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This summary

- highlights some directions for potential Australian business tax reform in the short term, addressing Australian tax impediments for businesses which restructure in a changing and volatile economic environment
- identifies the importance of a strong governance process relating to tax reforms, including transparent consultation processes before governments announce significant tax reforms and
- reconfirms the medium term reform priorities on which we have submitted and engaged in consultations previously.

### **Taxation reforms for consideration in the short term - to support business development and restructure in a time of change**

In our view potential Australian business tax reform in the short term should address Australian tax impediments for businesses which restructure in a changing economy. Reforms are needed to improve the position of Australian businesses which are affected by changed economic conditions and, under current tax rules, suffer real adverse tax outcomes.

Put simply, Australia's tax rules are designed for businesses and taxpayers which have ongoing business activities and are able to use the stream of tax deductions which flow from their losses and outgoings. Many of the deductions are deferred to match the revenue streams anticipated.

However, where a business suffers a downturn or adverse business conditions, its revenue stream might be impaired or indeed cease, its asset values might fall, its expenses might remain high and be increased pending the business' recovery. For tax purposes:

- While some of those outgoings might be immediately deductible, others might be deferred for up to 5 years or **might never be available** until the relevant asset is sold.
- even where there are immediate tax deductions, the business might have insufficient income to fully utilise all of its tax deductions and will thus deliver a tax loss.

So the tax benefit of losses is deferred; the business does not have the tax offset or tax benefit which a profitable business would have from immediate use of the tax deductions.

**Furthermore, the business might never be able to claim its tax losses** where it has a significant infusion of new capital to refinance it and changes its business activities.

The Australia's Future Tax System Review (the AFTS (Henry) Review) chaired by Dr Ken Henry identified the need to reform "tax arrangements that effectively impose an additional charge on the taxpayer, such as limitations on the use of losses..."<sup>1</sup>

In the attached three appendices we summarise some options for short term action to:

1. Improve the tax outcomes of restructure costs
2. Improve the outcomes of restructures under the tax loss and bad debts rules
3. Improve the competitiveness of Australia to attract business activity by reducing company tax rates, including potential examination of business expenditure tax options such as an Allowance for Corporate Equity (ACE).

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<sup>1</sup> AFTS (Henry) Review Report, Vol.1, page 169

## Governance of the tax system and tax administration

Australia's tax system needs reforms, and the AFTS (Henry) Review proposed many for debate, as there is not agreement with all its recommendations.

The reforms require a strong process of consultation and collaboration going forward - better governance around the tax reform process. Before government announcements of reforms are made, preliminary policy debate and analysis should develop a shared view of the need for reforms, their priority and direction. The Tax forum offers an opportunity to agree the processes, as are used for many reform process including reform of tax financial markets rules, and apply them generally.

Another immediate priority is improving governance of Australia's tax administration, which needs greater certainty and efficiency. This is particularly important given the potential over time for a more unified tax administration to cover various state and federal taxes. We note that Canada has one Revenue Agency to cover federal and provincial taxes.

## Longer term reform directions

The Forum is an opportunity to highlight the challenges and share and develop priorities for reform. The priorities include in our view

- a) Streamlining or eliminating inefficient taxes as identified by the AFTS (Henry) Review, which has major implications for state taxation and the respective state and federal tax and expenditure obligations
- b) Addressing the excessive reliance on income taxation in favour of indirect taxes as identified by the AFTS (Henry) Review, including consumption taxes such as the Goods and Services Tax
- c) Reducing tax impediments to drivers of Australian productivity and workforce participation
- d) Introducing business tax reforms including achieving lower corporate tax rates
- e) Enhancing savings and capital formation, where Australia has high tax rates as identified in the AFTS (Henry) Review
- f) Simplifying individual tax and transfer rules to enhance incentive and workforce participation
- g) Reducing tax and other constraints to infrastructure provision
- h) Improving governance of Australia's tax reform process, to develop a more systematic and transparent consultation process.

The Tax Forum is a unique opportunity to help create a new blueprint for tax reform and its directions.

Ernst & Young is ready to engage in the policy process after the Tax Forum, which will shape Australia's future economic environment.

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## Appendix 1

## Reducing income tax impediments to business restructures

Australian businesses are faced with significant challenges given the volatile global economy and the significant challenges of change in the Australian economy. Businesses are restructuring their activities to strengthen their positions and employment, with actions including:

- a) Refinance debt
- b) Recapitalise the business with new debt, participating debt (eg convertible notes) and equity
- c) Sell loss-making activities which are saleable or cease other loss-making activities
- e) Expand existing profitable activities
- f) Establish new business and/or acquisitions
- g) Transfer existing activities to different entities and/or locations.

