Business Tax Working Group (2012), *Final report on the tax treatment of losses* (recommendation 2).

13. At the same time, more economic activity is being undertaken by multinational corporations. As multinationals can choose where to locate their production they are more sensitive to the tax rates which apply to them than a purely domestic firm. Of course, other factors are important too such as the quality of the labour force, security, and access to both raw materials and markets. Multinationals have an even wider choice in where to locate their profits. This means there can be a difference between where economic activity is being undertaken and where the income it generates is being reported. Empirical studies indicate that the statutory tax rate is an important factor in decisions about where to report profits.⁵

14. Australia will face future challenges as its population continues to age, with an expected increase in demand for government provided goods and services at the same time as Australia's working age population declines. Australia's terms of trade are also expected to gradually decline over the medium term.⁶ In this context, multifactor productivity (that is, the output produced from a bundle of labour and capital inputs) will take on new importance. While Australia has a high level of labour productivity, multifactor productivity growth has declined over the past decade and while this can to some extent be attributed to sector-specific developments — in particular the increase in long-term mining and utilities investments — the trend has been evident across most industries.⁷ As noted above, a lower company tax rate can encourage more investment and so contribute to improved productivity.

Assessing the 'broad base, low rate' approach to tax reform

15. The Working Group's terms of reference stipulate that in order to pursue the economic benefits associated with a reduction in the company tax rate, savings should be identified from within the business tax system in order to progress reforms in a cost neutral way. The terms of reference also expressly restrict the Working Group from considering changes to the goods and services tax.

16. A comprehensive tax base that contains minimal special exemptions and deductions for certain investments can result in a more productive mix of different investment options and a broader tax base that will generate greater revenue to fund a lower company tax rate. That said, there may well be circumstances where a departure from a uniform tax base can be justified on economic grounds (such as encouraging activities that give rise to positive social benefits).

17. The Working Group's consideration of base broadening options builds upon its recent work on the tax treatment of losses whereby three areas were identified as worthy of additional analysis: interest deductibility; capital allowances and the treatment of capital expenditure; and the research and development (R&D) tax incentive. The Working Group is conscious that the base broadening options presented in this paper can be placed into two groups: those that are potentially available to all companies and those that are targeted at specific sectors.

18. When considering potential base broadening options, the Working Group will bear in mind likely behavioural responses of companies and investors and will be particularly interested in feedback from stakeholders on this point. The Working Group is also open to suggestions on potential transitional arrangements that could accompany any potential base broadening options.

⁵ For example, see De Mooij, R. & Ederveen, S. (2008), 'Corporate tax elasticities: a reader's guide to empirical findings', *Oxford Review of Economic Policy*, Vol 24 No 3, p 680-697.

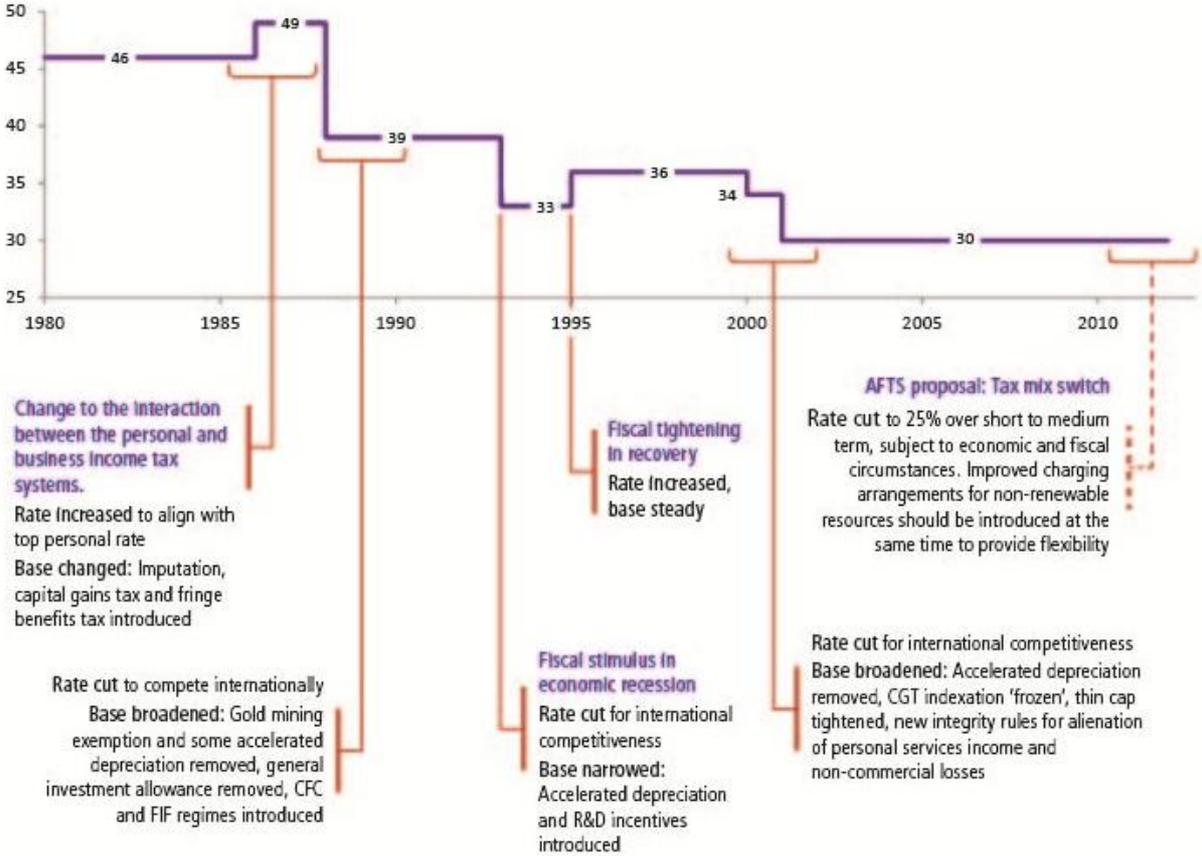
⁶ Statement 2 of Budget Paper No. 1, *The Budget Strategy and Outlook 2012-13*.

⁷ Dolman, B. and Gruen, D. (2012), *Productivity and Structural Change*, Address to the 41st Australian Conference of Economists.

19. To support a transparent debate about possible base broadening options, the discussion paper contains a description of the options currently under consideration by the Working Group and Treasury's preliminary estimate of the revenue implications. In light of responses to this discussion paper, the Working Group will further consider these options. Some may be dropped, others may be amended and new ideas might be canvassed. The inclusion of a base broadening option in this paper should not be interpreted as an indication that it will be adopted by the Working Group or the Government.

20. The Working Group is aware that the business tax base is already broad as a result of tax reform exercises over the past thirty years (see Chart 1 below). Current exceptions to a strictly uniform tax base therefore exist as a result of judgements made and policy rationales accepted, some very recently. Key questions for the Working Group are whether those judgements remain sound and policy rationales continue to hold and if so, whether the current rules continue to be an effective policy response.

Chart 1: Company tax rates in Australia (1980-present)



21. In considering whether a particular set of base broadening options implemented alongside a corporate tax rate cut would deliver a net benefit to the Australian economy, the Working Group will be guided by its principles for business tax reform (the full text of the principles is provided at Appendix C).

Revenue adequacy: The business tax system should raise revenue that, together with other taxes, helps to pay for public services that the community relies upon.

Economic efficiency: The business tax system should raise revenue in a way that minimises the effect of the tax system, on business decisions except where this is needed to correct for market failures.

Competitiveness: The business tax system should take into account Australia's integration with the global economy.

Distributional equity: The business tax system and potential reforms should be understood in terms of where the final incidence falls among capital owners, workers and consumers.

Simplicity: Business tax reform should be aimed at making the system as simple and as easy to comply with as possible, having regard to an often complex business environment, the need to ensure the integrity of the system and the costs and benefits of transitioning to any new rules.

New investment focus: Business tax reform should generally focus on new investment.

22. There will of course be tensions between these principles and the Working Group considers it important that trade-offs between the principles are transparently made. We require input from the business community to ensure that all aspects of these trade-offs are rigorously analysed. In some cases we are also seeking input on the impact of particular tax treatments on individual businesses to assist us in determining the impact on the revenue of removing or amending them.

23. The Working Group has also asked Treasury to undertake macroeconomic modelling to provide an assessment of the potential longer-run economic impacts of company tax reform. It is expected that the preliminary outputs from this exercise will be available around the time of the Working Group's draft final report. The Working Group notes that previous empirical studies have concluded that a cut to the company tax rate can have a substantial, positive impact on gross domestic product (GDP) in the long run.

24. The challenge facing the Working Group is essentially whether a 'broad base, low rate' approach to reform has the potential to deliver net-benefits to the Australian economy. The Working Group's preliminary view is that it does. We are interested in exploring whether trade-offs can be made between a lower company tax rate and removing or amending some specific provisions of the tax laws in a way that can improve the overall operation of the business tax system.

Allowance for corporate equity

25. The Working Group's terms of reference also require it to consider the merits of a business expenditure tax, including an allowance for corporate equity (ACE). The Working Group undertook its consideration through an examination of the economic literature, consultation with overseas academics and an examination of how an ACE would operate in the Australian taxation system. These considerations are set out in Appendix B.

26. The Working Group also considered international experience with the ACE. There has been limited international experience in implementing an ACE to date and no experience in implementing an ACE in a system that provides full dividend imputation. An ACE's interaction with the imputation system, its implications for the treatment of losses and how an equity base may be defined are just some of the design challenges that would need to be overcome.

27. Further, full implementation of an ACE would not be possible within the revenue neutral constraint imposed by the Working Group's terms of reference with the base broadening options identified in this paper. This is because many of the base broadening options discussed in this paper would not yield any long term gains to revenue since the ACE deduction would erode the benefit of accelerated depreciation compared to writing off a depreciating asset over its economic life. In addition, it is unlikely that changing thin capitalisation rules could be used to fund an ACE in the long run given that such a base broadening option would largely counteract the more neutral tax treatment of debt and equity finance that is offered by the ACE.

28. Further, the Working Group would not advocate increasing the corporate tax rate to fund the implementation of an ACE. Recent studies and reviews that have considered an ACE have consistently concluded that the introduction of an ACE paid for through a higher corporate tax rate would be counter-productive.⁸

29. For these reasons, the Working Group feels 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 issues considered by the Working Group in coming to this view are set out in Appendix B. The Working Group notes that its view is consistent with the position reached by the AFTS Review.

The Working Group is seeking feedback supported by evidence

30. The Working Group welcomes feedback in response to this discussion paper and has crafted a number of framing questions to assist stakeholders in preparing written submissions (see below). These questions emphasise the Working Group's preference for feedback that is supported by evidence either in the form of data or case studies.

31. Written submissions should be provided to the Working Group Secretariat at the Treasury by close of businesses on Friday, 21 September 2012. Information may be provided on an in-confidence basis but should be clearly marked as such. Further details on how to make a submission are provided at the end of the paper.

32. As stated in its recent consultation guide, the Working Group will also endeavour to meet with stakeholders over the course of August and September in relation to the discussion paper. Further information can be obtained from the Working Group's Secretariat.

33. The Working Group plans to release a draft of its final report to the Treasurer in late October 2012. That report will include a summary of the key themes from consultation on this discussion paper. The Working Group's final report to the Treasurer is due in December 2012.

⁸ For example, see: Mirrlees, J. et al (2011), *Tax by Design: the Mirrlees Review* (p 432) and Devereux, M. (2012) 'Trade-offs in the design of taxes on corporate profit', paper presented at the University of Melbourne seminar, 28 March 2012.

Consultation questions

Corporate tax rate cut

- A. In the context of your business, or businesses that you are familiar with, how would a cut to the corporate tax rate affect decisions about:
- i. undertaking new investment?
 - ii. choice of business structure?
 - iii. where new investment is undertaken?
 - iv. how new investment is financed?

Base broadening options

- B. What base broadening options would you support in order to fund a cut to the company tax rate?
- C. In the context of your business, or businesses that you are familiar with, how would any of the base broadening options affect decisions about:
- i. undertaking new investment?
 - ii. choice of business structure?
 - iii. where new investment is undertaken?
 - iv. how new investment is financed?
 - v. undertaking research and development?
- D. In the context of your business, or businesses that you are familiar with, for any of the base broadening options:
- i. would you expect compliance costs to change?
 - ii. what would you consider to be the most important transitional issues?
- E. Are there any alternative base broadening options, or refinements on existing options, that you would recommend that the Working Group consider?

Allowance for corporate equity

- F. Do you see merit in Australia exploring the introduction of an allowance for corporate equity in the longer term?
- G. What kind of information would be necessary to explore an allowance for corporate equity as a longer term option?

2. ECONOMIC CONTEXT

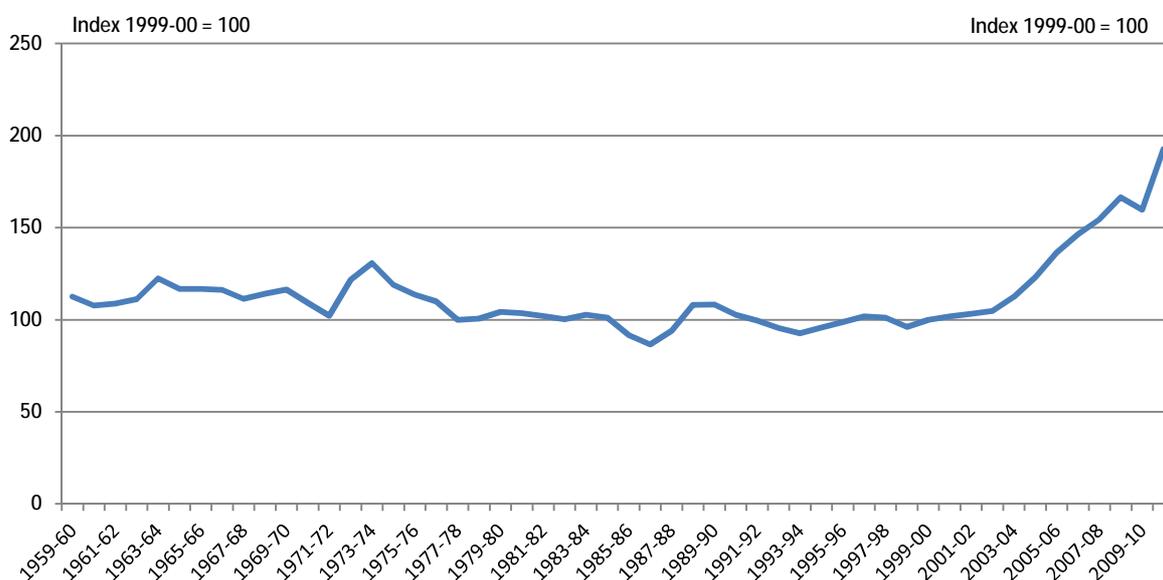
34. The globalised nature of world markets makes it essential for Australia to maintain a competitive tax system that encourages new business investment and enhances productivity. Despite difficult international economic conditions, Australia's economy remains strong. However, economic conditions remain uneven, with mining and mining-related sectors experiencing robust growth, while some sectors remain under pressure from the sustained high dollar, more cautious consumer behaviour, sector-specific structural changes and turbulence in the global economy.

35. The current economic environment makes it particularly important for Australia to ensure that businesses are well positioned to take advantage of emerging investment opportunities and are prepared to adapt to the changing economic conditions. Australia's future economic growth prospects are dependent on our ability to encourage new investment and enhance productivity growth within challenging international and domestic conditions.

The rise of Asia and structural adjustment

36. The rapid industrialisation being undertaken in China, India and other emerging economies is reshaping the world economy. The rise of Asia has significantly increased the worldwide demand for the natural resources necessary for industrialisation, which is fuelling growth in the mining and mining-related sectors of the Australian economy. While the terms of trade are believed to have peaked,⁹ they remain at historically high levels and are expected to remain high for some time yet (see Chart 2).¹⁰

Chart 2: Australia's terms of trade (1959-2011)



Source: Dolman & Gruen (2012)

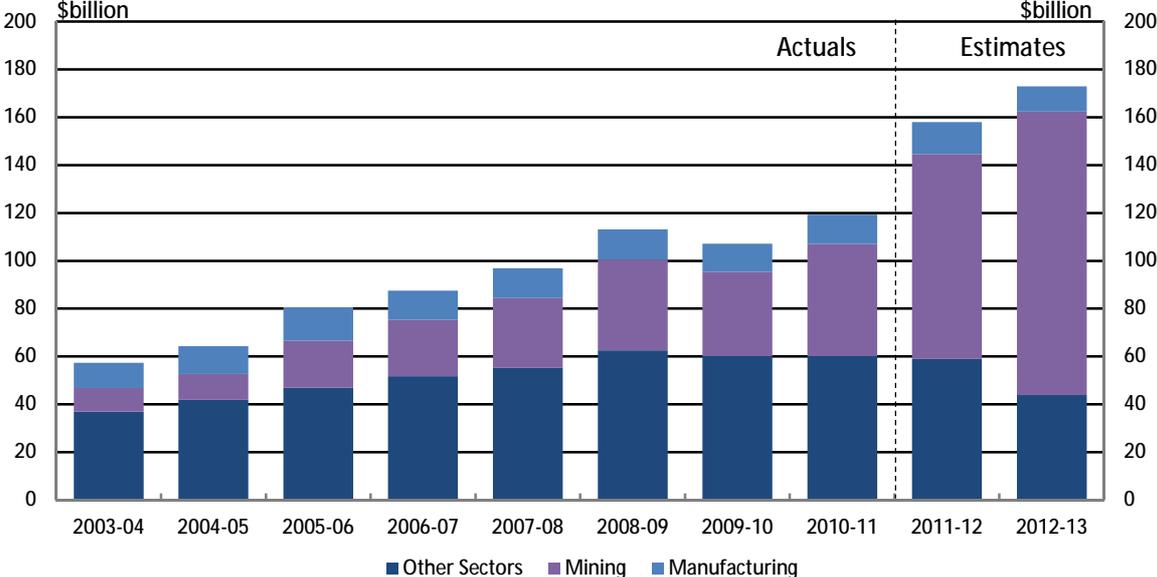
⁹ Statement 2 of Budget Paper No. 1, *The Budget Strategy and Outlook 2012-13*.

¹⁰ Dolman, B. and Gruen, D. (2012), *Productivity and Structural Change*, address to the 41st Australian Conference of Economists.

37. While beneficial for the economy as whole, the historically high terms of trade has created considerable adjustment pressures for Australian exporters in non-mining sectors, such as manufacturing, tourism and education. The high terms of trade and corresponding high Australian dollar has reduced the international competitiveness of these sectors by increasing the price that other countries pay for our goods and services. Ongoing consumer caution and changes in expenditure patterns within Australia are only compounding these issues for struggling sectors of the economy. These factors are contributing to Australia’s patchwork economy — with growth unevenly distributed across all sectors.

38. Australia is currently experiencing unprecedented levels of investment activity with new capital expenditure in the mining sector during 2010-11 being nearly four times the average annual expenditure of the past 30 years.¹¹ However, as demonstrated in Chart 3, investment in the mining sector far outstrips new investment in manufacturing and other sectors.

