# DEPARTMENT OF RESOURCES, ENERGY AND TOURISM

### **Minister for Information**

Min ID: B12/1048

### BUSINESS TAX WORKING GROUP DISCUSSION PAPER

Purpose: To provide you with information on the discussion paper released by the Business Tax Working Group (the 'Working Group').

**Background:** On 13 August 2012, the Working Group released a discussion paper that canvasses a number of possible ways in which a cut to the company tax rate could be funded from within the business tax system. The discussion paper follows on from the Working Group's previous report on the tax treatment of losses (B12/430 refers).

Issues: The Working Group's discussion paper includes a wide range of base broadening options. These options provide a sound basis for consultation to explore whether revenue forgone through these measures would be better directed at lowering the corporate tax rate. The identified savings options can be grouped into three areas, including:

- interest deductibility (including thin capitalisation rules);
- · capital allowances and capital expenditure; and
- the R&D tax incentive.

The business tax savings options identified in the Working Group's previous report, which included the removal of statutory effective life caps, the removal of the immediate deduction for exploration and prospecting, changes to the thin capitalisation rules and changes to the research and development non-refundable tax incentive, have been included in the discussion paper. A number of additional savings options have also been considered in the paper, including:

- · depreciation arrangements for buildings; and
- a reduction to the diminishing value rate used for capital depreciation.

Details of each savings option identified in the discussion paper, including Treasury advice on the costing for each, is at **Attachment A**. A preliminary estimate of the revenue cost of a company tax rate cut and a summary of the financial impacts of identified saving options is at **Attachment B**.

The Working Group will now conduct limited face to face consultations with stakeholders, as well as a submissions process, which closes on 21 September 2012. In light of responses to the discussion paper, some of the savings options may be abandoned, others may be amended, and new ideas may be considered. A draft report, including a set of draft recommendations, is expected to be released by the Working Group in late October 2012, followed by a second round of consultation. Final recommendations will be contained in a report to the Treasurer, which is due before the end of 2012.

The Department is currently liaising with industry with regard to the identified savings options and will provide further analysis as soon as practicable.

### Slipstream Version 20 August 2012

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### **IDENTIFIED SAVINGS OPTIONS**

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.

Further details regarding each of the options identified under these categories can be found below. Where possible, the Department has also provided some preliminary analysis and/or comments on certain savings options.

# CATEGORY 1 - INTEREST DEDUCTIBILITY AND THIN CAPITALISATION

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.

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.

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. The final two options involve a fundamental shift in Australia's approach to the deductibility of interest expenses.

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.

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

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

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.

In contrast to Option 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

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).

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)

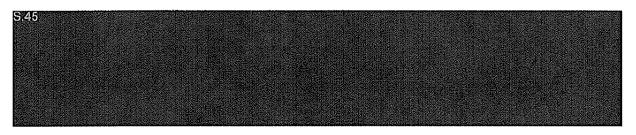
This option would involve:

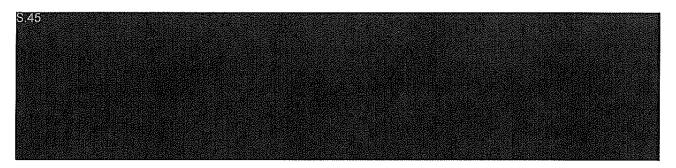
- Removing the thin capitalisation rules from the domestic law.
- Placing a cap on the deductibility of interest by limiting the net interest expense (the excess of interest paid over that received) to a set percentage of 'earnings before interest, taxes, depreciation and amortisation' (EBITDA) for all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

The limit would apply regardless of whether the taxpayer operates only domestically or has offshore operations.

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

This option extends Option 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.





# CATEGORY 2 - DEPRECIATING ASSETS AND CAPITAL EXPENDITURE

The Working Group has identified the following areas which 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.

### DIMINISHING VALUE METHOD

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).

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.

The 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.