Different tax rules may apply depending on the context of the restructure. The rules include:

- a) Capital gains tax cost base rules in relation to the acquisition or divestment of CGT assets. However, these rules generally do not apply to depreciating assets<sup>2</sup>, trading stock and revenue assets<sup>3</sup>
- b) The 'ordinary' section 8-1 deduction for losses or outgoings which are not capital in nature
- c) Specific statutory provisions dealing with particular costs including outgoings for tax related expenses (s.25-5); leasing costs [documentation (s.25-20), repair obligations (s.25-15); termination costs (s.25-110)]; borrowing costs (s.25-25); mortgage discharge (s.25-30).
- d) Deduction for project amounts (over the life of the project) including feasibility studies and information associated with a project (s.40-830) subject to their complex drafting
- e) Deduction for business related black hole capital expenditure (over 5 years) under s.40-880. This was introduced as a very restrictive measure with tight control over revenue costs and does not allow deductions where costs can be allocated to CGT cost bases for assets. In fact, **the black hole rules leave various black holes in existence with no tax deductions available.**

A range of problems exist in relation to the existing income tax provisions. These include:

- a) **Interaction between the CGT cost base rules and the project pool/black hole expenditure rules.** The tax treatment of incidental costs may flip from the black hole rules to the CGT rules depending on factors such as timing of the cost or whether the cost is related to a project compared with a business.

Example 1: Tax treatment of payments relating to entities which are in financial stress. Where parent company or investor in a company which is in financial stress makes payments to the company's creditors under a guarantee, the payments are added to the cost base of a CGT asset being the guarantor's subrogation and have no s.40-880 write-off. Refer example 27 in TR2010/D7. In some cases the guarantor might seek an outright tax deduction but this is contentious with the ATO. The guarantor might claim a capital loss which is inappropriate in our view as there is no real asset. The entity in financial distress might be able to claim its tax loss carryforward, but it may be precluded from such tax loss claims.

- b) **Inappropriate outcomes under black hole s.40-880 in relation to business cessation costs** where deduction is provided over 5 years when no future income may be derived. That is, the rules defer the deductions after the business is ceased, which generates tax losses which may be unusable (see separate discussion on tax losses).

<sup>2</sup> Division 40 "cost" rules need to be considered

<sup>3</sup> The section 8-1 general deduction provision needs to be considered

Example 2: A business which conducts three activities ceases one activity and the costs are not deductible under any other tax rules so s.40-880 is used. The business' deductions for restructure costs are spread over 5 years.

- c) **ATO interpretation of black hole s.40-880 has been quite narrow** and arguably not in the spirit of providing last-resort income tax recognition of capital expenditure not otherwise taken into account for income tax purposes. A draft ATO ruling TR2010/D7 (attached) has over 40 pages of intricate technical analysis of the blackhole rules. As mentioned, **the black hole rules leave various black holes in existence.**

Example 3: Tax treatment of end-of lease (make good) restoration expenditure. Assume a business restructures and terminates a particular lease of premises, incurring make good costs under the lease. S.40-880(5)(d) excludes these costs from the s.40-880 write-off of any capital costs because they relate to a lease or other legal or equitable right. Refer example 25 in TR2010/D7. A deduction may be available under the general rules but not if the outgoing is seen as a capital outgoing.

- d) **Lack of revenue-capital symmetry of treatment between treatment of income and expenses.** The distinction between revenue and capital outgoings for income tax purposes is creating significant uncertainty. The trend of court decisions has been to consider most business gains to be on revenue account, taxable as ordinary income. However when the deductibility of losses and outgoings involved in refinancing and restructure is considered, the position is not symmetrical: the ATO and courts' interpretation of the deduction rules see a greater willingness to deny deductions on the basis they are capital and thus non-deductible. As mentioned above, the black hole rule of s.40-880 has limited operation. We see an asymmetry between the tax treatment of income and expenditure for businesses undertaking restructure and refinancing costs.

## Reform options that should be considered

While the AFTS (Henry) Review made various recommendations to improve the operation of the capital allowances regime (principally small business focused) and tax loss rules (discussed below) there were no specific recommendations that suitably address the issues raised above.