Chart 3: Capital Expenditures by sector (2003-2013)



Source: ABS catalogue 5625.0

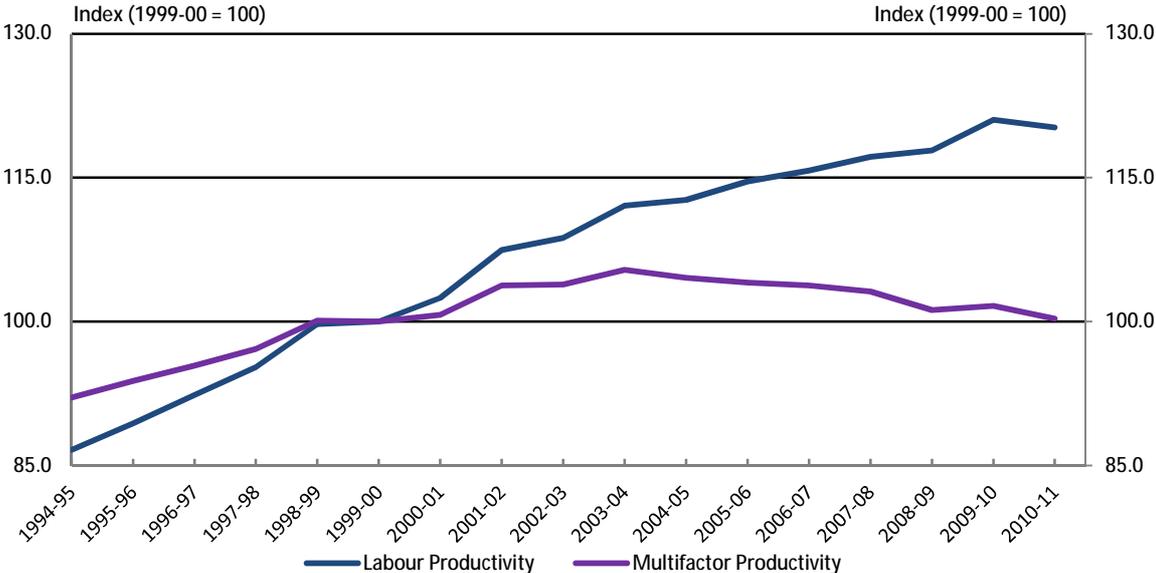
39. In response to the adjustment pressures being driven by the high terms of trade, businesses across the economy are adopting new business models, sourcing new plant and equipment, investing in their workforce and exploring new markets and product lines. Businesses are also seeking innovative ways to adapt to ongoing changes in technology, consumer preferences and market conditions. New investment is needed to meet these challenges. The loss-carry back reform recommended by the Working Group was developed to assist businesses with tight cash flows to internally fund the new investments they require for them to adapt to changing market conditions.

¹¹ New, R., Ball, A., Copeland, A. (2011), *Minerals and energy. Major development projects – April 2011 Listing*, Australian Bureau of Agricultural and Resource Economics and Sciences, Canberra.

The imperative to lift productivity and compete for global capital

40. While Australia has a high level of labour productivity, our productivity growth has slowed over the past decade. While labour productivity continued to grow over the past decade, it did so at a slower rate than in the 1990's. Meanwhile, multifactor productivity, which measures how well the economy as a whole is combining capital and labour into production, has been stagnating (see Chart 4). While this can to some extent be attributed to sector-specific developments — in particular the increase in long-term mining and utilities investments — the trend has been broadly evident across most industries.¹² A key challenge over the coming decade will be to boost multifactor productivity, as the contribution of the terms of trade to the growth in living standards is unlikely to be sustainable.¹³

Chart 4: Market sector productivity in Australia (1994-2011)



Source: Dolman & Gruen (2012)¹⁴

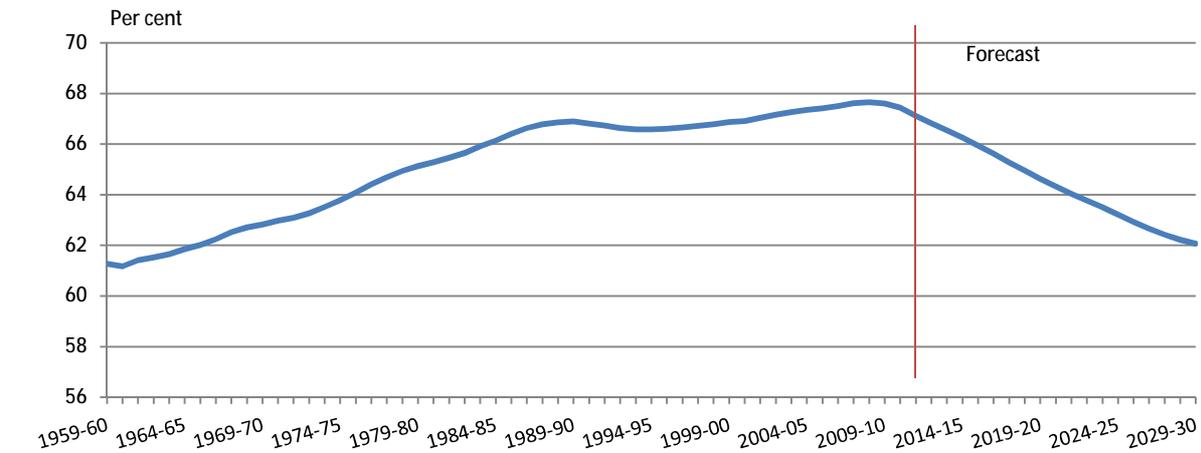
41. Raising productivity will be particularly important as the Australian population continues to age and the terms of trade gradually decline. This will place greater pressure on government to provide goods and services at the same time that Australia's working age population declines (see Chart 5). Tax reform more broadly, at both the federal and state level, will need to account for these increased demographic pressures on government revenues.

¹² Dolman, B. and Gruen, D. (2012) *Productivity and Structural Change*, address to the 41st Australian Conference of Economists.

¹³ In this context, it is welcome to see that labour productivity rose by 2.3 per cent in the March 2012 quarter to be 5.3 per cent higher through the year (ABS Cat. No 5206.0).

¹⁴ Data are for 16 market sector industries. 2011-12 labour productivity data are the average of the first three quarters.

Chart 5: Australia's working age population as a share of total population (1959-2030)



Source: Dolman & Gruen (2012)

42. Due to its relatively small size, Australia has always been dependent on international capital markets to respond to investment opportunities, and this is unlikely to change in the future. Australia's capacity to compete effectively for these flows will be key to financing new investment in the long term. A company tax rate reduction and simpler tax base could assist businesses to more easily fund investment opportunities through capital markets by lowering the pre-tax required rate of return for investors.

43. The Working Group is also mindful that deeper changes in how business is undertaken has significantly enhanced the capability of multinationals to shift profits to countries that offer the most favourable tax regimes. To the extent that a firm's value is tied to the value of their intellectual property, a firm is able to minimise their overall tax liability by basing such intangible assets in a country with a low statutory tax rate. Reductions in the Australian corporate tax rate may affect marginal location choices but will be unlikely to impact on choices where the difference in tax rates is large.

44. Profit shifting practices have been spurred by the increasing share of economic activity for which multinational corporations are responsible. Compared to purely domestic entities, multinational firms enjoy greater freedom and range of choice in their decision of where to locate production, making them more responsive to corporate tax rates. Of course other factors also contribute to a country's attractiveness as an investment destination, such as access to materials and the quality of the labour force.

3. THE CASE FOR A LOWER COMPANY TAX RATE

45. The Working Group is considering longer-term reform options for the business tax system at a critical juncture for the domestic and global economy. While the Australian economy demonstrated resilience through the global financial crisis by avoiding recession, and is now one of the strongest performing economies in the world, it faces an uncertain and shifting global environment. The economy's capacity to weather future shocks and seize long-term opportunities will depend on its openness, flexibility and dynamism.

46. While Australia's productivity levels are high, lifting our productivity performance will be a key driver of future prosperity. As previously mentioned, Australia's future economic growth has become increasingly dependent on its ability to improve how it combines labour and capital in production. Australia's weak multifactor productivity growth has been exacerbated by the existence of the patchwork economy, however, overcoming this issue is of even greater importance when considering that the current high terms of trade and rate of investment in mining industries is unlikely to continue forever.

47. A lower company tax rate will assist businesses in taking necessary steps towards becoming more productive by enabling greater investment in plant and equipment, encouraging innovation and adopting improved business models. These elements will improve business' ability to adapt to changing economic and market conditions, both of which are essential for future economic growth.

48. A lower corporate tax rate can spur investment across the economy by reducing the pre-tax required rate of return. It is not only the statutory company tax rate that drives behaviour. The effective average tax rate (EATR) and effective marginal tax rate (EMTR) also affect investment decisions in different ways (see Table 1).

Table 1: Effective tax rates

Effective average tax rate (EATR)	Measures the proportion of an investment that is paid in tax.	EATRs affect location decisions: Where to locate investment Where to locate profits
Effective marginal tax rate (EMTR)	Measures the effect of tax on the return to an investment that just breaks even or covers all of its economic costs.	EMTRs affect a business's choice of how much to invest in a project.

Appendix D provides further analysis concerning the relationship between EATRs and EMTRs.

The benefits of a lower company tax rate

49. The Government has stated that the Working Group's highest priority is to consider ways of funding a cut to the company tax rate from within the business tax system. Central to this task is an understanding of how a lower corporate tax rate can benefit the economy as a whole.

50. A lower company tax rate has consistently been regarded as central to Australia's international competitiveness through its attractiveness as an investment destination. As a result of the 1999 *Review of Business Taxation* (Ralph Report), the corporate tax rate was lowered from 36 per cent to 30 per cent and the 2009 AFTS Review recommended among other things, that the company tax rate be 'reduced to 25 per cent over the short to medium term with the timing subject to economic and fiscal circumstances'¹⁵ and that 'improved arrangements for charging for the use of non-renewable resources should be introduced at the same time'.¹⁶ Both advocated a lower rate to encourage capital flows considered crucial for Australia's long-term investment prospects, economic growth and employment.^{17 18}

51. A lower company tax rate will affect the quantity of investment in Australia by reducing EMTRs. The imposition of income tax creates a wedge between the before- and after-tax returns on investment received by a business. This tax wedge detracts from economic growth to the extent that it results in investment decisions that differ from those that would have been made in the absence of the tax. It can reduce the level of resources employed in an activity or cause resources to be put to less profitable uses.

52. A lower company tax rate is likely to increase the scale of investment by reducing the relevant EMTR and thereby the project's hurdle rate. The quantity of investment in the economy should increase to the extent that EMTRs are reduced, thereby resulting in an increased level of capital in the economy. Greater quantities of capital will enhance the marginal productivity of labour, resulting in an increase in incomes, productivity and economic growth.

53. A lower company tax rate can also reduce the extent to which departures from a uniform tax base distort business investment choices. For example, the current company tax system provides deductions for interest payments but not for equity financed investments. A cut to the company tax rate reduces the value of interest deductions and so reduces the impact of the different treatment of debt and equity.

54. As a rule of thumb, the efficiency cost of a tax increases with the square of the tax rate.¹⁹ For every one percentage point increase in rates, the additional efficiency cost increases at an accelerating rate. This is particularly important considering that estimates of the marginal welfare loss from different taxes suggest that company tax at its current rate is a relatively inefficient vehicle to use as an incremental source of tax revenue.²⁰

¹⁵ AFTS Review (2009), *Final Report to the Treasurer*, Treasury, Canberra (recommendation 27).

¹⁶ Ibid. Specifically, a 40 per cent resource rent tax on a range of non-renewable resources (recommendation 45).

¹⁷ Review of Business Taxation (Ralph Report) (1999), *Review of Business Taxation: A Tax System Redesigned*, Treasury, Canberra, p 24.

¹⁸ AFTS Review (2009), *Final Report to the Treasurer*, p 169.

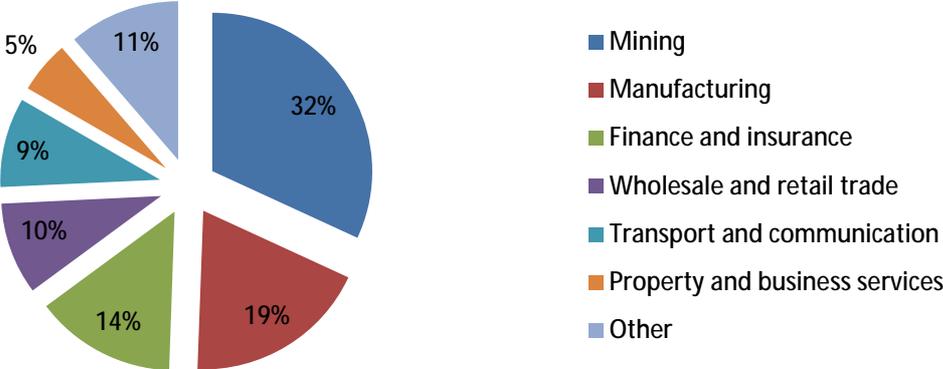
¹⁹ Harberger, A 1964, 'Taxation, Resource Allocation and Welfare', NBER chapters in: *The role of direct and indirect taxes in the Federal Reserve system*, National Bureau of Economic Research Inc, pp 25-80.

²⁰ Australia's Future Tax System Review (AFTS) (2009), *Final Report to the Treasurer*, Treasury, Canberra, p 13.

55. Theory suggests that a lower statutory rate and resulting lower EATR should enhance the incentives for multinational firms to invest in investment in Australia. Statutory tax rates and EATRs have been found to be significant determinants of investors' choices of location for investments.²¹ Increased economic globalisation has enhanced the prominence of location choice in multinationals' decision making processes. The AFTS Review cited evidence that on average a one percentage point increase in the rate of tax would result in a decrease in foreign direct investment of 3.72 per cent.^{22 23}

56. Australia currently has high levels of foreign direct investment (FDI) and substantial levels of pipeline investment in mining. However, only a narrow selection of industries have benefited from the significant levels of foreign investment that Australia has attracted in recent years. A lower corporate tax rate can attract foreign investment in industries that are currently struggling with difficult domestic and international economic conditions as well as providing a better environment for investment in the longer term.

Chart 6: Stock of foreign direct investment in Australia by industry (2011)



Source: ABS Cat. No. 5352.0 (2010)

57. Productivity can also be improved by reducing the complexity and compliance costs on businesses. These costs are significant and can affect the commercial viability of investment prospects by increasing the risks and costs involved without increasing expected returns. Ensuring that the tax system is as simple as possible for businesses to comply with forms part of the Working Group's terms of reference.

58. The benefits of a lower corporate tax rate will be dynamic rather than static. In the short run, a lower corporate tax rate should predominately benefit capital owners in the form of enhanced levels of profitability. Such higher rates of return may be reinvested within the business or distributed to shareholders. However, a reduction in the company income tax rate would also increase the after-tax return on investment, encouraging more investment and thereby enhancing the capital to labour ratio within the economy. This process of 'capital deepening' can increase the marginal product of

²¹ Altshuler, R., Grubert, H., & Newlon, T. (2000), 'Has U.S. Investment Abroad Become More Sensitive to Tax Rates?', *International Taxation and Multinational Activity*, National Bureau of Economic Research. Devereux, M (2003), 'Evaluating Tax Policy for Location Decisions', *International tax and public finance*, vol. 10, no. 2.

²² AFTS (2008), *Architecture of Australia's tax and transfer system*, Treasury, Canberra, p296.

²³ A lower statutory tax rate could also reduce the incentives for multinational firms to shift profits to lower-tax jurisdictions through transfer pricing and excessive gearing of Australian operations. However, profit shifting often involves tax havens with very lower company tax rates, so a small change to Australia's tax rate may have little impact.

labour, resulting not only in higher economic growth but also higher wages in the long term.²⁴ In the long run some of the incidence of a lower company tax rate should also fall on capital owners earning location-specific profits, such as those within the resource industry.²⁵ (See Appendix D for further analysis.)

Broad base, low rate reform will require assessment

59. Alongside considering the merits of reducing the company tax rate, the Working Group's terms of reference require it to identify a range of off-setting savings from the business tax system. The Working Group's task is to make an assessment as to whether a 'broad base, low rate' approach to business tax reform will deliver net-benefits to the Australian economy. This assessment will be made drawing on an evidence base informed by stakeholder consultation, reference to academic studies and results from macroeconomic modelling that the Working Group has asked Treasury to undertake.

60. A broader corporate tax base could enhance the quality of investment within Australia by minimising the extent to which business decisions are distorted by the different tax treatment of investments or activities. A broad tax base is associated with minimal tax deductions and concessions, and would ideally involve taxing all forms of income associated with business activity consistently.

61. The corporate tax base is now substantially broader and concessions to the base are more targeted than they were prior to those reforms. Bilicka, Devereux and Fuest have estimated that in 2011 Australia was middle ranking (10th) among G20 countries in terms of a measure of the breadth of the corporate tax base.²⁶

62. It is inevitable that a company tax rate cut funded through measures that broaden the corporate tax base will generally involve a redistribution from those who benefit from existing concessions to the broader corporate taxpaying base, at least in the short term. It is often easier to identify those who stand to lose from base broadening measures, compared to those who stand to gain (perhaps marginally) by a lower corporate tax rate.²⁷

63. While base broadening measures can in theory be tailored to provide a smoothed withdrawal of a concession or staged introduction of new rules, this has implications for the size of the rate cut that can be afforded and how soon it could be introduced.

64. A broader tax base enables company tax revenues to be maintained, whilst lowering the company tax rate. While a lower corporate tax rate should in turn spur new investment thereby adding to GDP, this will take time to be realised.

²⁴ AFTS (2008), *Australia's Future Tax System*, Treasury, Canberra, p 166.

²⁵ Henry, K. (2009), *A Tax System for Australia in the Global Economy*, speech to the Australian Business Tax Reform in Retrospect and Prospect colloquium, Sydney, 23 February 2009.

²⁶ Bilicka, K, Devereux, M and Fuest C (2011), *G20 Corporate Tax Ranking*, Oxford University Centre for Business Taxation. The measure used is the weighted average of the present value of allowances for plant and machinery, buildings and the purchase of a patent.

²⁷ OECD (2010), 'Choosing a Broad Base – Low rate Approach to Taxation', *OECD Tax Policy Studies*, No. 19.