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

This option would involve reducing the diminishing value rate of depreciation from 200 per cent to 150 per cent.

10				
10	170	700	1300	2180
ides with a ciation arr	in announcement i angements have b	in the 2013 Budge een assumed to ap	et on 14 May 2013 oply to contracts the	b. Changes to hat are signed,
	ides with a ciation arr	ides with an announcement ciation arrangements have b	ides with an announcement in the 2013 Budge ciation arrangements have been assumed to ap	costing has been prepared on the basis that the application date for ides with an announcement in the 2013 Budget on 14 May 2013 ciation arrangements have been assumed to apply to contracts the ruction that commences, or assets whose holding commences af

#### STATUTORY EFFECTIVE LIFE CAPS

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.

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.

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.

The Working Group has identified five options. The first option (Option 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

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
	٠0	70	. 300	625	995
Notes	coincides with a depreciation arr construction tha It is recognised, an investment pr	in announcement in angements have be it commences, or as however, that ofter roject is committed	he basis that the apply the 2013 Budget of en assumed to apply sets whose holding in there can be a signal and when contracts erefore need to be a	n 14 May 2013. (y to contracts that commences afte nificant time lag sommence. The	Changes to t are signed, r this date. between when e precise

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

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 imp (\$ million)	act 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

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 in (\$ millio		2013-14	2014-15	2015-16	- Total
	••	10	50	100	160
Notes	See Option B.2 Not zero but rous	nded to zero.			

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

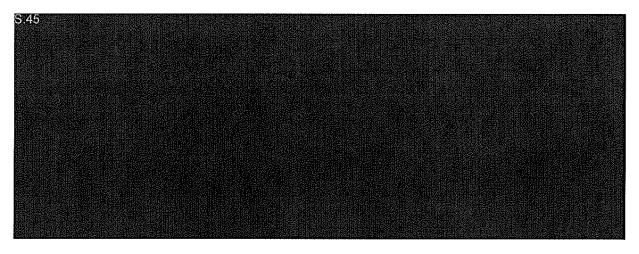
This option would involve removing the three-year effective live cap available for expenditure by irrigators and primary producers on water facilities, as outlined in sections 40-515 to 40-575 of the ITAA 1997. The affected assets would therefore be depreciated in line with their effective lives, rather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

Financial ir (\$ millio		2013-14	2014-15	2015-16	Total
77.77	••	5	10	15	30
Notes	See Option B.2 Not zero but round	led to zero.			

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

This option would involve removing the statutory effective life caps for aeroplanes and helicopters (other than those covered by Option 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 im (\$ million		2013-14	2014-15	2015-16	Total
	0	25	140	290	455
Notes	See Option B.2				



#### EXPLORATION AND PROSPECTING

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

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	coincides with a been assumed to	been prepared on an announcement in apply to contract olding commences	in the 2013 Budge is that are signed,	t on 14 May 2013 construction that of	i. Changes have commences and

Option B.S — First use exploration deduction — intangibles

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 7				

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

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).

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 imp reported as having eligible for an imi	g been deducted	under section 40-7	730 of ITAA 1997	7 would be

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

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 deductible under any other provision).

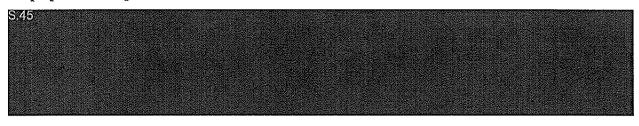
The removal of immediate deductibility would apply to exploration or prospecting expenditure in relation to depreciating assets (covered by section 40-80 of the ITAA 1997) and to capital expenditure on exploration or prospecting that is not in relation to depreciating assets (covered by section 40-730 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.