Potential reforms include:

- a) Adjusting the blackhole rules of s.40-880 to provide an **immediate tax deduction in relation to business cessation costs and in relation to unsuccessful ventures**, where there are no future revenues to be obtained. This would overcome the effect of the existing 5 year deferred deduction which results in a 'tail' of deductions after the revenue flow has ceased - a mismatch of deductions and the derivation of related income.
- b) An **express statutory clarification to ensure that s.40-880** can be used as a provision of last-resort for business related expenditure not otherwise taken into account for income tax purposes. This might adjust s.40-880 so that it operates in relation to all undeducted expenditures which have no other tax recognition to remove the black holes which are not currently covered.
- c) **Comprehensive review of the various income tax provisions dealing with restructure and incidental costs** to fully identify consistency, priority, timing and characterisation issues, and to ensure immediate deductibility where there are business cessation costs and unsuccessful ventures with no future commercial revenues to be obtained.

## Appendix 2

### Restructures - improving outcomes under tax loss and bad debts rules

Australia has many complex tax integrity rules to restrict claims for realised and unrealised losses, potential deductions for bad and doubtful debts, and to adjust the tax outcomes of debt and debt forgiveness. We accept the tax integrity drivers, but the rules operate inappropriately for businesses suffering challenging commercial circumstances.

#### Many complex rules overlaid over one another

To deduct carry forward tax losses a company must satisfy the more-than-50% continuity of ownership test (COT) in the period from the loss arising until it is recouped. If a company fails the COT test, the loss may be carried forward if the company passes the three same business tests (SBT) which require continuity of the same business, no new business and no new types of income.

Different tests apply to tax losses in trusts. These rules are challenging: in the *ConnectEast Case*<sup>4</sup> a widely held trust conducting a Victorian toll road was denied its losses due to failure to meet the complex trust loss COT test.

Some concessions apply for widely held entities. However only widely-held listed trusts have a SBT.

For tax consolidated groups the rules are modified. The period in which certain COT transferred losses are tested is modified, and passing the SBT in a diverse consolidated group may be difficult where there are changes in one or more businesses in the group. Even if the COT and SBT are satisfied there may be adverse consequences for loss utilisation under the tax consolidation rules. The available fraction rules which broadly limit the rate of use of losses in a year may apply to constrain the recovery of losses.

To deduct bad debts written off in a year, companies must meet the COT or SBT rules for certain periods, unless the ATO determines testing would be unreasonable in certain circumstances; modifications again apply for tax consolidated groups.

For a bad debt to be deductible under the specific deduction rule, further conditions apply.

#### Tax challenges following restructure activities

Restructure activities undertaken as part of business turnaround efforts may include

- a) Recapitalise the business with new debt, participating debt (eg convertible notes) and equity
- b) Refinance debt
- c) Sell loss-making activities which are saleable or cease other loss-making activities
- d) Expand existing profitable activities
- e) Establish new business and/or acquisitions
- f) Transfer existing activities to different entities and/or locations
- g) Change organisational structures.

The change (a) above might cause the business to breach the COT, even in some circumstances where majority ultimate ownership is maintained. So the company must then rely on the secondary SBT test.

But the SBT test is challenging as most turnarounds also involve changes to business operations and offerings as noted above. The multiple requirements of the three same business tests combined with the ATO's "strict" approach to applying the tests often make it difficult or, in some cases, impossible to comply with the tests in such cases to allow prior year losses to be deducted.

The tax treatment of loss deductions:

- a) defers or potentially denies completely the tax benefit arising from the use of the tax losses against taxable income

<sup>4</sup> *ConnectEast Management Ltd v Commissioner of Taxation* [2009] FCAFC 22

- b) leads to the result that when the business generates income, to accelerate the taxation of those profits, which will not be sheltered by real economic outflows to the business.

These outcomes cause real commercial damage to loss-making entities.

### **Budget 2011 reform: excluding some tax losses from tax loss SBT and COT rules**

The government recognised in the 2011 Budget that the tax loss rules impede economic activity. It announced reforms, but restricted only to unspecified infrastructure projects, to

- a) allow them to carry forward losses with an uplift factor to maintain their value and  
b) to “exempt those losses from the continuity of ownership test and the same business test.”

This government action confirmed the inappropriate economic outcomes of Australia’s tax rules which:

- Reduce the economic value of tax losses in all cases and
- Deny the carryforward of losses in many cases, which is quite inequitable.