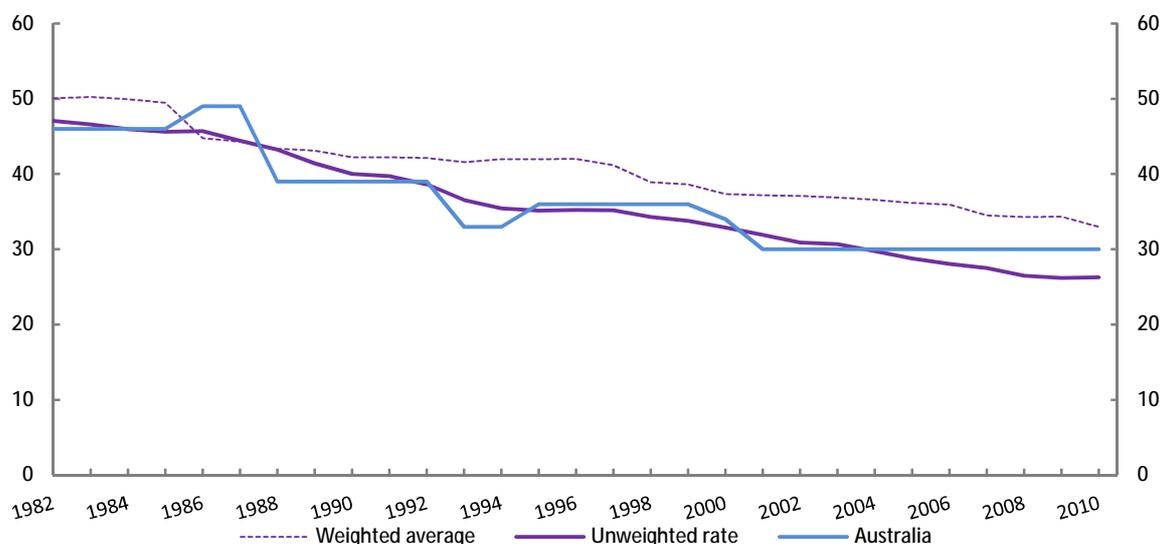
4. INTERNATIONAL TRENDS

65. Australian businesses operate within a global environment in which countries have been trending towards lower rates of business taxation while broadening the base. However, the tax systems of individual countries still vary considerably, such as by the varying ways in which they provide shareholder relief on dividend income. This can make comparing the company tax rates of different countries a complicated process.

67. Business tax reform over the past 25 years in Australia and internationally has been characterised by successive movements towards a broader base and a lower corporate tax rate. This trend is common across most OECD countries. Lower rate, broader base reform packages are considered by OECD governments to be necessary measures for enhancing a country's international competitiveness, productivity and economic growth.²⁸ By attracting greater levels of investment, governments often cite enhanced employment and incomes as further benefits from this model of corporate taxation.

68. Company income tax rates have fallen across the OECD in recent decades. The average statutory corporate tax rate within OECD countries has declined from a weighted average of approximately 50 per cent in 1983 to around 33 per cent in 2010 (see Chart 7). This level is still higher than Australia's corporate tax rate, however, the unweighted average tax rate has also fallen to a lower level, around 27 per cent, suggesting further reductions in Australia's corporate tax rate would be in line with international trends.

Chart 7: Company tax rates of OECD countries (1982-2010)



Source: OECD 2011²⁹

²⁸ OECD (2011), 'Tax Reform Trends in OECD Countries', *OECD 50th Anniversary - Challenges in designing competitive tax systems*.

²⁹ Data does not include Chile, Estonia, Israel and Slovenia. Data for Czech Republic, Hungary, Slovakia and Turkey begins in 1991.

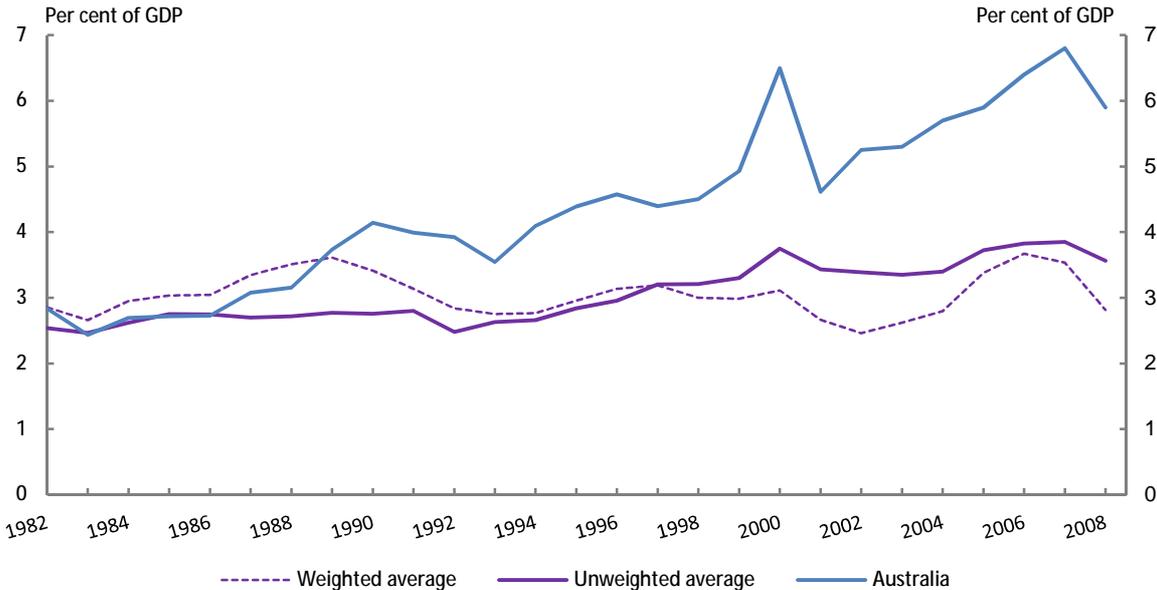
69. Many OECD countries have plans to further reduce their company tax rates. In recent budgets, the United Kingdom (UK) and Canadian governments reaffirmed plans for further corporate tax rate reductions. The UK corporate tax rate has been reduced from 26 to 24 per cent in 2012, and is expected to be further reduced to 23 per cent in 2013 and to 22 per cent in 2014. Canada, which has cut its federal rate from 18 to 16.5 per cent in 2011, will lower this further to 15 per cent. The Canadian Government has also called for provincial corporate tax rates to be reduced. The combined federal and provincial corporate tax rate in Canada ranges between 25 per cent and 31 per cent.

70. As rates have been cut, bases have been broadened. In many cases, countries have opted to reduce or eliminate accelerated depreciation allowances in order to more closely align allowances with economic rates of depreciation. Between 1982 and 2005, 11 OECD countries reduced their tax depreciation rates for investment in plant and machinery. Allowances for intangibles, plant and machinery and especially buildings have all become less generous in the past two decades. Some countries have also funded tax rate cuts by abolishing their dividend imputation systems.

71. Base broadening has also been achieved through tighter thin capitalisation rules, which limit the extent to which a company may claim deductions for interest paid on debt. Thin capitalisation reforms were recently implemented in Germany (2008) and New Zealand (2010). Several other countries have recently announced proposals to tighten their thin capitalisation rules, including Belgium, Canada, Finland and Sweden.

72. Despite headline company tax rates declining over the past three decades, company tax revenues as a proportion of GDP have slightly increased across the OECD (see Chart 8). The size of company tax revenue as a share of GDP is a function of not only the tax rate and the tax base, which have generally had offsetting impacts over the period, but also the rate of corporate profitability and the contribution of the corporate sector to GDP. However, company tax revenue as a proportion of GDP is measured gross of the imputation credits that domestic shareholders can receive for franked dividends in Australia (see Chart 12 for more detail). If the net effects of imputation were incorporated, the proportion would be lower for Australia (as too would the proportions for the OECD averages if other countries' systems for providing shareholder relief were incorporated).

Chart 8: Company tax revenues as a percentage of GDP in the OECD (1982-2009)³⁰

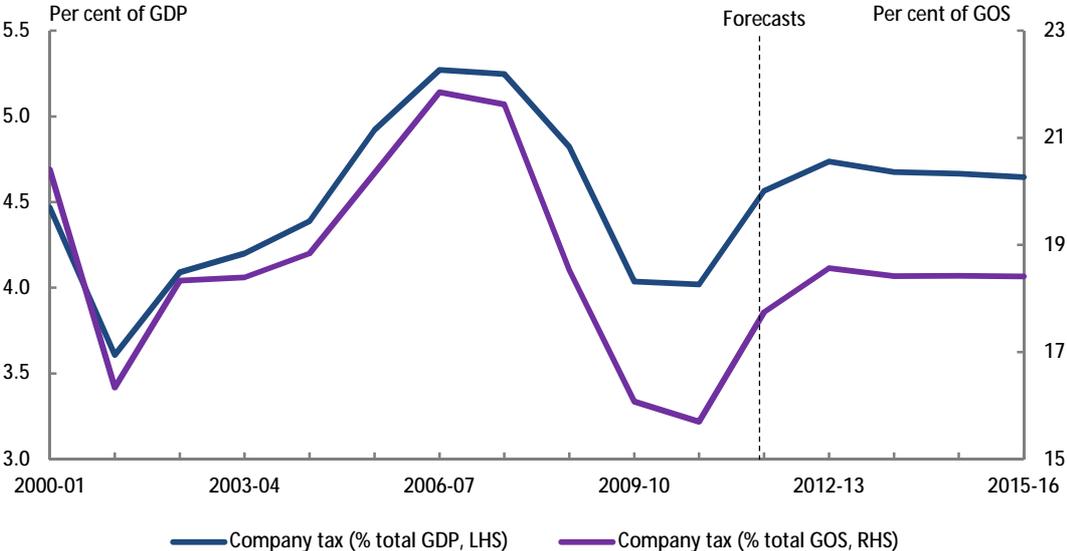


Source: AFTS (2009) Report to the Treasurer.³¹

³⁰ The spike in Australian company tax revenues in 2000 reflects the introduction of the PAYG system.

73. Now and into the future, company tax revenue as a share of GDP for Australia will also be influenced by the expansion of investment in the mining sector. New investment is leading to larger deductions for depreciation at the same time as profits are relatively strong.

Chart 9: Australian company tax revenue as a share of GDP and gross operating surplus (GOS) (2000-2016)



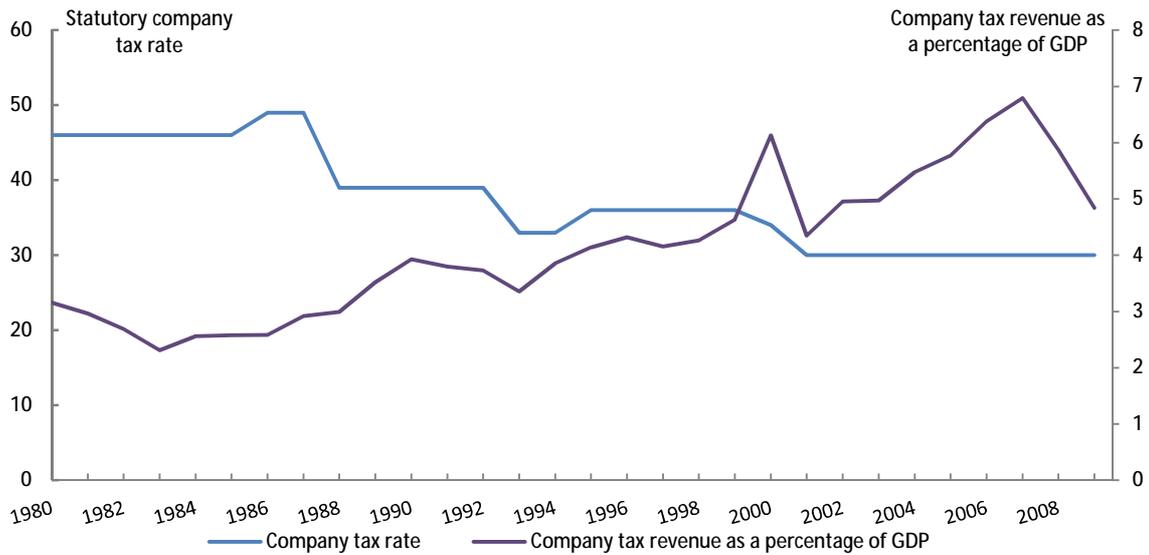
Source: Treasury

74. In Australia, the proportion of company tax revenues has significantly increased, despite the decline in the rate of company tax (see Chart 10). As a result, Australia has a relatively high reliance on company tax revenue. This is in part due to Australia’s comparatively high levels of corporate sector profits, and particularly the profitability of the resource sector. Company tax revenue includes the additional tax on oil and gas profits collected under the Petroleum Resource Rent Tax. Norway, another resource-rich country, has the highest corporate tax revenue to GDP ratio within the OECD due to an additional 50 per cent tax being levied on its petroleum extraction activities. Another key factor that has affected company tax revenue as a share of GDP in Australia has been the corporatisation and privatisation of previously tax-exempt public sector enterprises.³²

³¹ Data does not include Chile, Estonia, Israel and Slovenia. Data for Czech Republic, Hungary, Slovakia and Turkey begins in 1991.

³² Clark, Pridmore, Stoney (2007), ‘Trends in aggregate measures of Australia’s corporate tax level’, *Economic Roundup*, Canberra, Winter 2007.

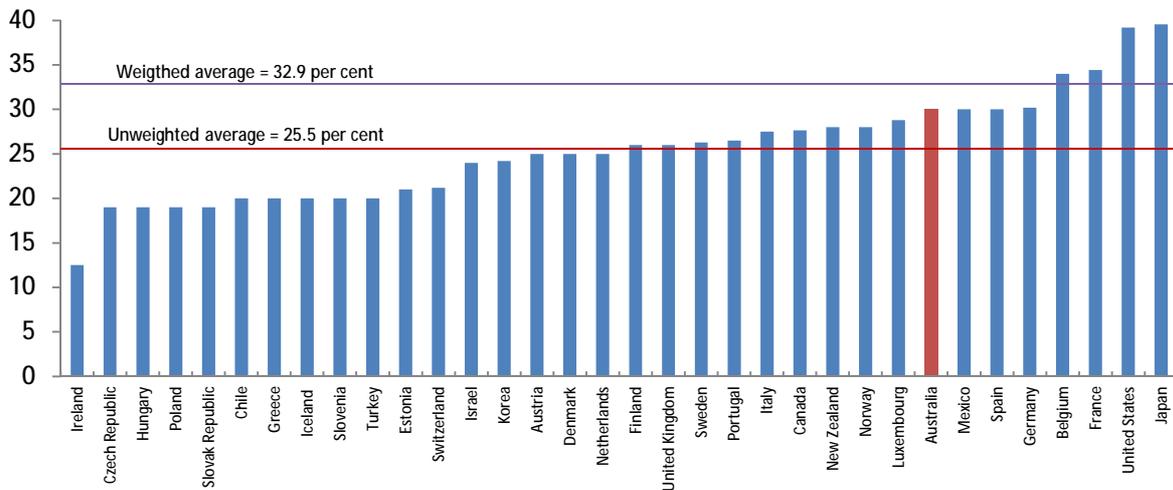
Chart 10: Corporate tax in Australia — rate and revenues (1980-2009)



Source: OECD Revenue Statistics 2011.

75. In 2001, when Australia reduced its company income tax rate to 30 per cent, the rate was the ninth lowest rate in the OECD. It is now sits at the higher end of the OECD spectrum (see Chart 11) but is still below the weighted average rate.

Chart 11: Company tax rates of OECD countries (2011)

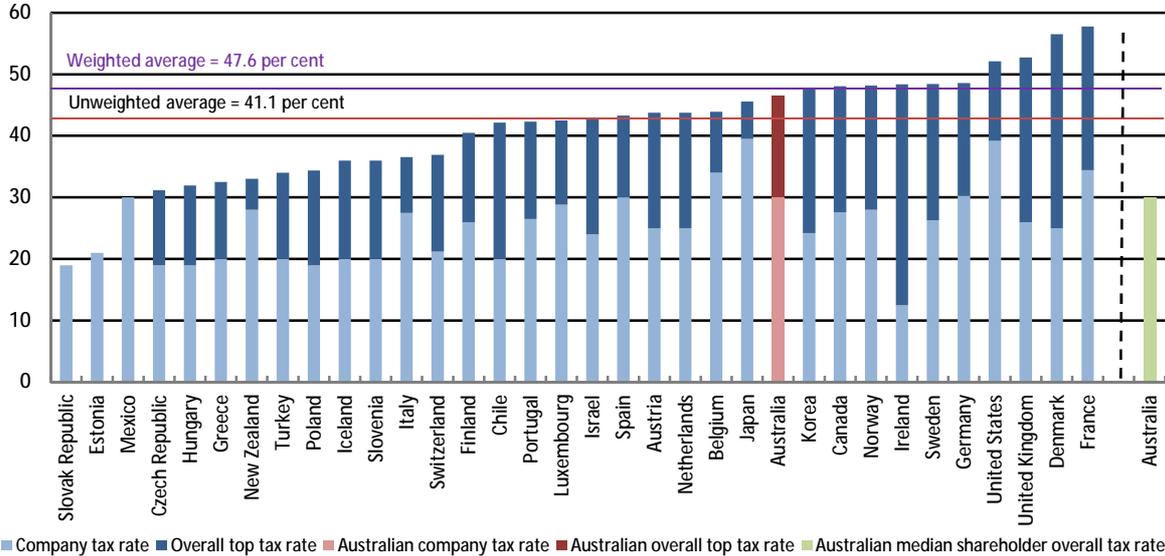


Sources: OECD Tax Database (2011) and IMF World Economic Outlook Database (2011).

76. However, after adjusting for the effects of varying personal income tax systems and shareholder relief mechanisms employed in different OECD countries, Australia has the eleventh highest overall top statutory level of tax paid on company profits distributed as dividends to domestic shareholders (see Chart 12).³³ This reflects the effects of Australia’s dividend imputation regime, which avoids double taxing income by providing a full tax credit to domestic shareholders for company tax paid.

77. In this respect, the Australian company tax system acts as a withholding tax, with shareholders paying (or being refunded) the difference between the company tax rate and their marginal tax rate on dividend income. Full dividend imputation therefore results in the overall rate of tax paid on domestic source dividend income equalling the marginal income tax rate of shareholders.³⁴ For top marginal rate shareholders in Australia, this was equal to 46.5 per cent in 2011. Based on 2009-10 data, the median investor in domestic shares faces the top marginal rate. However, looking across all individual taxpayers reporting dividend income, the typical investor faces a marginal tax rate of 30 per cent (the green bar in Chart 12).

Chart 12: Overall top statutory tax rates on domestic source dividend income in OECD countries (2011)



Sources: OECD Tax Database (2011) and IMF World Economic Outlook Database (2011).³⁵

³³ The difference between the company tax rate and the overall top statutory rate is determined by both the type of shareholder relief and the top personal income tax rate. For example, some countries that have a lower company tax rate than Australia but a higher overall tax rate, including Korea (partial imputation), Canada (full imputation at federal level), Norway (operates a unique shareholder model), Ireland (classical), Sweden (classical), the UK (partial imputation) and Denmark (modified classical). On the other hand, some countries have a higher or equal company tax rate than Australia but a lower overall top statutory tax rate, including Japan (modified classical), (Spain (modified classical) and Mexico (full imputation). An example of personal tax rates affecting the overall tax rate can be seen by comparing Mexico and Australia. Both have a company tax rate of 30 per cent and operate full imputation systems, however, because the top marginal tax rate in Mexico (30 per cent) is lower than in Australia (46.5 per cent), the overall tax rate is lower in Mexico.

³⁴ Canada, Chile, Mexico and New Zealand also operate full imputation systems. However, there has been a general trend away from this form of shareholder relief. Many European Union members, including the UK (1999) and Germany (2001), replaced their full imputation systems with other systems to comply with Article 56 of the EC Treaty, which prohibits restrictions on the free flow of capital within the European Union. The trend has also extended into Asia with Singapore (2003) and Malaysia (2008) also abandoning their systems.