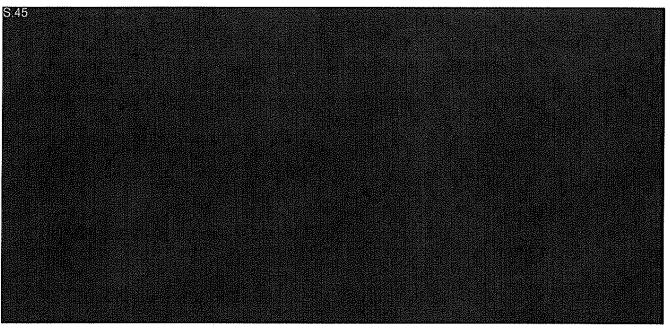
Financial im		2013-14	2014-15	2015-16	Total
	0	800	700	600	2100
Notes	See Option B.9				

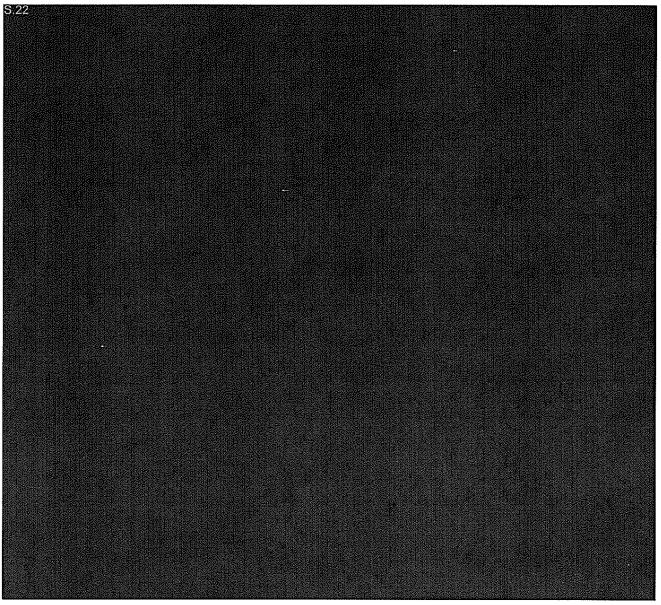
### Option B.11 — Exclude feasibility studies from exploration expenditures

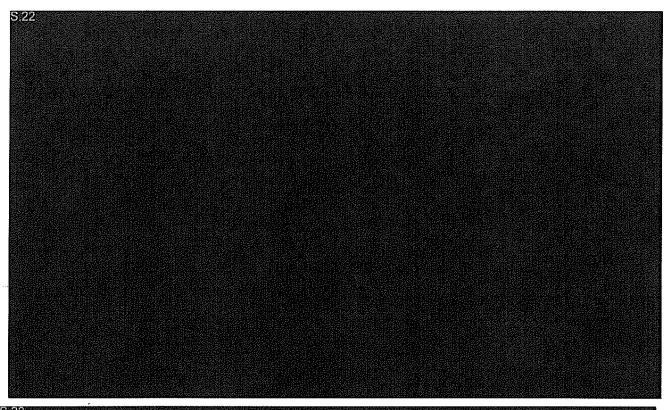
This option would remove feasibility studies from the definition of exploration and prospecting expenditure under section 40-730 of the ITAA 1997. The main focus would be on removing studies undertaken to evaluate the economic feasibility of mining or quarrying a site once minerals have been discovered.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

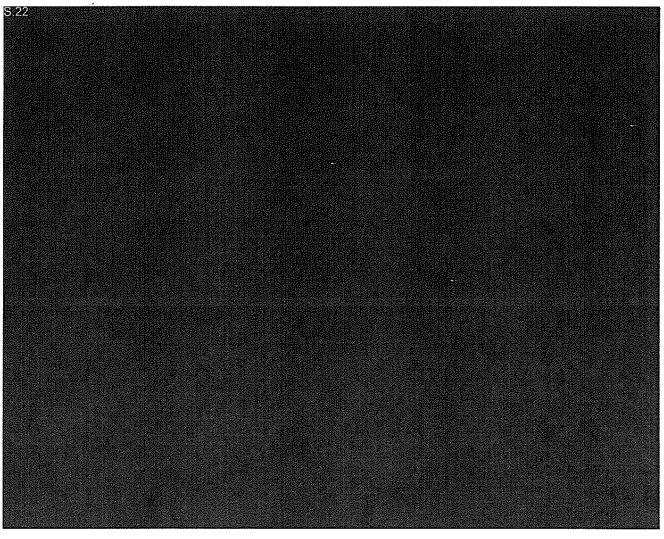
Tax return data is not sufficiently disaggregated to allow Treasury or the ATO to identify what proportion of expenditure currently deducted under section 40-730 relates to feasibility studies.