This welcome announcement was referenced to the AFTS (Henry) Review but did not actually deliver the recommendation 32 of the Henry Report which proposed a tax loss carryback.

### **Proposed solutions**

We propose actions for consideration including:

- a) Introduction of a loss carryback rule along the lines of the AFTS recommendation 32, but with a two year carryback not the limited one year carryback recommended
- b) Broaden the application of the Budget 2011 measure to preserve the real value of losses by an uplift factor to maintain their value. This broader application might be limited, for example, to cases of real restructures, and would reduce the circumstances where loss carryback would deliver no value
- c) Protect certain losses arising from reorganisations in the same way as envisaged in the Budget 2011 measure to “exempt those losses from the continuity of ownership test and the same business test.”
- d) At minimum, improve the company same business test. It should contain a purpose test such as applies in the Division 175 integrity rules, so that it applies only where a company or trust is acquired or has a major ownership change for a non-incidental purpose of using its losses.
- e) A comprehensive review of the policy underpinning the carryforward of losses by companies and trusts in circumstances where there are real losses incurred in real business activities not involving loss trafficking, to
- I. Consider the interaction of the loss rules with tax consolidation.
  - II. Extend the SBT for trusts conducting real business activities.

We note that submissions by the professional accounting and industry bodies were sent to Treasury in early 2006 in response to the former Assistant Treasurer's request concerning Government proposals to explore options for improving the operation of the SBT. The review was said to be used for consideration by the then government in the 2006 Budget context. Unfortunately this review did not proceed as expected.

## Appendix 3

### Reducing the corporate tax rate and considering an ACE

In the modern global economy, capital is highly liquid and competition to attract investment is strong. The AFTS (Henry) Review has confirmed that Australia's combination of a broad taxation base and high rate of corporate taxation make Australia an expensive location for business and affect our competitiveness.

Australia's headline corporate tax rate is no longer competitive given the global trend for several years of corporate tax rate reductions<sup>5</sup>:

- In the Asia-Pacific region, in addition to established low tax rate centres of Hong Kong and Singapore, Australia must now compete also with Taiwan's 17% corporate tax rate or Malaysia's 22% rate.
- Even Europe, traditionally a high-tax region, has seen a significant trend to lower corporate tax rates. For example the UK is reducing its Corporation Tax rate (26% for 2011-12) in stages to a 23% company tax rate by 2014.
- **Canada, which is highly comparable to Australia, is moving towards a headline corporate tax rate of 25% for 2012.** Canada has a federal company tax rate of 16.5% and provincial income taxes and the 2011 combined rates approximate 26.5%<sup>6</sup>. With the corporate tax rate reducing from 16.5% to 15% for 2012<sup>7</sup>, the headline combined rate will be 25%.

Australia's tax deductions for business are relatively low so the effective tax rate is high<sup>8</sup>. A 2011 study by the US Cato Institute<sup>9</sup> found that Australia's estimated effective corporate tax rate on new business investment in 2010 was 26%, the average for new business investment our region is 18.1% and Singapore's effective rate was estimated at 8.5%. Ernst & Young's study on Taxation of Investment in Australia in 2006 reached the same conclusion.

The AFTS (Henry) Review recommended lowering the corporate tax rate from 30% to 25%, in recommendation 27<sup>10</sup>.

As well, the AFTS (Henry) Review recommended exploration of a potential move over time towards a business level expenditure tax, such as an allowance for corporate equity ("ACE") , in recommendation 26<sup>11</sup>:

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

<sup>5</sup> AFTS (Henry) Review Report vol. 1, page 160

<sup>6</sup> [http://www.ey.com/Publication/vwLUAssets/Tax\\_Rate\\_Card\\_-\\_2011\\_Corporate/\\$FILE/Corporate2011.pdf](http://www.ey.com/Publication/vwLUAssets/Tax_Rate_Card_-_2011_Corporate/$FILE/Corporate2011.pdf)

<sup>7</sup> [http://www.ey.com/Publication/vwLUAssets/Tax\\_Alert\\_2011\\_No\\_11/\\$FILE/TaxAlert2011No11.pdf](http://www.ey.com/Publication/vwLUAssets/Tax_Alert_2011_No_11/$FILE/TaxAlert2011No11.pdf)

<sup>8</sup> AFTS (Henry) Review Report vol. 1, page 162

<sup>9</sup> [http://www.cato.org/pubs/tbb/tbb\\_64.pdf](http://www.cato.org/pubs/tbb/tbb_64.pdf)

<sup>10</sup> AFTS (Henry) Review Recommendation 27: The company income tax rate should be reduced to 25 per cent over the short to medium term with the timing subject to economic and fiscal circumstances. Improved arrangements for charging for the use of non-renewable resources should be introduced at the same time.