³⁵ The measurement of the overall top statutory tax rate on domestic source dividend income is based on a number of assumptions, and conclusions drawn from international comparisons are subject to a number of caveats: the threshold for

78. Dividend imputation generally increases the overall post-tax return for domestic investors (including those not on the highest marginal tax rate). However, a consideration with regard to the competitiveness of Australia's tax system is whether dividend imputation is likely to significantly lower the cost of capital for Australian companies. In small open economies like Australia, the marginal investor is likely to be a foreign investor that does not have access to imputation credits.³⁶

79. The AFTS Review noted that because the marginal investor is likely to be a foreign investor, the benefits to investment resulting from Australia's imputation regime are likely to be muted, and become more muted as Australia further integrates with the global economy.³⁷ Accordingly, for international comparisons of the effect of tax systems on the cost of capital to businesses, the statutory company tax rate and withholding tax rate for non-residents are most relevant.³⁸ The overall statutory tax rates that domestic shareholders face are less important for such comparisons, but more relevant to considerations of the impact of taxation on savings behaviour and on distributional outcomes.

80. It should also be noted that that the Working Group is not considering changes to Australia's dividend imputation system, as it operates outside of the business tax system and is therefore outside the scope of the Working Group's terms of reference.

entering the top income tax bracket across countries varies significantly, making it difficult to compare like shareholders; share ownership extends beyond individuals in the top income tax bracket, which results in varying overall rates for different shareholders within countries; shares can be held on behalf of workers through superannuation funds, which are taxed at preferential rates; the measure captures the legal incidence of tax but does not take into account where the economic incidence of the tax may fall; and the measure doesn't capture the tax treatment for retained profits, which are taxed through the capital gains tax system when the shares are sold.

³⁶ The marginal investor is regarded as the entity that invests at the margin, thereby determining the cost of capital.

³⁷ AFTS Review (2009), *Final Report to the Treasurer*, Treasury, Canberra p 193

³⁸ In Australia, withholding taxes for non-resident shareholders are generally only applied to non-franked dividends. The rate of withholding tax applied varies depending on whether Australia has a tax treaty covering withholding taxes with the country of the non-resident. If a treaty exists, the withholding tax rate is generally 15 per cent. If a treaty does not exist, the rate is usually 30 per cent.

5. BASE BROADENING OPTIONS

81. Consistent with its terms of reference, the Working Group is currently considering a range of measures that would broaden the business tax base to fully finance a corporate tax rate cut.³⁹ Past base broadening efforts have often included measures to move the tax system closer to the benchmark of having tax depreciation reflect the economic life of an asset. Removing departures from effective life depreciation would increase the effective tax rate on investments in some assets. From a whole of economy perspective, this may improve the allocation of resources across the economy but it will inevitably have implications for a sector's ability to compete for investment.

82. The Ralph Report instigated significant base broadening through the removal of accelerated depreciation for many industries. Revenue neutrality concerns aside, the Ralph Report emphasised that creating uniformity in the tax base was essential for ensuring that scarce resources were directed to their most productive use. The AFTS Review also highlighted the potential benefits of further base broadening through a move towards economic life depreciation,⁴⁰ but recommended a move towards a 25 per cent corporate tax rate in the context of the introduction of improved charging arrangements for non-renewable resources.⁴¹

83. The Working Group is conscious that while a move towards economic depreciation for all assets could reduce distortions and improve simplicity, it is difficult to measure economic depreciation accurately and transitional arrangements could add complexity to the system. Rates of economic depreciation will depend on a number of factors including the type of asset, how it is used and where it is used.

84. There may also be cases where departures from uniform tax treatment are justified on economic grounds, social or environmental grounds, for example where particular activities generate large negative or positive spillovers. In such cases, favourable tax treatment ensures that investment continues in activities such as R&D and innovation, despite the benefits being enjoyed by entities outside the investing organisation. However, the tax system may not necessarily be the best tool for achieving such policy goals and if existing concessions are not influencing investment consistent with the policy rationale then there may be a case for their removal (at least in part).

85. The Working Group is aware that some of the options currently under consideration would involve reversal of measures that have only recently been enacted and some that are longstanding and were not pursued in previous base broadening exercises. Further, some of these options would potentially affect a wide range of taxpayers in a range of industries whereas others would be more targeted. Nonetheless, the terms of reference require the Working Group to test whether the revenue forgone through these measures and rules would be better directed at lowering the corporate tax rate.

86. Broadening the business tax base may also involve appropriately limiting the deductibility of costs incurred in relation to debt financing, for example through thin capitalisation rules, increasing the share of foreign source income in the business tax base, or increasing the scope of withholding taxes on returns to foreign investment in Australia. Strengthening integrity provisions in the business tax system was a feature of the Ralph Report recommendations and may also be described as

³⁹ While the Working Group is also permitted to identify savings from business spending programs, they tend to be time-limited and are therefore not suitable to fund an ongoing reduction in the company tax rate. The terms of reference preclude the Working Group from considering changes to the goods and services tax.

⁴⁰ AFTS Review (2009), *Final Report to the Treasurer*, Treasury, Canberra, p 87 (recommendation 28).

⁴¹ *Ibid*, 86 (recommendation 27).

broadening the base, as it reduces the scope for business income to escape the tax net and for different tax outcomes to apply to otherwise comparable activities.

87. Following on from its *Final report on the tax treatment of losses*, the Working Group has focussed on developing options in three broad categories of base broadening:

- interest deductibility (including thin capitalisation rules);
- capital allowances and the treatment of capital expenditures, and
- the R&D tax incentive.

In response to earlier feedback, the Working Group has included in this discussion paper a description of each option and Treasury's current estimate of the revenue implications of the option. A summary table is provided at Appendix E.

88. In light of responses to this discussion paper, the Working Group will further consider these options. Some may be dropped, others may be amended and new ideas might be canvassed. The inclusion of a base broadening option in this paper should not be interpreted as an indication that it will be adopted by the Working Group or the Government.

89. In addition to comments on specific base broadening options, the Working Group welcomes input on the need for, and design of, possible transitional rules should any of these options proceed. Consistent with the Working Group's principles for business tax reform, transitional rules will need to balance a new investment focus and a desire for simplicity in the design of any new laws.

90. As made clear earlier in this paper, the Working Group considers that a 'lower rate, broader base' reform approach has the potential to provide significant benefits to the Australian economy through increased investment opportunities and improved productivity. It is the task of the Working Group to assess the extent to which a lower rate, broader base reform package can provide a net economic benefit for Australia. Consultation on this discussion paper is intended to assist the Working Group in making such an assessment, as will Treasury modelling of the macroeconomic benefits of reform options.

Preliminary revenue implications

91. Treasury's preliminary estimates for a range of company tax rate cuts are provided below (see table 2). These figures should be read as orders of magnitude only and will be refined for the Working Group's draft final report. These preliminary estimates assume a 1 July 2013 start date for any cut to the company tax rate. They take into account limited behavioural effects, specifically a bring forward of activity into 2012-13 (since deductions will have a greater tax value at a 30 per cent rate). This bring forward effect would be expected to increase the larger the anticipated cut to the rate. However, these estimates do not consider behavioural effects; nor do they factor in the dynamic gains — to investment, wages, productivity and growth — that would flow from a lower company tax rate. These preliminary estimates do, however, assume that around 20 per cent of the cost of any cut to the company tax rate is clawed back through higher personal tax receipts (due the imputation system). Work is continuing to refine this assumption.

Table 2: Preliminary estimate of the revenue cost of a company tax rate cut⁴²

New company tax rate (from 30 per cent)	Preliminary estimated cost (\$million)				
	2012-13	2013-14	2014-15	2015-16	Total
29 per cent	300	1,400	1,800	1,900	5,400
28 per cent	300	2,700	3,600	3,800	10,400
27 per cent	500	4,200	5,300	5,600	15,600
26 per cent	1,000	5,600	7,000	7,300	20,900
25 per cent	1,300	6,900	8,700	9,100	26,000

92. Treasury has also estimated the financial impact over the 2012-13 forward estimates period of the different base broadening options considered by the Working Group in accordance with its approach to the costing of Budget proposals and election commitments.

93. The estimated revenue implications of each reform option currently being considered by the Working Group and discussed in this paper are presented below. The data and assumptions underpinning these revenue estimates are provided in Appendix E. It is important to note that the costings are undertaken individually and are therefore not necessarily additive. When and how a reduction in the company tax rate is phased in (and its size) will depend on the quantum of savings that can be delivered and how soon they can be realised.

94. The costings presented below and in Appendix E assume that the reforms concerned apply, at the earliest, from the date of their announcement. The timing of the commencement of reforms and the nature of transitional arrangements are important considerations and may be significant factors in determining the viability of proceeding with certain reform options. Further, in each case, new legislation would be required to give effect to the reform.

Interest deductibility and thin capitalisation

95. The thin capitalisation regime, in its current form, was enacted in 2001. The regime aims to limit the capacity of multinational firms to move profits out of Australia by assigning an excessive amount of debt to their Australian operations. When the Australian subsidiary's borrowing exceeds a defined threshold, its interest expenses can no longer be deducted from its income. The regime applies to all of the debt of a relevant multinational and not just to the debt borrowed from foreign related parties, as was the case under the previous rules.

96. Australian subsidiaries can apply one of a number of thresholds under the rules, including the 'safe harbour' limit, the 'arm's length' debt limit and (for outward investors) a worldwide gearing ratio limit. Different safe harbour limits apply to 'general entities', non-bank financial entities and banks.

⁴² Figures have been rounded to the nearest hundred million dollars.

97. Most developed economies have adopted tax measures to restrict the capacity of multinationals to shift profits to lower-tax jurisdictions. Thin capitalisation rules must strike the right balance between revenue protection, on the one hand, and allowing firms to structure their finances as they see fit, on the other.

98. When assessed against other countries' thin capitalisation regimes, the Australian rules could be seen as overly generous. There are flaws with particular rules, including the arm's length test (particularly when it does not have a firm-specific element), which in its current form could allow significant profit shifting to occur. As a discretionary test, moreover, it is difficult for the ATO to administer. The large information asymmetry that third parties face when auditing (or potentially auditing) tax calculations that can be based on subjective market and firm-specific information and assumptions raises integrity concerns.

99. It should also be kept in mind that the gearing levels these rules allow are higher than the levels employed by those firms that have little capacity/incentive to shift profits out of Australia (that is, purely domestic firms or firms that rely on truly independent financing arrangements). This gives multinationals a tax advantage over their Australian market competitors.

100. Recent experience also suggests that the arm's length capital test (only available to banks) is not used. All banks appear to use the applicable safe harbour capital ratio, with the calculations and outcomes closely resembling those arising from having to comply with the capital adequacy prudential regulations.

101. The Working Group has identified five reform options dealing with interest deductibility and thin capitalisation for business taxpayers. The first three options would reduce the scope for multinationals to shift profits offshore and reduce their Australian tax by changing the thin capitalisation regime.

102. A more fundamental change would be to limit the scope for all firms (domestic and foreign subsidiaries) to claim interest deductions — a move toward the so-called comprehensive business income tax. This would reduce the corporate tax system's bias in favour of debt (the costs of which are deductible) over equity (where the returns are taxed), addressing a major distortion. Heavily-gearred companies would be disproportionately affected by this change. The implications for banks would have to be carefully considered, given possible conflicts with existing prudential regulatory requirements.

103. The potential savings that might be realised from options dealing with interest deductibility and thin capitalisation is likely to be significant. As noted in the Working Group's final report on the tax treatment of losses, Treasury's costing of the savings that might be realised from possible changes to thin capitalisation rules (option A.1 in this paper) was criticised as being too low by stakeholders. Estimates of the potential savings from the thin capitalisation options are currently under review. Variations on this proposal (such as options A.2 and A.3) can have a substantial impact on the revenue estimate. For example, retaining the arm's length tests (option A.2) would reduce the potential saving, while extending the scope of the measure to also tighten the safe harbour rules for financial institutions (option A.3) would increase the potential savings.

104. Options A.4 and A.5 involve a fundamental shift in Australia's approach to the deductibility of interest expenses. Potential savings that might be expected from these options is heavily dependent on unresolved features of the proposal. The Working Group does not have sufficient information at this point in time to instruct Treasury so that they could reliably estimate the potential savings from this proposal. Among other things, further detail on how these options would apply in practice and possible effects on business are needed. Submissions on these aspects would be particularly welcome.

105. The Working Group is developing a survey to facilitate the collection of data that could be used to gain a better understanding of the potential revenue gains from these options. Interested parties wishing to participate should contact the Working Group Secretariat (contact details are provided at the end of the paper).

Option A.1 — Remove arm's length tests and reducing safe harbour gearing levels — general entities

106. This option would involve:

- removing the arm's length debt test (for general entities and non-bank financial entities) and the arm's length minimum capital amount (for banks) from the domestic law;
- reducing the safe harbour maximum debt limit for general entities from 75 per cent to 60 per cent on a debt-to-total assets basis (or from 3:1 to a 1.5:1 debt-to-equity basis); and
- reducing the worldwide gearing ratio for general entities and non-bank financial entities from 120 per cent to 100 per cent.

Option A.2 — Reduce safe harbour gearing levels — general entities

107. This option would involve:

- reducing the safe harbour maximum debt limit for general entities from 75 per cent to 60 per cent on a debt-to-total assets basis (or from 3:1 to a 1.5:1 debt to equity basis); and
- reducing the worldwide gearing ratio for general entities and non-bank financial entities from 120 per cent to 100 per cent.

108. In contrast to Option A.1, the arm's length test would be retained to permit gearing at a level that could have been borne by an independent party operating under the same terms and conditions.

Option A.3 — Reducing safe harbours for financial institutions

109. This option would involve:

- For banks (authorised deposit-taking institutions):
 - increasing the safe harbour for the minimum equity requirement from 4 per cent to 6 per cent of the risk weighted assets (as determined under APRA regulations) of the Australian operations; and
 - increasing the worldwide capital ratio from 80 per cent to 100 per cent.
- For 'non-bank financial entities':
 - reducing safe harbour gearing limit for general activities (after the application of the 'on-lending' rule) from 75 per cent to 60 per cent (domestic debt-to-total assets basis) or 3:1 to 1.5:1 (domestic debt-to-equity basis); and
 - reducing the safe harbour overall maximum debt limit from 95.24 per cent (on a debt to total assets basis) or 20:1 (on a debt to equity basis) to 93.75 per cent of debt-to-total asset (or 15:1 debt to equity basis).

110. These options would reflect changes in the minimum capital requirements in the regulatory banking environment.

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

111. This option would involve:

- Removing the thin capitalisation rules from the domestic law.
- Placing a cap on the deductibility of interest by limiting the net interest expense (the excess of interest paid over that received) to a set percentage of 'earnings before interest, taxes, depreciation and amortisation' (EBITDA) for all taxpayers, excluding banks.
 - This means there is an uncapped deduction of interest expenses up to the amount of interest income.

112. The limit would apply regardless of whether the taxpayer operates only domestically or has offshore operations. The international practice in respect of the EBITDA benchmark rate ranges between 25 per cent (France) to 50 per cent (the US (related party debt focus) and New Zealand (narrow targeted application) with the majority clustered around 30 per cent. Countries that have adopted this approach have generally allowed for the carry forward of unused EBITDA capacity and denied interest deductions — see Appendix F for further details.

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

113. This option extends Option A.4 to banks. The inclusion of banks is consistent with the approach taken by Germany. There, the interest cap applies equally to all sectors of the economy.

Depreciating assets and capital expenditure

114. As noted earlier, reducing or eliminating accelerated depreciation allowances in order to more closely align allowances with economic rates of depreciation has been a common form of base broadening internationally.

115. Ideally, the business tax system should be neutral and should not seek to favour certain types of investments or activities over others. The benchmark for the neutral treatment of capital expenditure is that tax depreciation should be aligned as closely as possible with economic depreciation. The Australian tax system has moved closer to this benchmark, principally through the adoption in 2001 of the uniform capital allowances regime. However, the system retains a number of departures from the benchmark.

116. As discussed above, the Working Group is not arguing that neutrality is an end in itself. In some cases, there are good reasons to favour some types of capital expenditure — for example, to correct for a significant market failure. In other circumstances, however, there may be no compelling policy rationale. It should also be kept in mind that economic depreciation is inherently difficult to measure. Departures from neutral treatment will sometimes reflect this fact.

117. In light of these considerations, the following areas may merit consideration for reform:

- the diminishing value method of depreciation;
- statutory effective life caps;
- the immediate deductibility for exploration or prospecting expenditure; and
- building depreciation.

118. For consistency, the Working Group has included all current departures from effective life depreciation noting that this necessarily involves consideration of the removal of long standing rules

(such as those applying to water facilities and aeroplanes) and those that have only recently been introduced (specifically the new concessions for shipping assets). As stated earlier in this paper, the Working Group is open to feedback as to whether these rules should be retained or whether they should be traded off in pursuit of a lower corporate tax rate.

I. Diminishing value method

119. Under the tax law there are two methods of calculating the decline in value of a depreciating asset: the prime cost (straight line) method and the diminishing value method. Under the diminishing value method, the decline in value of a depreciating asset is assumed to be greatest in the first year and smaller in each following year. The lower the diminishing value rate, the lower the deduction in the early years of an asset's life (although total depreciation over time remains unchanged).

120. In the 2006-07 Budget, the Government increased the diminishing value rate for determining depreciation deductions from 150 per cent to 200 per cent of the corresponding prime cost rate for all eligible assets. It equated to a 33 per cent increase in the allowable depreciation rate for all eligible assets in the first year. For example, a \$40,000 asset being depreciated over four years at the 150 per cent rate would be eligible for a depreciation deduction in the first year of \$15,000. In contrast, at the 200 per cent rate, the allowable depreciation deduction would be \$20,000.

121. The effect of the measure was to increase depreciation deductions in the early years of an asset's life. The stated purpose of the change was to better align depreciation deductions with the actual rate at which assets decline in value.

122. The selection of a rate of between 150 and 200 per cent is supported by a number of academic studies.⁴³ While generally considered to be soundly based, these studies are now decades old and as mentioned before it is difficult to accurately measure economic depreciation.⁴⁴ Any estimate of an average depreciation rate of a heterogeneous population of assets will not, by definition, describe the performance of a single asset.

123. This Working Group is mindful that lowering the rate of diminishing value depreciation would reverse a recent reform, the stated objective of which was to more closely align depreciation rates with the actual rate of decline in the economic value of assets. However, as noted above, economic life can be a difficult concept to measure in practice and may vary across different assets.

⁴³ Hulten, Charles R. and Franck C. Wykoff (1981), 'The Measurement of Economic Depreciation Using Vintage Asset Prices: An application of the Box-Cox Power Transformation', *Journal of Econometrics*. Vol 15 No. 8 cited in New Zealand Inland Revenue and Treasury Departments (2004), *Repairs and maintenance to the tax depreciation rules: An officials' issues paper*, Policy Advice Division of the Inland Revenue Department, New Zealand..

⁴⁴ As New Zealand regulators have noted, studies that measure economic depreciation are difficult, expensive and complex. The landmark studies of Hulten and Wykoff are now several decades old and are necessarily limited because of a lack of reliable, representative data (New Zealand Inland Revenue and Treasury Departments (2004), page 43). The Hulten and Wykoff studies relied for their estimates on second hand sale data for a large population of assets types. One of the limitations of this methodology is that the trade in second hand goods is often 'thin', meaning that sale prices may not be a true indication of economic value.