## CATEGORY 3 - THE R&D TAX INCENTIVE

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).

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

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 in (\$ million		2013-14	2014-15	2015-16	Total				
	0	250	1050	950	2250				
Notes		0 20 100 750 2200							

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

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.

In contrast to Option 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.

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 impa (\$ million)	ict 2012-13	2013-14	2014-15	2015-16	Total
\$10 Billion	0	50	250	250	550
Threshold					
\$20 Billion	0	50	200	200	450
Threshold	·				
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

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 in (\$ million		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

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.

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 imp		2013-14	2014-15	2015-16	Total
	0	50	250	250	550
Notes	See Option C.1	. •			



Attachment B

# PRELIMINARY ESTIMATE OF THE REVENUE COST OF A COMPANY TAX RATE CUT

New company	Preliminary estimated cost (\$million)					
tax rate (from 30 per cent)	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	

# SUMMARY OF FINANCIAL IMPACTS OF IDENTIFIED SAVINGS OPTIONS\*

Option	2012-13	2013-14	2014-15	2015-16	Total
	(\$m)	(\$m)	(\$m)	(\$m)	(\$m)
B.1. Reducing the diminishing value rate for depreciation from 200 per cent to 150 per cent	10	170	700	1300	2180
B.2. Remove the effective life provided to	0	70	300	625	995
certain depreciating assets	-	12			
B.3. Remove the capped effective life provided to	0	30	100	200	330
depreciating assets used in oil and gas extraction					
and petroleum					
B.4. Remove the capped effective life provided		10	50	100	160
to depreciating assets used in primary		-			
production					
B.5. Remove the capped effective life provided to	**	5	10	15	30
water facilities					
B.6. Remove the capped effective life used in	0	25	140	290	455
non-specified industries					
B.7. Remove or reduce the first use exploration					
deduction					
Over 5 years	0	900	800	600	2300
Over effective life	0	900	1000	1000	2900
B.8. First use exploration deduction -					
intangibles					
Over 5 years	0	200	200	100	500
Over effective life	0	200	200	200	600
B.9. Deduction for non-depreciating exploration					
expenditure					
Over 5 years	0	100	100	100	300
Over effective life	0	100	200	100	400
B.10. Removal of immediate deduction for	0	800	700	600	2100
exploration expenditure by large companies	i				
B.12. Depreciate building over effective lives					
Optional diminishing value	0		20	50	70
Prime cost only	0	5	45	120	170
B.13. Remove building depreciation deductions	0	5	75	190	270
B.14. Allow a uniform rate of depreciation of 2.5	0		5	10	15
per cent per annum					
C.1. Abolish the 40 per cent non-refundable tax	0	250	1050	950	2250
offset					
C.2. Impose a turnover threshold above which the					
40 per cent non-refundable tax offset could not be			1		
claimed			i		
\$10 Billion Threshold	0	50	250	250	550
\$20 Billion Threshold	0	50	200	200	450
C.3. Impose a cap on the amount that can be	0	50	200	200	450
claimed annually under the 40 per cent non-			ŀ		
refundable tax offset					
C.4. Cut the rate of the non-refundable tax offset to	0	50	250	250	550
37.5 per cent				1	

<sup>\*</sup> The options are not necessarily additive.