<sup>11</sup> AFTS (Henry) Review Recommendation 26: The structure of the company income tax system should be retained in its present form, at least in the short to medium term.

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



We support exploration of both of these proposals to reduce the tax burden on Australian companies

- to lower the corporate tax rate to 25% or less in the near term and
- to transparently investigate an allowance for corporate equity (ACE), its benefits, challenges and competitiveness issues and whether it merits consideration for adoption in Australia.

We agree with the AFTS (Henry) Review that these two measures are not mutually exclusive.

### **We support moves to a reduced headline corporate tax rate**

If Australia is committed to maintaining its current broad tax base, one option to ease the pressure on Australian corporates and attract increased business activity is to lower the corporate tax rate. Ernst & Young supports the recommendation of the AFTS (Henry) Review that the company tax rate should be reduced to 25% over the short to medium term.

A benefit of this economy-wide approach is its simplicity. No new taxation compliance systems are required for corporations.

We recognise that, when taking into account dividends paid by Australian companies to their Australian resident shareholders, that a lower corporate tax rate for Australian companies 'washes out'. That is, the lower Australian corporate tax rate and imputation credit mean that higher taxes are paid by Australian shareholders. But a lower corporate tax rate is of benefit when attracting foreign capital to grow Australian business and employment.

Action is needed, given the mobility of business investment. We are seeing international comparative tax rates being promoted by developed countries around the world to attract business and to induce business to relocate.

### **We support analysis and debate about an Allowance for Corporate Equity in addition to corporate rate reductions**

An ACE involves, broadly, a tax deduction applied to a company's equity. Effectively, ACE provides an additional tax deduction on an amount equivalent to a "return" calculated on the "equity" invested in a company, which approaches to some extent the deduction for interest payments.

The potential benefits of an ACE are seen as reducing the incentive for businesses to use debt. Also, an ACE regime is of more benefit for businesses currently making lower returns. The AFTS (Henry) Review noted that "the various forms of business expenditure tax exempt the normal return from tax, only taxing economic rents"<sup>12</sup>.

However the AFTS (Henry) Review confirmed that the ACE needs research and analysis:

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

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

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

<sup>12</sup> AFTS (Henry) Review Report vol. 1, p.164



The economic effects and impact on Australia's competitiveness merit debate and analysis, including:

- a) **defining the equity base.** For example various adjustments to accounting equity are set out in the Consultation Document of the AFTS (Henry) Review and in papers commissioned by it<sup>13</sup> and the Belgian Notional Interest Deduction (NID), the primary international comparative for an ACE, involves several adjustments to calculate the equity
- b) **defining the allowance rate**
- c) considering **transitional changes** required for adoption of the ACE, the experience of the proposed Resources Super Profits Tax, replaced by the Mining Resources Rent Tax (the RSPT/MRRT experience) involved some of these issues.
- d) the **impact of the ACE for fast-growing companies** such as Australian IT and services companies, which might have significant internally-generated economic value which is not reflected on the face of their financial reports
- e) sustainability of the regime in a global move towards lower tax rates. What is the impact of an ACE for high-earning companies if Australia's competitors are moving to low corporate tax rates? We note the AFTS (Henry) Review preference for Australia to be in a leading group of countries adopting ACE, if there were such a trend
- f) Lessons to be learned from
  - o European 'early adopters' of ACE concepts which abandoned their ACE variants, such as Austria, Italy and Croatia. We understand that reasons included complexity and the global trend to lower tax rates for all domestic businesses
  - o Countries currently using the ACE, notably Belgium and more recently Latvia
- g) compliance costs
- h) funding of the ACE. If ACE was 'paid for' by increases in other taxes what would be the benefit?

We support a transparent analysis of the issues.

We agree with the AFTS (Henry) Review that the two reforms of:

- achieving lower corporate tax rates for all companies and
- considering alternative business taxes

are not mutually exclusive.

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<sup>13</sup>Consultation Paper 10 December 2008, Appendix E, and Auerbach (2010) and Sørensen & Johnson (2010) papers referenced in AFTS (Henry) Review Report vol. 1, p. 165 - all available at <http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/home.htm>