Option B.1 — Reduce the diminishing value rate for depreciation from 200 per cent to 150 per cent

124. The Option would involve reducing the diminishing value rate of depreciation from 200 per cent to 150 per cent.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
	10	170	700	1300	2180
Notes	The costing has been prepared on the basis that the application date for the reform coincides with an announcement in the 2013 Budget on 14 May 2013. Changes to depreciation arrangements have been assumed to apply to contracts that are signed, construction that commences, or assets whose holding commences after this date.				

II. Statutory effective life caps

125. Statutory effective life caps shorten the period over which selected assets can be depreciated, providing a benefit for their owners. Statutory caps represent one of the largest categories of tax expenditure in the business tax system but only apply to a narrow range of depreciating assets and assets used in certain industries.

126. Statutory effective life caps were first introduced in 2002 in response to concerns that the removal of accelerated depreciation (as part of the reforms following the Ralph Report) would adversely affect investment in certain sectors. A detailed summary of statutory effective life caps is set out in Appendix G.

127. The beneficiaries of statutory caps include the oil and gas, petroleum, agricultural and transport industries and irrigation water providers. Statutory caps apply to three broad categories:

- aeroplanes, helicopters and certain light commercial vehicles, minibuses, trailers and trucks and certain shipping vessels;
- assets used in certain industries: transmission and distribution assets used in the gas supply industry, certain oil and gas production assets, certain assets used in petroleum refining and harvesters and trucks used in primary production; and
- expenditure by irrigators and primary producers on water facilities.

128. The removal of statutory effective life caps could be seen as eliminating a distortion in our corporate tax system. A more neutral system would, in turn, foster a more efficient allocation of resources across the economy. In the short-term, however, a number of investment projects, including some very large ones, would be threatened. The relative attraction of investing in Australia over other countries would also be affected in some cases.

129. The removal of statutory effective life caps for certain assets would also reduce after tax returns to investments by unincorporated taxpayers, such as primary producers, who would not benefit from a cut to the company tax rate.

130. The Working Group has identified five options. The first option (Option B.2) would involve removing all the statutory effective life cap provisions that exist in the current tax system. The remaining options target certain types of assets that are currently eligible for statutory caps.

Option B.2 — Remove the capped effective life provided to certain depreciating assets

131. This option would involve removing the statutory effective life caps available for the depreciating assets listed in 40-102(4) and 40-102(5) of the *Income Tax Assessment Act 1997* (ITAA 1997) and the three-year effective life cap available for expenditure by irrigators and primary producers on water facilities, as outlined in sections 40-515 to 40-575 of the ITAA 1997. The affected assets would therefore be depreciated in line with their effective lives, rather than the capped lives outlined in the legislation.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
	0	70	300	625	995
Notes	<p>The costing has been prepared on the basis that the application date for the reform coincides with an announcement in the 2013 Budget on 14 May 2013. Changes to depreciation arrangements have been assumed to apply to contracts that are signed, construction that commences, or assets whose holding commences after this date.</p> <p>It is recognised, however, that often there can be a significant time lag between when an investment project is committed and when contracts commence. The precise application arrangements would therefore need to be a matter for further consideration.</p>				

Option B.3 — Remove the capped effective life provided to depreciating assets used in oil and gas extraction and petroleum

132. This option would involve removing the statutory effective life caps available to depreciating assets used by the oil and gas and petroleum industries as outlined in 40-102(5) of the ITAA 1997. The affected assets would therefore be depreciated in line with their effective lives, rather than the capped lives outlined in the legislation.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
	0	30	100	200	330
Notes	See Option B.2				

Option B.4 — Remove the capped effective life provided to depreciating assets used in primary production

133. This option would involve removing the statutory effective life caps available for depreciating assets used by the primary production industry, namely, harvesters, tractors, aeroplanes used for agricultural spraying or dusting and helicopters used predominantly for mustering, agricultural spraying or dusting. The affected assets would therefore be depreciated in line with their effective lives, rather than the capped lives outlined in the legislation.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
	..	10	50	100	160
Notes	<p>See Option B.2</p> <p>.. Not zero but rounded to zero.</p>				

Option B.5 — Remove the capped effective life provided to water facilities

134. This option would involve removing the three-year effective live cap available for expenditure by irrigators and primary producers on water facilities, as outlined in sections 40-515 to 40-575 of the ITAA 1997. The affected assets would therefore be depreciated in line with their effective lives, rather than the capped lives outlined in the legislation.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
	..	5	10	15	30
Notes	See Option B.2 .. Not zero but rounded to zero.				

Option B.6 — Remove the capped effective life used in non-specified industries

135. This option would involve removing the statutory effective life caps for aeroplanes and helicopters (other than those covered by Option B.4) and certain buses, light commercial vehicles, minibuses, trailer and trucks and certain shipping vessels. The affected assets would instead be depreciated in line with their effective lives.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
	0	25	140	290	455
Notes	See Option B.2				

III. Exploration and prospecting

136. The Working Group has examined the immediate deductions for expenditure on exploration and prospecting. There are two aspects to these deductions: depreciating assets 'first used' in exploration or prospecting; and expenditure on actual exploration or prospecting. The immediate deductibility for exploration and prospecting expenditure is a long-standing feature of the income tax system. It is intended to encourage mineral exploration, in recognition of potential spillover benefits from the publication of the results of exploration activity. However, it is a matter for judgement whether these concessions provide an optimal level of support.

137. Criticisms of the current exploration concessions could include that they are poorly targeted (particularly the 'first use' test), may be misapplied (for example, when an exploration right ('tenement') changes hands immediately before being converted into a mining tenement), and may not benefit junior miners (who do not have income against which expenses can be deducted).

138. However, the reduction or removal of exploration concessions would be expected to increase marginal effective tax rates for explorers, reducing the scale of exploration in Australia and encouraging some investors to transfer activities overseas.

139. The Working Group has identified four options for reforming the tax treatment of capital expenditure relating to exploration and prospecting. Reforms options that propose requiring depreciating assets to be written-off over five years or longer instead of immediately would not result in an increase in the nominal value of the relevant deductions over time. However, the present value of these deductions would be reduced. Such reforms would involve deductions for affected companies to be 'pushed back' to later years, leading to reduced tax payments in these years.

Option B.7 — Remove or reduce the 'first use' exploration deduction

140. This option would remove or reduce the immediate deduction for depreciating assets first used in exploration or prospecting by miners. Reducing the deduction would involve the asset being written off over five years or over its effective life of the asset rather than immediately.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
Over 5 years	0	900	800	600	2300
Over effective life	0	900	1000	1000	2900
Notes	The costing has been prepared on the basis that the application date for the reform coincides with an announcement in the 2013 Budget on 14 May 2013. Changes have been assumed to apply to contracts that are signed, construction that commences and assets whose holding commences or expenditure incurring after this date.				

Option B.8 — First use exploration deduction — intangibles

141. This option would remove or reduce the immediate deduction for interests in exploration 'tenements', which confer upon the owner a right to engage in this activity. Instead deductions would be available over five years or the effective life of the asset.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
Over 5 years	0	200	200	100	500
Over effective life	0	200	200	200	600
Notes	See Option B.7				

Option B.9 — Deduction for non-depreciating exploration expenditure

142. This option would require capital expenditure on exploration or prospecting that is not for depreciating assets to be written down over five years or the effective life of the project. This treatment would be codified in the law (that is, the expenditure would not be deductible under any other provision).

143. This deduction relates to expenditure on non-depreciating assets used in exploration or prospecting, such as transport, materials, labour and administrative costs. The deduction is not available where the expenditure is part of the cost of a depreciating asset and, consequently, the balancing charge provisions do not apply.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
Over 5 years	0	100	100	100	300
Over effective life	0	100	200	100	400
Notes	See Option B.7 The financial impact has been estimated on the basis that none of the expenditure reported as having been deducted under section 40-730 of ITAA 1997 would be eligible for an immediate deduction under section 8-1 of the ITAA 1997.				

Option B.10 — Removal of immediate deduction for exploration expenditure by large companies

144. This option would require capital expenditure incurred in exploration or prospecting to be deducted over five years rather than being immediately deductible. However, the five year write-off would only apply to companies or other entities that have a turnover over \$500 million. This treatment would be codified in the law (that is, the expenditure would not be deductible under any other provision).

145. The removal of immediate deductibility would apply to exploration or prospecting expenditure in relation to depreciating assets (covered by section 40-80 of the ITAA 1997) and to capital expenditure on exploration or prospecting that is not in relation to depreciating assets (covered by section 40-730 of that Act). The former expenditure is covered by the uniform capital allowances system and a balancing charge may arise when the asset is sold. If a depreciating exploration asset is sold by the company before five years have elapsed, then the balancing charge may be reduced.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
	0	800	700	600	2100
Notes	See Option B.9				

Option B.11 — Exclude feasibility studies from exploration expenditures

146. This option would remove feasibility studies from the definition of exploration and prospecting expenditure under section 40-730 of the ITAA 1997. The main focus would be on removing studies undertaken to evaluate the economic feasibility of mining or quarrying a site once minerals have been discovered. Instead of being immediately deductible, the cost of feasibility studies would be deductible over five years.

147. Tax return data is not sufficiently disaggregated to allow Treasury or the ATO to identify what proportion of expenditure currently deducted under section 40-730 relates to feasibility studies. Submissions on this point would assist the Working Group in considering whether this option should be pursued further.

IV. Building depreciation

148. Taxpayers can claim a deduction for expenditure incurred in constructing capital works, including buildings and structural improvements. These expenses can be depreciated over 40 years at a rate of 2.5 per cent each year. For short-term traveller accommodation, more generous rules apply (25 years, 4 per cent).

149. The use of fixed rates of depreciation means that capital works deductions are calculated without regard to a structure's effective life. Neutrality would require a different approach. Two options might be considered: basing the depreciation rate on an estimate of effective life; or dispensing with depreciation entirely and instead factoring construction expenses into the cost base for capital gains tax. Under either approach, the cost of repairs would continue to be the subject of an immediate deduction. The Ralph Report recommended the first approach, bringing buildings and structures under a general depreciation regime applicable to all depreciable assets.

150. There is a case for scaling back existing building allowances because the tax system recognises depreciation in other ways, for example, by providing a deduction for costs of insurance, maintenance and repairs and reflects the actual depreciation (or appreciation) as a capital loss (or gain) on disposal. The United Kingdom has significantly scaled back the availability of building depreciation.⁴⁵ In 2010, New Zealand changed the depreciation rate of buildings with long estimated useful lives to zero per cent. This change is intended to make New Zealand's tax rules more neutral and non-distortionary.⁴⁶

151. Any move to a less generous building depreciation regime can be expected to raise EMTRs on investments by a range of businesses. To the extent that residential construction is brought within scope, investment in this area may be adversely affected with implications for housing affordability. However, any such impact could be expected to be marginal as the impact of the additional tax would be widely distributed.

152. The adoption of an effective life regime for buildings would also raise policy design and implementation challenges. The ATO would have to determine the effective lives, but in practice these vary depending on the type of construction, the nature of the building itself and the use to which it is put. The value of a purchased building would have to be established separately from the land — this process may be difficult, costly and open to manipulation. By contrast, deductions under the building depreciation regime are based on the original cost of construction.

153. The Working Group has identified three options for reforming the tax treatment of capital works expenditure that would, in turn, bring buildings within the uniform capital allowances system, adopt a similar approach to recent reforms in the United Kingdom and New Zealand or merely reduce the rate at which expenditure can be deducted.

Option B.12 — depreciate buildings over effective lives

154. The proposal would involve making new capital works subject to the uniform capital allowances systems such that they are depreciable over their effective lives and subject to balancing adjustment provisions. The cost of repairs would continue to be the subject of an immediate deduction.

⁴⁵ HRMC (2007), *Business tax reform: capital allowance changes*, London.

⁴⁶ New Zealand Inland Revenue and Treasury Departments (2010), *Taxation (Budget Measures) Act 2010: Changes to building depreciation*, New Zealand.

155. Making capital works subject to the uniform capital allowances regime would enable taxpayers to claim depreciation using the diminishing value method. Contrary to the assumptions underpinning that method, the value of buildings appears to decline slowly initially with a sharper fall in later years. An alternative costing has been prepared on the basis that buildings would be depreciable using only the prime cost method.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
Optional diminishing value	0	..	20	50	70
Prime cost only	0	5	45	120	170
Notes	<p>The costing has been prepared on the basis that the application date for the reform coincides with an announcement in the 2013 Budget on 14 May 2013. Changes to depreciation arrangements have been assumed to apply to contracts that are signed, construction that commences, or assets whose holding commences after this date.</p> <p>.. Not zero, but rounded to zero.</p>				

Option B.13 — remove building depreciation deductions

156. This option would involve removing capital works deductions consistent with recent reforms in the United Kingdom and New Zealand. The cost of repairs would continue to be the subject of an immediate deduction.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
	0	5	75	190	270
Notes	<p>See B.11 above. For this option it is assumed there is negligible CGT impact within the forwards estimates period.</p>				

Option B.14 — allow a uniform rate of depreciation of 2.5 per cent per annum

157. This option would involve retaining the existing system but imposing a uniform rate of deduction for all capital works at the current rate of 2.5 per cent per annum.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
	0	..	5	10	15
Notes	<p>See B.11 above.</p> <p>.. Not zero, but rounded to zero.</p>				

The R&D Tax Incentive

158. Governments support R&D activities because of the positive benefits they can generate for the wider economy. When framing R&D concessions, policy-makers must calibrate the support they provide with the external benefits being sought. They should also consider the likely responses of different types of firms. Large firms are likely to engage in some R&D without any public support, but this cannot be said for smaller firms which, apart from other things, lack access to external finance.

159. The R&D Tax Incentive provides support to eligible companies in two ways. Companies with an aggregated annual turnover less than \$20 million are entitled to a 45 per cent refundable tax offset for expenditure on eligible R&D activities (unless they are controlled by exempt entities). All other eligible companies are entitled to a 40 per cent non-refundable tax offset for expenditure on eligible R&D activities, which may be able to be carried forward to reduce future tax liabilities. There is no limit on the amount of R&D expenditure that companies can claim. This program applied a more tightly targeted definition of eligible R&D activity and provided higher base rates of support than the one it replaced.

160. Evidence suggests that tax incentives have different impacts on the R&D performed by small relative to large firms.⁴⁷ To the extent that the incentive is not, or is unlikely to be, effective in influencing company R&D investments there is an argument that the revenue forgone could be better employed. This is a point on which the Working Group would welcome feedback from the business community.⁴⁸ However, the reforms could, depending on transitional arrangements, affect the returns of long-term projects that were modelled on the basis of the pre-existing regime. As a result, some companies may relocate their R&D to countries that offer better incentives.

161. The removal or limitation of the R&D incentives based on turnover may place more pressure on integrity rules. For example, company groups close to a new turnover threshold might restructure their business in order to retain access to the R&D Tax Incentive.

162. The Working Group has identified four options for potentially better targeting the R&D Tax Incentive. These options would operate to limit or deny the non-refundable tax offset. Expenditure that no longer qualifies for the tax offset would remain eligible to be deducted or written off under the ordinary taxation provisions. To the extent that it contributed to a tax loss this could be carried forward or carried back (under announced loss carry back arrangements).⁴⁹

⁴⁷ OECD (2011), *Tax Reform Options: Incentives for innovation*, Testimony by the OECD, United States Senate Committee on Finance (September, 2011).

⁴⁸ It should also be noted that 2011-12 will be the first year to which the new R&D Tax Incentive applies and there is limited evidence of the effectiveness of the incentive as currently configured.

⁴⁹ Treasury (2012), *Improving access to company losses: Discussion Paper*, Canberra.

Option C.1 — Abolish the 40 per cent non-refundable tax offset

163. This option would involve denying the R&D offset to companies with a turnover for the year greater than \$20 million. Companies would instead be entitled to deductions for R&D expenditure under the normal deduction provisions in the tax law.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
	0	250	1050	950	2250
Notes	The costing has been prepared on the basis that the proposal applies to expenditure incurred on activities conducted on or after 1 July 2013.				

Option C.2 — Impose a turnover threshold above which the 40 per cent non-refundable tax offset could not be claimed

164. This option would involve maintaining the current rate of non-refundable tax offset but imposing a maximum turnover threshold. Companies above that upper threshold would be denied access to the offset and would instead deduct the R&D expenditure under the normal deduction provisions in the tax law.

165. In contrast to Option C.1, an additional turnover test would allow some companies to qualify for a non-refundable offset. The threshold could be set at a level to ensure that the incentive remains available to large, 'knowledge-intensive' companies.

166. Treasury's preliminary estimate is that imposing an upper turnover threshold at a relatively high level of \$10 billion would provide savings of around \$250 million per year. A threshold of \$20 billion would produce savings of around \$200 million per year. Introducing such a threshold would be expected to affect a small number of very large companies with very large R&D spends. The turnover threshold would be applied on the same basis as the current \$20 million aggregated annual turnover test that determines access to the 45 per cent refundable tax offset.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
\$10 Billion Threshold	0	50	250	250	550
\$20 Billion Threshold	0	50	200	200	450
Notes	See Option C.1				

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

167. This option would involve retaining the 40 per cent non-refundable tax offset for all companies with an aggregated annual group turnover of greater than \$20 million but imposing a cap on the dollar amount of expenditure that qualifies for an offset. Beyond that cap, companies would be entitled to deductions for R&D expenditure under the normal deduction provisions of the tax law. This approach targets the offset more towards smaller companies that are more likely to respond to R&D incentives.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
	0	50	200	200	450
Notes	See Option C.1				

Option C.4 — Cut the rate of the non-refundable tax offset to 37.5 per cent

168. The final approach identified by the Working Group would involve lowering the rate of the R&D non-refundable tax offset. Companies with an aggregated annual group turnover of \$20 million or more would continue to be eligible for the R&D tax offset, and would be able to carry forward the tax offset to reduce future tax liabilities.

169. Reducing the rate of the non-refundable tax offset recognises that companies with an aggregated annual turnover greater than \$20 million generally have greater capacity to undertake R&D and therefore may require less assistance than is currently provided.

Financial impact (\$ million)	2012-13	2013-14	2014-15	2015-16	Total
	0	50	250	250	550
Notes	See Option C.1				

6. RESPONDING TO THE DISCUSSION PAPER

170. Responses to this discussion paper will inform the preparation of a draft final report which the Working Group plans to release in late October 2012. The draft final report is expected to contain:

- draft recommendations which reflect the Working Group's current thinking on potential savings options;
- a summary of the key themes from consultation on the discussion paper; and
- further information and analysis which have informed the Working Group's thinking so far, including potential impacts on national income and macroeconomic risks.

171. The Working Group's final report to the Treasurer is due in December 2012.

Making a submission

172. Written submissions in response to this discussion paper are requested by close of business Friday 21 September 2012.

173. While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please submit responses sent via email in a Word or RTF format. An additional PDF version may also be submitted.

174. Submissions should be provided to:

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

Email: BTWG@treasury.gov.au

Phone: (02) 6263 3115

175. All information (including name and address details) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information, marked as such, in a separate attachment. Legal requirements, such as those imposed by the *Freedom of Information Act 1982*, may affect the confidentiality of your submission.

Consultation meetings

176. The Working Group will also endeavour to meet with a range of stakeholders throughout August and early September. Interested parties should contact the Working Group Secretariat.

Consultation questions

177. Stakeholders may like to consider the following consultation questions in responding to the discussion paper.

Consultation questions

Corporate tax rate cut

- A. In the context of your business, or businesses that you are familiar with, how would a cut to the corporate tax rate affect decisions about:
- i. undertaking new investment?
 - ii. choice of business structure?
 - iii. where new investment is undertaken?
 - iv. how new investment is financed?

Base broadening options

- B. What base broadening options would you support in order to fund a cut to the company tax rate?
- C. In the context of your business, or businesses that you are familiar with, how would any of the base broadening options affect decisions about:
- i. undertaking new investment?
 - ii. choice of business structure?
 - iii. where new investment is undertaken?
 - iv. how new investment is financed?
 - v. undertaking research and development?
- D. In the context of your business, or businesses that you are familiar with, for any of the base broadening options:
- i. would you expect compliance costs to change?
 - ii. what would you consider to be the most important transitional issues?
- E. Are there any alternative base broadening options, or refinements on existing options, that you would recommend that the Working Group consider?

Allowance for corporate equity

- F. Do you see merit in Australia exploring the introduction of an allowance for corporate equity in the longer term?
- G. What kind of information would be necessary to explore an allowance for corporate equity as a longer term option?

APPENDIX A: ABOUT THE BUSINESS TAX WORKING GROUP

Terms of Reference

Objectives

1. The Working Group will make recommendations on how the Australian business tax system can be improved to make the most of the challenges and opportunities arising from transformations in the broader economic environment, including the patchwork economy.
2. The revenue neutral reforms to the business tax system will aim to increase productivity, while delivering tax relief to struggling businesses.

Scope

3. The Working Group will focus on reform options that relieve the taxation of new investment:
 - 3.1. in the near term, by reforming the tax treatment of business losses; and
 - 3.2. in the longer term, by reducing the corporate tax rate further or moving to a business expenditure tax system, particularly an allowance for corporate equity.
4. For its final reports, the Working Group will provide specific analysis of these business tax reform options, including:
 - 4.1. description of how these reforms options operate overseas and evidence on their effectiveness;
 - 4.2. potential priorities for reform, including transitional paths;
 - 4.3. worked examples of how these options would affect business taxpayers, including their financial and tax accounts;
 - 4.4. revenue integrity provisions, such as measures necessary to limit: the inappropriate claiming of tax losses; the equity allowance to new equity; and small and closely held businesses converting labour into business income;
 - 4.5. how the reform options integrate with the rest of the tax system now and in the future;
 - 4.6. impacts on national income and macroeconomic risks; and
 - 4.7. costings.
5. The working group will also identify a range of off-setting budget savings from existing Commonwealth business taxation (or spending) measures. Changes to the GST should not be considered.
 - 5.1. The savings to be generated by the particular options will be costed by the Treasury in accordance with the budget rules.

6. In developing its recommendations, the Working Group should have regard to the report of the *Australia's Future Tax System Review* and relevant international experience and expertise.

Timing

7. The Working Group is required to provide the Treasurer with:
 - 7.1. an initial report on the proposed directions for improving the tax treatment of losses and offsetting savings in mid-November 2011;
 - 7.2. a final report on the treatment of losses and the offsetting savings in March 2012; and
 - 7.3. a further report on longer-term business tax reform options and offsetting savings by the end of 2012.

Consultation

8. For its final reports, the Working Group should consult widely with industry and the broader community.
9. The Working Group may establish technical sub-groups to consider specific issues or seek input from other sources of expert advice.

Support

10. The Working Group will be supported by a Secretariat within Treasury.

Chronology

October 2011 — Business Tax Working Group established

- The Working Group was established by the Treasurer to look at how Australia's tax system could be improved to make the most of the challenges and opportunities arising from the broader economic environment, including the patchwork economy. The Working Group's task is to be conducted in two phases:
 - Phase 1: consideration of reforms for the short-term, by improving the tax treatment of business losses.
 - Phase 2: consideration of longer-term reform directions for Australia's business tax system.

December 2011 — Interim report on the tax treatment of losses — released

- The interim report explored the tax treatment of losses in Australia, in particular how this treatment affects Australian businesses' ability to respond to emerging challenges and take advantage of new opportunities presented by changes in the local and international economy. The report also outlined possible reform options that may increase business productivity, while delivering tax relief to struggling businesses.

February 2012 — Interim report on the tax treatment of losses — consultation

- Submissions in response to the interim report closed in February.

March 2012 — Interim report on the tax treatment of losses — consultation

- Consultation meetings were held between Working Group members and interested stakeholders throughout March.

April 2012 — Final report on the tax treatment of losses — released

- The Working Group considers that loss carry back would be a worthwhile reform in the near term. However, the Working Group advised the Treasurer that it had not had an opportunity to explore the relative net-benefit of loss carry back compared with other business tax reforms.

The Working Group also recommended that the Government undertake further work to develop a model for reforming the same business test. The Working Group considers that further analysis and consultation is required before any conclusions can be drawn on possible savings options to fund reforms to the tax treatment of losses.

APPENDIX B: AN ALLOWANCE FOR CORPORATE EQUITY

1. The Working Group's terms of reference require it to consider whether it is preferable to move to a business expenditure tax system, particularly an allowance for corporate equity (ACE), as a means of relieving the tax on new investment. While an ACE has some theoretical attractions, there are a significant number of practical issues that the Working Group has confronted in its consideration of an ACE.

2. In particular, full implementation of an ACE may not be possible while maintaining revenue neutrality. In addition, there has been limited international experience in implementing ACE reforms, so the introduction of an ACE in Australia would involve considerable implementation risks. Furthermore, there are a number of key design issues that appear to be significant obstacles to achieving the theoretical attractions of such a change. Given the uncertainty being faced by business from developments in the global economy, now is not the time to introduce significant uncertainty in the business tax system. For these reasons, the Working Group feels 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.

What is an allowance for corporate equity?

3. Under the current tax system in Australia, entities are allowed a deduction for the returns on debt investment, as part of the deduction for interest payments on debt. However, they are not allowed a similar deduction for equity investments. An ACE would allow deductions to be made on the normal return to equity, approximated by the long-term government bond rate.⁵⁰ Above normal returns would not be deducted, and therefore would be taxed at the company tax rate.⁵¹

4. An ACE is seen as a way of achieving equivalent outcomes to a source-based cash-flow tax but through a model that can be integrated with the existing business tax system. A cash-flow tax is an alternative to the current tax system that is advocated as a way to address the inefficiencies arising from the timing of taxable income and expenses. A cash-flow tax would allow a full deduction for all expenditure when it is incurred,⁵² eliminating timing issues that exist with respect to the current treatment of capital assets. A pure cash-flow tax could incorporate a full loss offset — so that negative cash flows are treated identically to positive cash flows, or it could approximate this with uplift of losses.

⁵⁰ Normal returns refer to the return required to compensate for the time value of money (that is deferring consumption from now into the future) and the level of risk involved.

⁵¹ Above-normal returns refer to any returns above that which is required for a business' investment to break-even (that is to compensate for the level of risk and time value of money involved). Above-normal returns can come about due to: a limited supply of relatively immobile inputs, such as land or mining rights; patents; government regulation; product branding; and economies of agglomeration (where firms benefit from clustering in specific geographic locations).

⁵² A cash-flow tax aims to only tax above-normal returns, exempting marginal investment from taxation. There are three different cash-flow tax bases: the real (R base), real and financial (R+F) base and share (S base). The R+F base, of which the ACE can be seen as a variant, taxes both real and non-equity financial cash flows (borrowing net of lending and repayments of debt).

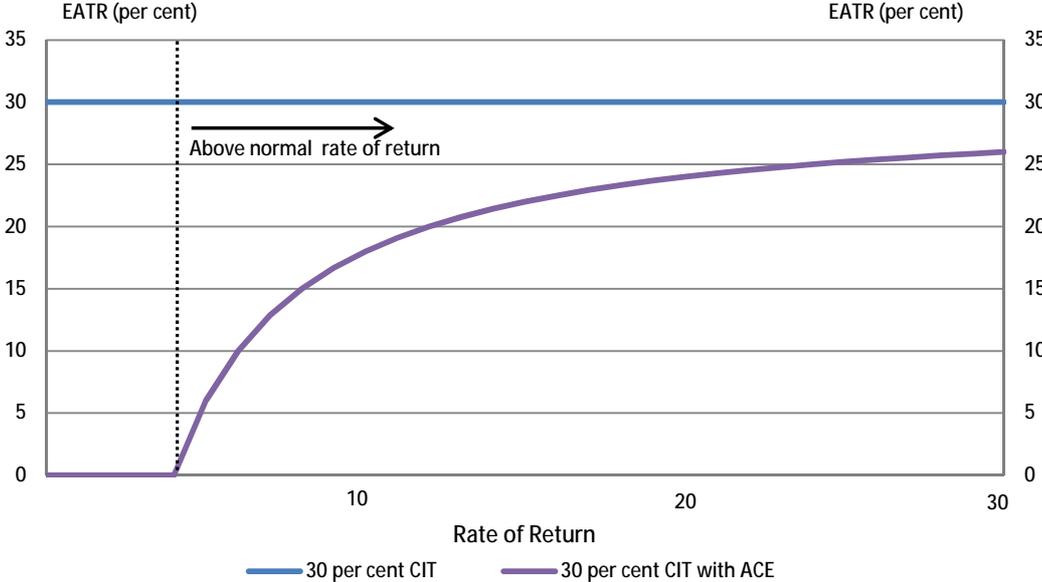
5. Rather than allowing immediate expensing, the ACE provides a deduction in respect of the total value of a business' equity that has not been written off for tax purposes. The ACE allowance seeks to ensure that capital allowance deductions have the same present value as the original expense that would have been deducted in a cash-flow model. As with a cash-flow tax, losses would either be immediately available or they would be uplifted in the same way as undepreciated investments.

6. An ACE would reduce distortions that exist because of the difference between economic and tax depreciation. If depreciation is claimed up-front (accelerated) then both the undepreciated equity balance and the ACE are zero, but if depreciation is claimed over the economic life of the asset (or some other period), an ACE is deducted in each year for the undepreciated portion of the asset's value. The extra ACE deduction for slower depreciation would provide similar additional value to that currently generated through immediate write-offs. Under the current tax system, there is a bias towards debt financing. Accelerated depreciation in combination with debt financing can lead to negative EMTRs (a subsidy via the tax system – see Figure 3 at Appendix D). An ACE would correct this bias.

7. Like a cash-flow tax, a 'pure' ACE would eliminate the tax on the normal return to investment and only tax above normal returns. As a result, effective tax rates on marginal investments (EMTRs) would be zero. Not taxing the normal return would increase the range of potential investments that meet investors' required after-tax rate of return. Where above normal returns are mobile, the tax on above normal returns could provide incentives for these activities to move offshore. Where above normal returns are immobile, such as those related to location-specific natural resources, the taxation of above normal returns should have little impact upon investment decisions.

8. A partial ACE would reduce effective average tax rates on all equity-financed investments, including those with significantly above normal returns, compared to a system like that operating in Australia where normal and above normal returns to equity are taxed at the same rate.

Figure 1: Effective average tax rate on equity-financed investment with an ACE



9. An ACE also removes the tax distinction between debt and equity and removes the distorting effect of depreciation allowances that differ from economic depreciation. It also generates a similar

effect by reducing the distortion that arises because capital gains are taxed on a realisation, rather than an accruals, basis.⁵³

10. However, if the allowance is below the rate at which a business discounts its deferred deductions, then the distortions will be reduced but not eliminated.

11. While the introduction of an ACE would itself introduce further complexity into the system, this could potentially be offset to some extent in the longer term by making depreciation, capital gains tax, Taxation of Financial Arrangements and thin capitalisation rules less significant and therefore open to simplification.

An ACE in the Australian corporate tax system

12. Australia's business tax system, which broadly operates as a tax on the full return to equity, could be adapted to reduce taxation of the normal return through an ACE. However, Australia's tax system has several important features that could complicate the implementation of an ACE.

13. Overseas experiences and the academic literature focus mainly on the application of an ACE to companies, though in the Australian context further consideration would need to be given to the potential application of an ACE to other business entities, since many businesses (particularly small businesses) operate through unincorporated structures such as trusts, partnerships and sole traders.

Losses are important to the operation of an ACE

14. The treatment of losses is an important part of how the ACE's value is realised in a business' bottom line. As a deduction, the ACE would reduce taxable income. If taxable income is positive after deducting the ACE allowance, then the ACE will have acted as an immediate shield against taxation. But if taxable income is negative after claiming the ACE, then claiming the ACE will have added to the company's carry forward loss.

15. An ACE may increase the frequency and size of deductible losses – deductions for interest may decline, while those for equity would increase. Under Australia's current tax arrangements, which do not allow for a full loss offset, at least some of the value of the ACE to businesses that experience losses would be eroded in the same way that other non-refundable deductions are often eroded in value.

ACE and the imputation system

16. Australia's imputation system provides a more neutral treatment of incorporated and unincorporated businesses and has less impact on financing and distribution decisions than a classical corporate income tax system.

17. By crediting the value of tax paid at the business level against personal tax liability, a company income tax with imputation effectively acts as a withholding tax for domestic shareholders. Therefore, the benefit to companies and their shareholders of avoiding or deferring company income through an ACE would be reduced.

⁵³ Accelerated depreciation and the deferred recognition of accruing capital gains are both offset by a lower equity base and lower ACE deductions.

Designing an ACE

18. An ACE deduction is worked out as the tax equity base of the business multiplied by the ACE rate. There are a number of ways to define equity for the purposes of an ACE and to choosing an ACE rate.

19. Having regard to the Working Group's revenue neutrality constraint, it would be difficult to implement a full ACE due to the costs involved. Therefore, feasible approaches may involve significant departures from the 'pure' policy setting and an ACE implemented along these lines may therefore fall short of the benefits that a pure ACE might be expected to deliver.

Choosing an ACE rate

20. The ACE rate, in order to achieve cash-flow tax equivalent outcomes, should be the rate at which a business would discount its deferred deductions.⁵⁴ If the value of these deductions is considered to effectively be owed by the government, the long-term government bond rate may be appropriate if there were a full loss offset.

21. In the absence of a full loss offset, a higher allowance rate could be justified, since the notional loan to the government carries additional risk of not being realised. In these circumstances, the ACE rate should be set at a higher rate like the average corporate bond rate to compensate for that risk.

22. As noted above, in light of the revenue neutrality constraint, the Working Group does not consider a theoretically 'pure' ACE to be feasible in the short to medium term. More feasible partial options would involve a lower ACE rate or a split rate ACE in which the normal return is subject to a lower tax rate.

23. It would not be necessary for the ACE rate to equal the theoretical benchmark to realise some of the potential benefits of an ACE. An allowance rate below that benchmark would be effective to the extent that it reduces taxation of the normal return. The revenue cost of introducing a partial ACE rate would be commensurately lower. However, the compliance and administrative costs of the ACE are likely to be the same, such that the benefits of a very low ACE rate may not justify the costs of additional complexity in administering the ACE deduction.

24. The European experience with the ACE illustrates that 'partial' options that deviate from the 'pure' model have been accepted in practice.

Choosing an ACE base

25. The ACE is worked out as a return on the total amount of the entity's owners' funds, known as the equity base. In principle, on incorporation of a company the opening value would be the amount subscribed in the initial share capital.

26. The equity base of a business can change as a result of transactions that can occur within a year. Some transactions, such as retaining profits from the previous year and issuing new shares of equity, can increase the equity base of a business. In contrast, paying out dividends, purchasing shares in other companies and allocating equity to overseas branches are examples of transactions that can reduce the equity base. Accounting for these possible transactions, the equity base for a given year could be broadly calculated as set out in the following box.

⁵⁴ Whereas a cash-flow tax provides an immediate deduction for all expenditure, the ACE approximates this by uplifting the balance of undeducted expenditure.

Working out the tax equity base for an ACE

Tax equity base for the current year = Tax equity base for the previous year ± adjustments

For an ACE that applies to new equity only, the tax equity base would initially be set at zero. For an ACE that applies to existing equity, there are a range of possible measures (discussed below).

Adjustments to the tax equity base for the previous year would need to be made to take account of those transactions that occur within the income year and which affect the level of shareholder funds. These adjustments would include adding and subtracting the following amounts:

+ *Taxable income from previous year*

Taxable income of the previous year would be grossed up by ACE for the previous year (since it represents an uplift of the previous equity base to preserve its present value).

+ *Exempt dividends received*

Exempt dividends (example from a foreign subsidiary) are not included in taxable income but increase the value of equity.

+ *Net new equity issued*

This would include secondary issues of capital and be net of any share buy-backs or returns of capital.

- *Tax payable on profits in previous year*

Tax payable reduces the amount of profits to be retained.

- *Dividends paid*

Distributions of profits to shareholders will reduce the value of equity.

- *Net new equity in other companies*

To prevent 'double deductions', equity investments in other companies (whether financed by equity or debt) reduce the value of shareholder equity since the purchase price of these shares will be included in the equity base of the company that issued the shares. The value of new equity in foreign companies is excluded, because dividends received from these companies are exempt from taxable income.

- *New equity in foreign branches*

For investments by a business in another country there should be a reduction in the equity base. This is on the basis that an ACE should not be provided against income that is exempt. Complications may arise where the foreign income is partially exempt (for example, it does not entirely consist of 'active' foreign income of a company).

Source: Adapted from Sørensen & Johnson (2009).

Transitioning to an ACE

27. A difficult practical issue facing the ACE is whether it could be implemented prospectively — so that only new equity qualifies, or whether it would apply retrospectively — so that existing equity qualifies as well.

28. Applying an ACE to equity invested before the start date of the ACE would confer a windfall on existing investors, by effectively exempting the normal return of pre-existing investments. It would have an effect on future investment, but it would do so at a significant cost to revenue.

29. Restricting the ACE to only new equity would involve setting the initial equity base value to zero. This approach maximises the boost to equity-financed investment for each dollar of revenue forgone. It can also provide an incentive for taxpayers to re-characterise existing equity as new equity, for example by liquidating an existing company and starting a new company that is in substance the same business. While the operation of the ACE base calculation will correct this through adjustments to the base, complex anti-avoidance rules would be required to maintain the integrity of this approach, which would increase the costs of administering the business tax system.

Revenue impact of an ACE

30. Company tax collections would likely be more sensitive to economic cycles under an ACE. In addition, as unused ACE balances would be carried forward, revenue from company tax could be subdued for a period after an economic downturn. While these effects could be challenging for governments in tight fiscal circumstances, they are a feature of an effective ACE in practice.

APPENDIX C: PRINCIPLES FOR BUSINESS TAX REFORM

Policies that remove impediments in the tax system to new investment will enhance productivity across the economy, supporting Australia's growth prospects and living standards. The Working Group's principles are intended as a framework for thinking about business tax reform in this context. Each principle is accompanied by explanatory text to guide its application.

The application of these principles will necessarily involve judgements about how a particular package of reforms performs against an individual principle and against the framework as a whole. In seeking to reform the tax system, principles can conflict and there will necessarily be trade-offs that need to be made in getting the balance right. A critical aspect of these trade-offs is that they be made transparently.

The terms of reference require the Working Group to have regard to the Australia's Future Tax System (AFTS) Review. In its final report to the Treasurer, the AFTS Review set out some core design principles for the tax-transfer system: equity; efficiency; simplicity; sustainability and policy consistency. Using these principles as a foundation, the Working Group has developed its principles for business tax reform.

1: Revenue adequacy: The business tax system should raise revenue that, together with other taxes, helps to pay for public services that the community relies upon.

- The primary function of any tax system is to raise revenue to fund the provision of goods and services by the government. The Australian community will continue to demand efficient, responsive and relevant public services, funded by taxes.
- Business tax revenues make a contribution towards funding these goods and services. This will continue to be the case, regardless of the particular reform options adopted.
- The integrity of the system is important in securing predictable adequacy of revenue.

2: Economic efficiency: The business tax system should raise revenue in a way that minimises the effect of the tax system, on business decisions except where this is needed to correct for market failures.

- By distorting investment and production decisions, the business tax system can deter investment and lead to an inefficient allocation of resources within the economy. In this way, it can detract from Australia's productivity performance and future living standards.
- Business tax should be applied in a way that minimises its impact on business decision making. It can be useful to think about the impact of business tax on the following set of decisions:
 - What to invest in?
 - Where to invest?
 - How much to invest?
 - How to finance investment?
 - The organisational form through which to undertake the investment?
 - Where to record profits arising from investment?

- How to distribute income?
- When to invest?
- Efficiency gains arising from business tax reform will be realised as a result of changes in business decisions which in turn, over time, change prices and quantities. However, different tax reform proposals will affect these decision margins in different ways. All feasible options will retain some form of distortion, but the aggregate impact of some options will be smaller than others. Assessing these impacts is challenging, given the complexity of the overall tax system and the range of factors that influence business behaviour.
- Efficiency enhancing reforms are more likely to be successfully implemented and sustainable if the rationale for change is clear and well understood by businesses and the public.
- The tax system is one tool which the Government has at its disposal to correct for the failure of the market to take account of positive and negative spillovers or externalities. Tax concessions can be used to encourage socially beneficial activities in which there would otherwise be underinvestment. Similarly, tax can discourage activities that impose a cost on the community as a whole.

3: Distributional equity: The business tax system and potential reforms should be understood in terms of where the final incidence falls among capital owners, workers and consumers.

- The size and openness of the Australian economy and the existence of economic rents suggest that in the long run most of the burden of Australia's company tax is probably borne by labour and consumers, but with some of the incidence falling on capital owners earning resource and other immobile rents.
- In the short run, it is likely that a larger share of the incidence of a reduction in Australia's company tax rate (relative to rates applying elsewhere) would be captured by capital owners.
- The company tax system raises revenue by acting as a final tax on foreign investors and, as a result of imputation, as a withholding tax on domestic investors. Proposed reforms need to be understood in terms of their impact on after-tax returns to different investors.
- The interaction of business tax with elements of the broader tax-transfer system such as capital gains tax and personal income tax must be understood. Regard needs to be given to the distribution of share ownership among resident households and superannuation funds and non-residents and the different tax treatments of their income from companies.

4: Competitiveness: The business tax system should take into account Australia's integration with the global economy.

- Australia has long been a net capital importing country, and will continue to be so, making it important that our business tax settings take into account the potential for the tax system to discourage investment by increasing the cost of foreign capital.
- The growing importance of outbound investment means the competitive position of Australian business offshore is an important consideration for Australia's business tax policy.
- The competitiveness of Australia's business tax arrangements also needs to be considered in the context of the range of other, non-tax factors that make Australia a good place to do business and invest.

5: Simplicity: Business tax reform should be aimed at making the system as simple and as easy to comply with as possible, having regard to an often complex business environment, the need to ensure the integrity of the system and the costs and benefits of transitioning to any new rules.

- Businesses are more likely to make efficient decisions, and respond as intended to policy signals, if the business tax system is simple to understand and the processes necessary to comply are not unduly complex.
- Simplicity can deliver productivity gains by allowing scarce resources to be reallocated away from tax compliance and administration.
- However, the business tax system also needs to be able to cope with sophisticated business transactions and arrangements.
- That said, complexity can undermine the integrity of the business tax system. The ongoing integrity of the business tax system is essential to its role in collecting revenue.
- Complexity in the business tax system can also arise from interactions with other parts of the broader tax system.
- Even where a particular reform may ultimately lead to a more efficient and less complex system in the long run, these gains should be assessed against the costs of transition in the short to medium term.

6: New investment focus: Business tax reform should generally focus on new investment.

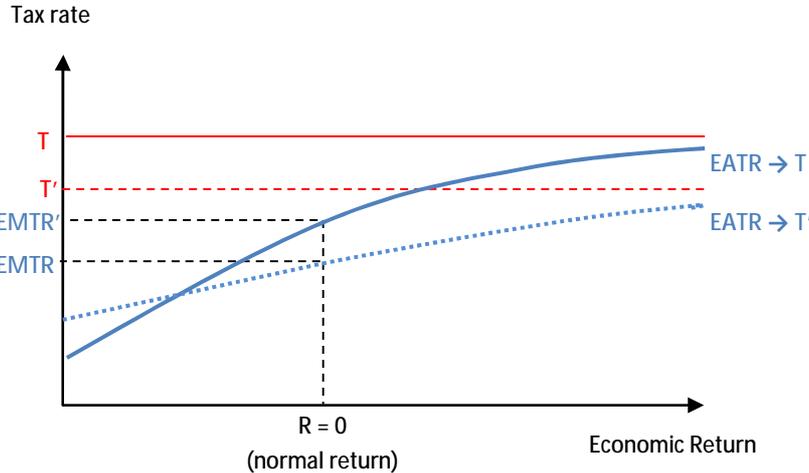
- Generally, business tax reforms are forward-looking. However, retrospective changes will sometimes be desirable. It is important that any reform proposals include a clear pathway from current arrangements to the desired reform destination. Transitional arrangements can also raise issues of fairness and system design.
- Changing the tax outcome of existing business ventures may deliver a windfall gain or loss to taxpayers. This needs to be weighed against any potential impact that tax reform may have on the revenue adequacy, efficiency and simplicity of the tax system.
- Difficult decisions need to be made about the appropriate commencement of business tax reforms, taking account of the potential impacts resulting from these trade-offs.

APPENDIX D: THE CORPORATE TAX BURDEN

The relationship between effective tax rates

1. Effective tax rates, as opposed to statutory tax rates, are a more valuable measure of the company tax burden. Unlike statutory tax rates, effective tax rates capture structural elements of the tax system, such as concessions and allowances, which affect the amount of actual tax paid by companies. As such, effective tax rates will usually be lower than the statutory company tax rate because they account for the various tax reliefs provided by a tax system.
2. Effective average tax rates (EATRs) are a weighted average of the effective marginal tax rate (EMTR) on normal returns and the statutory rate on above-normal returns.⁵⁵ For firms with a high profitability the EATR will thus converge on the statutory tax rate.
3. If the EMTR for a particular investment is below the statutory tax rate ($EMTR < T$), then for higher rates of economic profit the EATR will increase and converge to the statutory tax rate (T).
4. Conversely, if the EMTR is above the statutory tax rate ($EMTR > T$), then for higher rates of economic profit the EATR will decrease and converge to the statutory tax rate (T).
5. The EMTR of investments affected by the removal of accelerated depreciation would be expected to increase. Were the base broadening accompanied by a rate cut, this would offset the impact of the base broadening, leading to lower EATRs at higher levels of profitability as the EATR would now converge to a lower statutory rate. The dotted blue line below shows the increase from EMTR to EMTR' and a decrease in the EATR for higher rates of economic profit as the EATR converges to the new statutory tax rate of T' .

Figure 1: EMTRs and EATRs under company tax rate and base broadening



⁵⁵ Devereux, M & Griffith, R 2003, 'Evaluating tax policy for location decisions', *International tax and public finance*, Vol 10, pp 107-126.

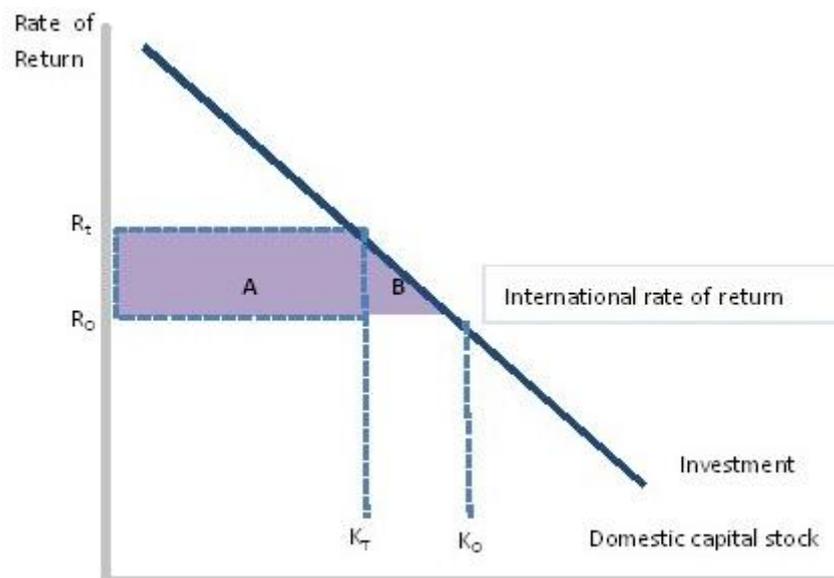
The impact of company tax on the scale of investment

6. The level of investment in Australia depends on decisions of Australian businesses about the scale of their investments in Australia.

7. Assuming perfect capital mobility, the rate of return on investment in a small open economy like Australia will approximate the world rate of return. Therefore the imposition of company tax will reduce the flow of international capital to finance investment in Australia until the before-tax return on investment is high enough to offset the company tax.

8. Figure 2 shows how imposing company tax increases the marginal pre-tax rate of return to R_t from the return that investors could obtain from elsewhere in the world, R_0 . The company tax results in a fall in the scale of investment, reducing the capital stock from K_0 to K_T . Company tax revenue is represented by the area A and the deadweight loss of corporate taxation, being the loss of economic value due to the imposition of the tax, is represented by area B.

Figure 2: Impact of company tax on the scale of investment

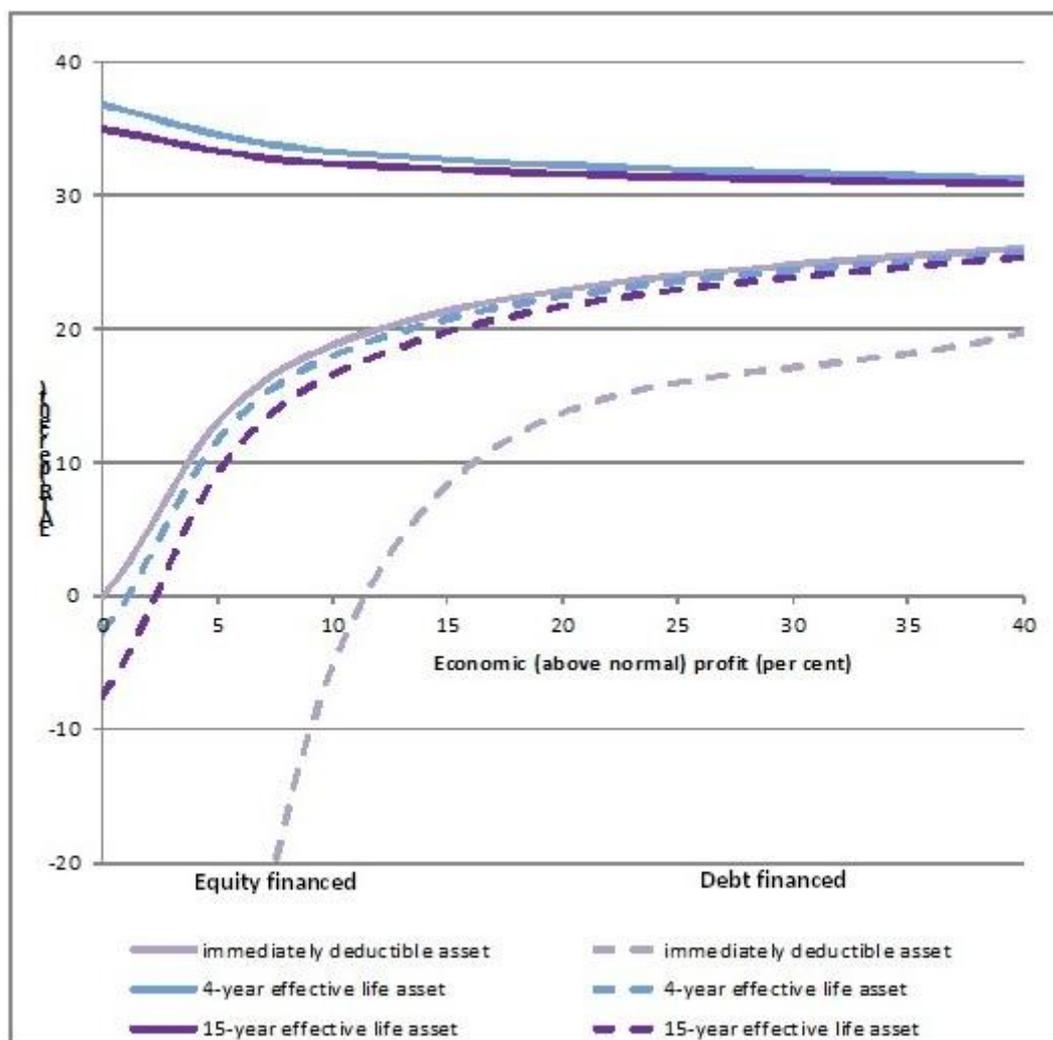


9. The figure below shows the different EMTRs and EATRs for investments in selected depreciating assets financed by equity and debt (assuming an inflation rate of 2.5 per cent and real rate of return of 6 per cent). The EMTRs are represented by the points on the y-axis where economic profit is zero. The EATRs are represented by the solid lines (100 per cent equity-finance) and the broken lines (100 per cent debt finance).

- Equity financed investments: the EMTR is above the statutory company tax rate (30 per cent) for the two assets that are depreciated over their effective lives (four years and 15 years). These EMTRs are above the statutory company tax rate due to the interaction of inflation and historic cost depreciation. The asset that benefits from an immediate write-off has an EMTR of zero when equity financed.
- Debt financed investments: alternatively, when the assets are financed by debt the EMTR for all three assets is negative. Negative EMTRs occur for debt financed assets depreciated over their effective life because the full nominal interest expense is deductible. An immediate write-off for a debt-financed investment results in a large negative EMTR.

10. For more profitable investments, whether financed by equity or debt, the EATR converges to the company statutory rate.

Figure 3: EMTRs and EATRs on investments in depreciating assets financed by equity and debt



Source: Treasury, based on estimates by Sørensen & Johnson (2010).

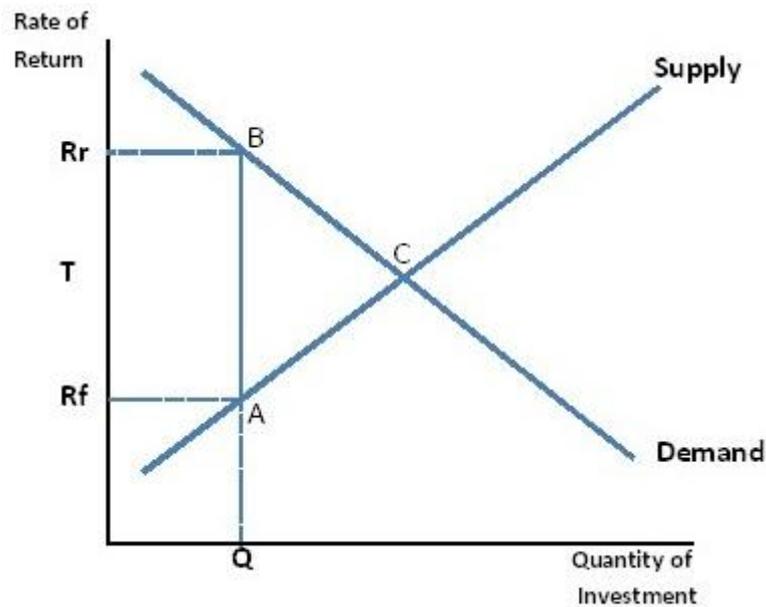
Efficiency gains from a lower company tax rate

11. Figure 4 illustrates the general case of a downward sloping demand curve for business investment and an upward sloping supply curve for funds. The horizontal axis measures investment quantity, and the vertical axis measures rate of return. The area under the demand curve includes the normal return on capital, a risk premium, and economic rents.

12. The supply curve represents the sum of domestic saving plus overseas capital inflow, including both debt and equity. (A special case of Australia as a small capital importer would be a perfectly elastic, or horizontal, supply curve at the cost of capital determined in global markets.)

13. The current tax (T) on business returns (r), is applied at rate τ , with $\tau = T/r$. The tax sets a tax wedge between the required pre-tax rate of return on investments, R_r , and the after-tax return received by savers, R_f . Relative to a tax free context, the tax reduces investment to Q . The tax provides revenue TQ , which has an efficiency cost of triangle ABC . Note that the efficiency cost increases more than proportionately with the tax rate.

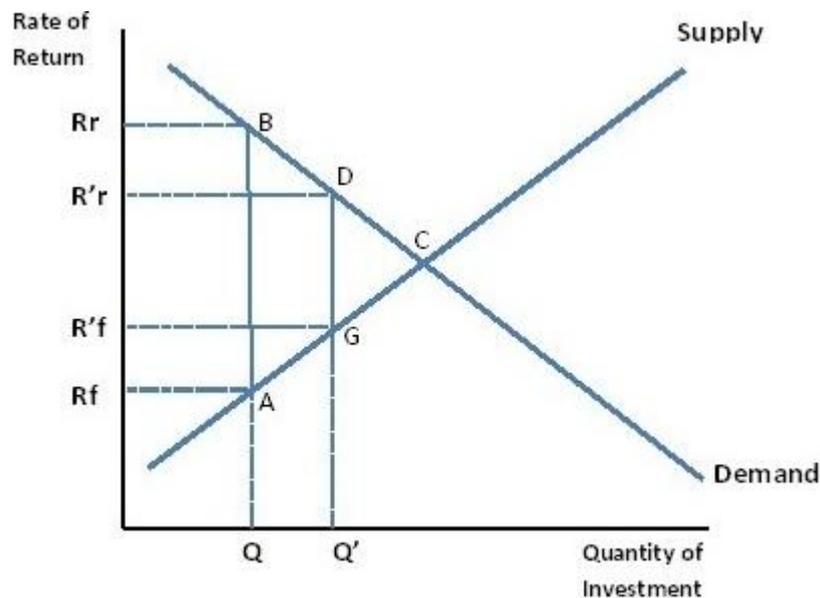
Figure 4: Rates of return and the quantity of investment



14. In Figure 5 the tax rate is lowered from $T = AB$ to $T' = DG$. As a result of the lower tax rate:

- There is a fall in the required pre-tax return and an increase in investment from Q to Q' . The investment increase is larger the more responsive or elastic investment demand and supply are to changes in returns.
- In time, the extra investment adds to a larger capital stock and, if there are increases in capital per worker, higher labour productivity, and then higher wages.
- There is a change in tax collected equal to area $R'fR'rDG$ less area $RfRrBA$.
- The efficiency cost of the tax is reduced by area $ABDG$. Note that this efficiency gain diminishes as the tax rate is lowered.

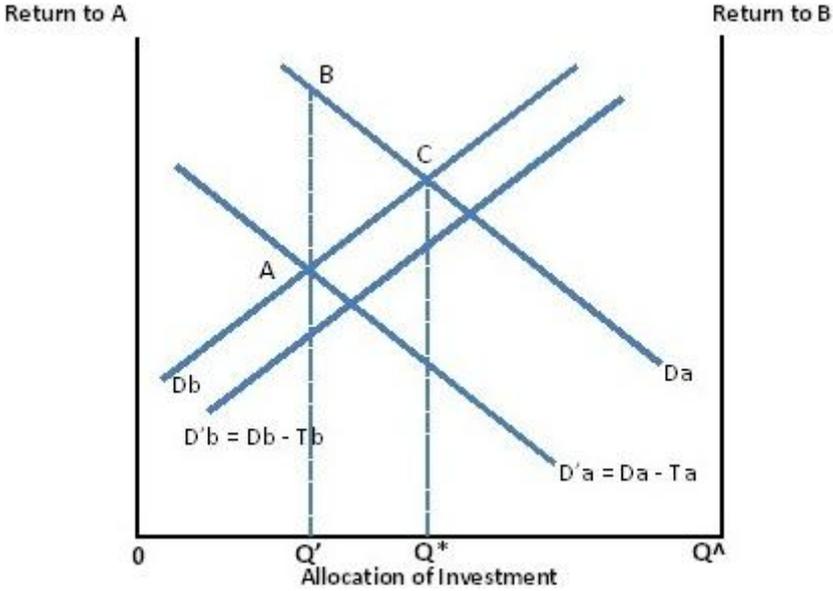
Figure 4: Rates of return and the quantity of investment impacted by tax



Efficiency gains of a broader company tax base

- 15. In addition to funding a lower company tax rate (see Section 5, Table 2), removing tax expenditures would deliver efficiency gains from a less distorted mix of investment choice options.
- 16. Consider in Figure 6 just two investment options, A and B, and a fixed aggregate investment level of Q^{\wedge} . Each investment option has a downward sloping investment demand function. A is shown with reference to the left hand axis and B with reference to the right hand axis.
- 17. In the absence of taxation, and with no market distortions, the efficient allocation of investment between the two options is at Q^* . At Q^* the marginal rates of return on the different options are equated.

Figure 6: Allocation of investment between alternative projects



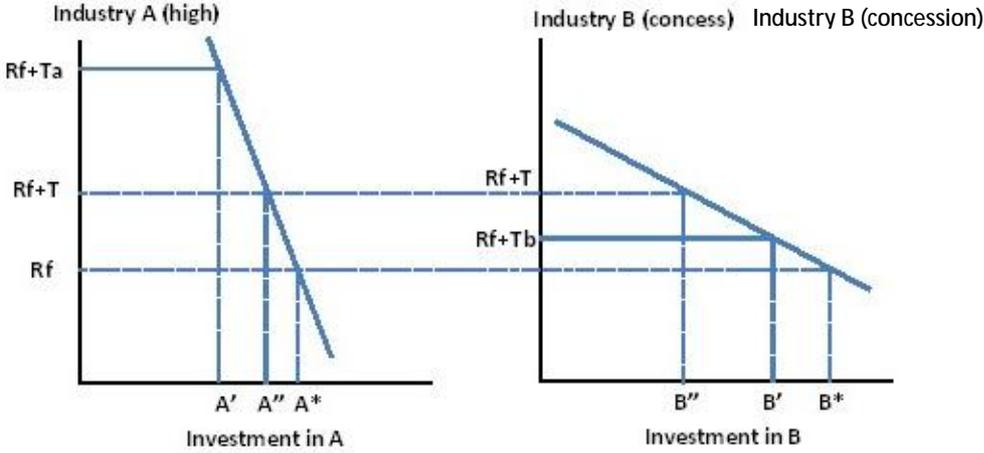
- 18. Now, impose a business tax, but with a concession to B in the form of, say, accelerated depreciation, not afforded to A. Then, the tax rate on A, T_a , is greater than that on B, T_b . With the differential tax rates, more of the capital is allocated to B, namely $Q' > Q^*$, and less is allocated to the relatively heavily taxed option A. The efficiency cost of this changed allocation is given by:

$$\text{Area ABC} = 0.5 (T_a - T_b) (Q' - Q^*)$$

- 19. Note that the efficiency loss increases with the square of the tax rate differential and with the elasticities of the two investment option demand curves.
- 20. A tax reform package which eliminates the tax expenditure and imposes a revenue neutral lower tax rate (meaning $T_a = T_b = T$) would achieve the efficient investment mix at Q^* , with efficiency gain of area ABC.
- 21. The model of Figure 6 for a fixed aggregate quantity of investment can be generalised to the case of a rising aggregate supply of investment funds.
- 22. The analysis above was based on an assumption that Q^{\wedge} was optimal. However, suppose that there is a tax distortion as described in Figure 5 and 6 above, meaning Q^{\wedge} is below an optimal level. For simplicity, assume a perfectly elastic supply of capital in aggregate at the required world rate of return R_f .

23. There are two investment options, A and B with respective demand for investment functions. At present, A faces a relatively high business income tax of T_a , while B benefits from a tax expenditure and a lower effective tax rate of T_b . Option A chooses investment level A' and option B chooses level B' . Note that relative to the efficient investment levels of A^* and B^* there are distortion costs with the present system.

Figure 7: Allocation of investment across industries



24. Next, consider the effects of an aggregate revenue neutral package which removes the tax expenditure provided to investment option B and to fund a lower flat rate of T on both investment options. The common effective tax rate of T means a fall for A and an increase for B. As a result, the investment level increases for A to A'' and falls for B to B'' . Note that only under special circumstances will the net change in aggregate investment be zero, as assumed in Figure 7. The net change in aggregate investment and whether this leads to a net efficiency gain or loss will ultimately depend on the relative responsiveness of investment demand in industries A and B.

APPENDIX E: SUMMARY OF BASE BROADENING OPTIONS⁵⁶

Option	2012-13 (\$m)	2013-14 (\$m)	2014-15 (\$m)	2015-16 (\$m)	Total (\$m)	Data and assumptions
A.1 to A.5 thin capitalisation and interest deductibility						<p>The potential savings that might be realised from reform options dealing with interest deductibility and thin capitalisation is likely to be significant. As noted in the Working Group's final report on the tax treatment of losses, Treasury's costing of the savings that might be realised from possible changes to thin capitalisation rules (option A.1 in this paper) was criticised as being too low by stakeholders. Estimates of the potential savings from the thin capitalisation options are currently under review. Variations on this proposal (such as options A.2 and A.3) can have a substantial impact on the revenue estimate. For example, retaining the arm's length tests (option A.2) would reduce the potential saving, while extending the scope of the measure to also tighten the safe harbour rules for financial institutions (option A.3) would increase the potential savings.</p> <p>Options A.4 and A.5 involve a fundamental shift in Australia's approach to the deductibility of interest expenses. Potential savings that might be expected from these options is heavily dependent on unresolved features of the proposal. The Working Group does not have sufficient information at this point in time to instruct Treasury so that they could reliably estimate the potential savings from this proposal. Among other things, further detail on how these options would apply in practice and possible effects on business are needed. Submissions on these aspects would be particularly welcome.</p> <p>The Working Group is developing a survey to facilitate the collection of data that could be used to gain a better understanding of the potential revenue gains from these options. Interested parties should contact the Working Group Secretariat.</p>

⁵⁶ Note that the options in this table are not necessarily additive.

Option	2012-13 (\$m)	2013-14 (\$m)	2014-15 (\$m)	2015-16 (\$m)	Total (\$m)	Data and assumptions
B.1. Reduce diminishing value rate for depreciation to 150%.	10	170	700	1300	2180	<p>Costing assumes that the application date coincides with the announcement data, in order to minimise adverse incentive effects.</p> <p>Data are derived from the Australian Bureau of Statistics (ABS) national accounts data on net capital stock and Australian Taxation Office (ATO) data on depreciable asset base for assets with statutory effective life caps. Data is grown out by Budget taxation parameters to calculate the new investment in subsequent years.</p> <p>Effective lives used in the model are from the Australian Master Tax Guide 2012 and ABS.</p> <p>The diminishing value method is used for 55% of the value of asset purchases. The remaining 45% uses the prime cost method.</p> <p>Clawback due to the imputation system and timing are included in the costing.</p>
B.2. Remove capped effective life provided to depreciating assets & industries (including aeroplanes, trucks, certain shipping vessels, gas production and supply assets, tractors, water facilities etc).	0	70	300	625	995	<p>The costing has been prepared on the basis that the application date for the reform coincides with an announcement in the 2013 Budget on 14 May 2013. Changes to depreciation arrangements have been assumed to apply to contracts that are signed, construction that commences, or assets whose holding commences after this date.</p> <p>All data used is consistent with the data used to estimate the value of statutory effective life caps tax expenditures as reported in the 2011 Tax Expenditure Statement.</p> <p>These data are taken from a number of sources, varying according to asset class. These include</p> <ul style="list-style-type: none"> § The Civil Aviation and Safety Authority (CASA) civil aircraft register for 2007, 2008, 2009 and 2010. § IBIS World Commercial Vehicle Wholesaling in Australia Industry Report. § Tax Office data on the oil and gas projects that have come online
B.3: Remove capped effective life of oil and gas extraction and petroleum refining assets.	0	30	100	200	330	
B.4. Remove capped effective life of primary production assets.	..	10	50	100	160	
B.5. Remove the capped effective life of water facilities.	..	5	10	15	30	

Option	2012-13 (\$m)	2013-14 (\$m)	2014-15 (\$m)	2015-16 (\$m)	Total (\$m)	Data and assumptions
B.6 Remove the capped effective life of aeroplanes and helicopters not used in agriculture, and certain buses, light commercial vehicles, minibuses, trailers and trucks.	0	25	140	290	455	<p>since 1 July 2002 supplemented with information from the Australian Petroleum Production & Exploration Association.</p> <p>§ Tractor and Machinery Association of Australia data on tractor and harvester sales.</p> <p>§ Australian Bureau of Agricultural and Resource Economics (ABARE) publication Australian Commodity Statistics.</p> <p>Base data was grown according to growth rates specific to each asset class.</p> <p>Assumptions were made for each asset regarding the proportion using the Diminishing Value Method. The diminishing value rate used is 200%. Assets are assumed to be purchased uniformly throughout the year.</p> <p>Depreciation schedules for the statutory cap and the safe harbour effective lives were used to determine the change in deduction. The tax impact of the change in deduction was then calculated.</p> <p>Assumptions were also made regarding the company share of each asset class. An average marginal tax rate of 35% was used for individuals.</p>
B.7. First use exploration assets to be depreciated.						<p>The costing has been prepared on the basis that the application date for the reform coincides with an announcement in the 2013 Budget on 14 May 2013. Changes have been assumed to apply to contracts that are signed, construction that commences, assets whose holding commences or expenditure incurring after this date.</p> <p>Data are taken from the ABS (mining exploration expenses), ATO (deductions for mining exploration expenses), ABARE publication 'Mine site rehabilitation report' (site rehabilitation provisions), and Index Mundi (iron ore price).</p> <p>Costings were undertaken on the basis of the following:</p> <ul style="list-style-type: none"> • effective life of expenditure assumed to be 15 years;
Over 5 years.	0	900	800	600	2300	
Over effective life.	0	900	1000	1000	2900	
B.8. First use exploration intangible assets to be depreciated.						<p>Costings were undertaken on the basis of the following:</p> <ul style="list-style-type: none"> • effective life of expenditure assumed to be 15 years;
Over 5 years.	0	200	200	100	500	
Over effective life.	0	200	200	200	600	

Option	2012-13 (\$m)	2013-14 (\$m)	2014-15 (\$m)	2015-16 (\$m)	Total (\$m)	Data and assumptions
B.9. Non-depreciating exploration expenditure written off over five years.						<ul style="list-style-type: none"> the proportion of deductions utilised (estimated to be 26% for all companies, 58% for companies with a turnover greater than \$500 million, and 8% for companies with a turnover less than \$500 million); the proportion of deductions relating to intangible assets (estimated at 19% of immediate write off amount); and the proportion of deductions made by companies with turnover greater than \$500 million (estimated at 36%).
Over 5 years.	0	100	100	100	300	
Over effective life.	0	100	200	100	400	
B.10. Exploration expenditure by large companies (>\$500m turnover) written off over five years.	0	800	700	600	2100	<p>The financial impact of Options B.9 and B.10 has been estimated on the basis that none of the expenditure reported as having been deducted under section 40-730 of ITAA 1997 would be eligible for an immediate deduction under section 8-1 of the ITAA 1997.</p>
B.11. Exclude feasibility studies from exploration.	*	*	*	*	*	
B.12 Building depreciation — depreciate over effective lives.						<p>Base data is the value of capital works deductions extracted from income tax returns. ABS data from Table 71 of catalogue 8752.0 Building Activity, Australia and Table 11 of catalogue 5609.0 Housing Finance was also used to estimate the percentage of the deductions using the concessional 4% rate of depreciation.</p> <p>Growth rates for the value of new work over the forward estimates equal to are DED's parameter for new buildings.</p>
Diminishing value method available.	0	..	20	50	70	
Prime cost only.	0	5	45	120	170	
B.13 Building depreciation — remove depreciation deduction.	0	5	75	190	270	<p>Approximately 17% of the value of new building relates to buildings that receive the 4% depreciation rate.</p>
B.14 Building depreciation — uniform rate of depreciation of 2.5%.	0	..	5	10	15	<p>The new arrangements will apply prospectively only.</p> <p>Buildings begin depreciating half way through the income year on average. An average tax rate of 30% is assumed for taxpayer claiming the capital works deductions.</p> <p>Timing is 100% on assessment.</p>

Option	2012-13 (\$m)	2013-14 (\$m)	2014-15 (\$m)	2015-16 (\$m)	Total (\$m)	Data and assumptions
C.1. Abolish 40% non-refundable tax offset for companies with a turnover >\$20m.	0	250	1050	950	2250	The costing has been prepared on the basis that the proposal starts from 1 July 2013, noting that legislative changes would be required to repeal the 40 % non-refundable tax offset for R&D.
C.2. Abolish 40% non-refundable tax offset for companies with high turnover.						Australian Taxation Office individual company data on R&D expenditure and company income were used to estimate this proposal.
\$10 billion threshold.	0	50	250	250	550	Companies with an income of less than \$20 million were removed from consideration because their R&D tax treatment would not change under the proposals. The proposed R&D turnover thresholds, spending caps and offset rates were applied to each company to determine the change in offset under the various proposals. Summing the changes in offset for all companies impacted by each proposal gives the total revenue impact.
\$20 billion threshold.	0	50	200	200	450	
C.3. Impose a \$100 million cap on annual claims under the 40% non-refundable tax offset.	0	50	200	200	450	Timing and clawback were also modelled.
C.4. Cut the rate of the non-refundable tax offset from 40% to 37.5%.	0	50	250	250	550	

APPENDIX F: INTEREST DEDUCTIBILITY ACROSS JURISDICTIONS

Table 1: Jurisdictions using an EBITDA test

Country	EBITDA % cap	Debt focus	Carry forward rules
Interest limited solely under an EBITDA test			
Italy	30%	Total debt focus	Denied deductions — unlimited carry forward Unused EBITDA — can be carried forward
Germany	30%	Total debt focus	Denied deductions — unlimited carry forward Unused EBITDA — 5 year carry forward
Spain	30%	Total debt focus	Denied deductions — unclear Unused EBITDA — 5 year carry forward
United States	50%	Related party debt	Denied deductions — unlimited carry forward Unused EBITDA — 3 year carry forward
EBITDA test applies in addition to other debt limit tests			
France	25%	Total debt focus	Denied deductions — unlimited carry forward Unused capacity — carried forward but reduced by 5% per year from the second year
New Zealand	50%	Total debt focus	No

APPENDIX G: STATUTORY EFFECTIVE LIFE CAPS

Table 1: capped lives of depreciating assets: 40-102(4) of the ITAA 1997

Kind of depreciating asset	Period
Aeroplane used predominantly for agricultural spraying or agricultural dusting	8 years
Aeroplane — other	10 years
Helicopter used predominantly for mustering, agricultural spraying or agricultural dusting	8 years
Helicopter — other	10 years
Bus with a gross vehicle mass of more than 3.5 tonnes	7.5 years
Light commercial vehicle with a gross vehicle mass of 3.5 tonnes or less and designed to carry a load of 1 tonne or more	7.5 years
Minibus with a gross vehicle mass of 3.5 tonnes or less and designed to carry 9 or more passengers	7.5 years
Trailer with a gross vehicle mass of more than 4.5 tonnes	10 years
Truck with a gross vehicle mass of more than 3.5 tonnes (other than a truck that is used in mining operations and that is not of a kind that can be registered to be driven on a public road in the place in which the truck is operated)	7.5 years

Table 2: capped lives of certain depreciating assets used in certain industries: 40-102(5) of the ITAA 1997

Kind of depreciating asset	Industry in which asset is used	Period
Gas transmission asset	Gas supply	20 years
Gas distribution asset	Gas supply	20 years
Oil production asset (other than an electricity generation asset or an offshore platform)	Oil and gas extraction	15 years
Gas production asset (other than an electricity generation asset or an offshore platform)	Oil and gas extraction	15 years
Offshore platform	Oil and gas extraction	20 years
Asset (other than an electricity generation asset) used to manufacture condensate, crude oil, domestic gas, liquid natural gas or liquid petroleum gas, but not if the manufacture occurs in an oil refinery	Petroleum refining	15 years
Harvester	Primary production sector	6 2/3 years
Tractor	Primary production sector	6 2/3 years

Table 3: depreciation over three years for water facilities

The water facilities tax concession	
What is a water facility?	<p>A water facility is plant or a structural improvement, or an alteration, addition or extension to plant or a structural improvement that is primarily for the purpose of conserving or conveying water.</p> <p>For expenditure incurred on or after 1 July 2004, a water facility also includes:</p> <ul style="list-style-type: none">• capital repairs to plant or structural improvements that are primarily for the purpose of conserving or conveying water, and• a structural improvement, or an alteration, addition, extension or capital repair to a structural improvement that is reasonably incidental to conserving or conveying water. <p>Examples of a water facility are dams, earth tanks, underground tanks, concrete or metal tanks, tank stands, bores, wells, irrigation channels or similar improvements, pipes, pumps, water towers, windmills and extensions or improvements to any of these items.</p> <p>Things that are reasonably incidental to conserving or conveying water include a culvert, a fence to prevent livestock entering an irrigation channel and a bridge over an irrigation channel.</p>
Who can claim?	<p>The water facilities tax concession can be claimed by primary producers and irrigation water providers (for expenditure incurred on or after 1 July 2004). An irrigation water provider is an entity whose business is primarily the supply (other than by using a motor vehicle) of water to primary producers.</p>

