

# 5: General business tax issues

## Overview

This chapter provides an overview of the business tax system in an increasingly digitised and globalised world.

### Key points

- Tax is becoming increasingly important as competition for foreign investment intensifies and businesses become more mobile. Australia's corporate tax rate is high compared to many countries we compete with for investment, especially those in the Asia-Pacific region.
- While company tax is paid by companies, the burden is passed on to shareholders, consumers and employees. A more competitive business tax environment would encourage higher levels of investment in Australia and benefit all Australians through increased employment and wages in the long run.
- Dividend imputation ensures there is no double taxation on income from Australian shares owned by Australian resident shareholders and supports the integrity of the business tax system. However, it makes little contribution to attracting foreign investment to Australia other than eliminating dividend withholding tax for franked dividends paid to foreign shareholders. It also involves a significant cost to revenue and may impose more compliance costs to achieve similar outcomes to other jurisdictions.
- Australia's corporate tax system is also extremely complex. Artificial distinctions embedded in the system often create unintended biases towards particular forms of investment, distort business decisions and increase incentives to engage in complex tax planning.
- Business innovation encompasses improvements to goods and services, processes and marketing. Benefits can include productivity enhancements, firm growth, job creation and higher living standards. The research and development tax incentive and concessional taxation of employee share schemes are two ways the tax system supports business innovation.

## 5.1: Overview of the business tax system

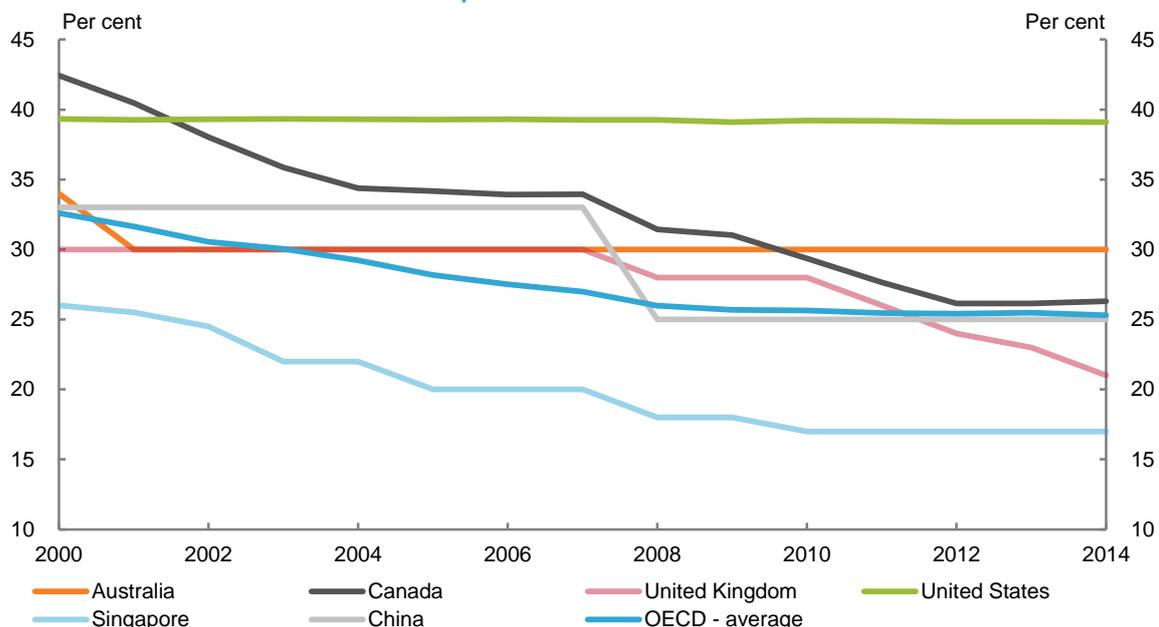
Businesses can be taxed differently depending on their structure, such as whether they operate through a company, partnership, trust or as a sole trader, and whether they are closely held by a small number of private shareholders or widely held, like a publicly-listed company. There are also special tax arrangements for small businesses. These are considered in Chapter 6, with this chapter addressing tax issues that apply to businesses more generally.

Most business income in Australia is derived through corporations, rather than partnerships or trusts. Accordingly, this chapter focuses primarily on the taxation of corporations, particularly widely-held corporations. Where relevant, some specific considerations for closely-held corporations or businesses conducted through partnerships or trusts are highlighted.

Corporate income tax is currently levied at a rate of 30 per cent on all taxable income earned by companies. This means Australia's corporate tax rate is higher than many countries we compete with for investment (Chart 5.1 and Chart 5.2).

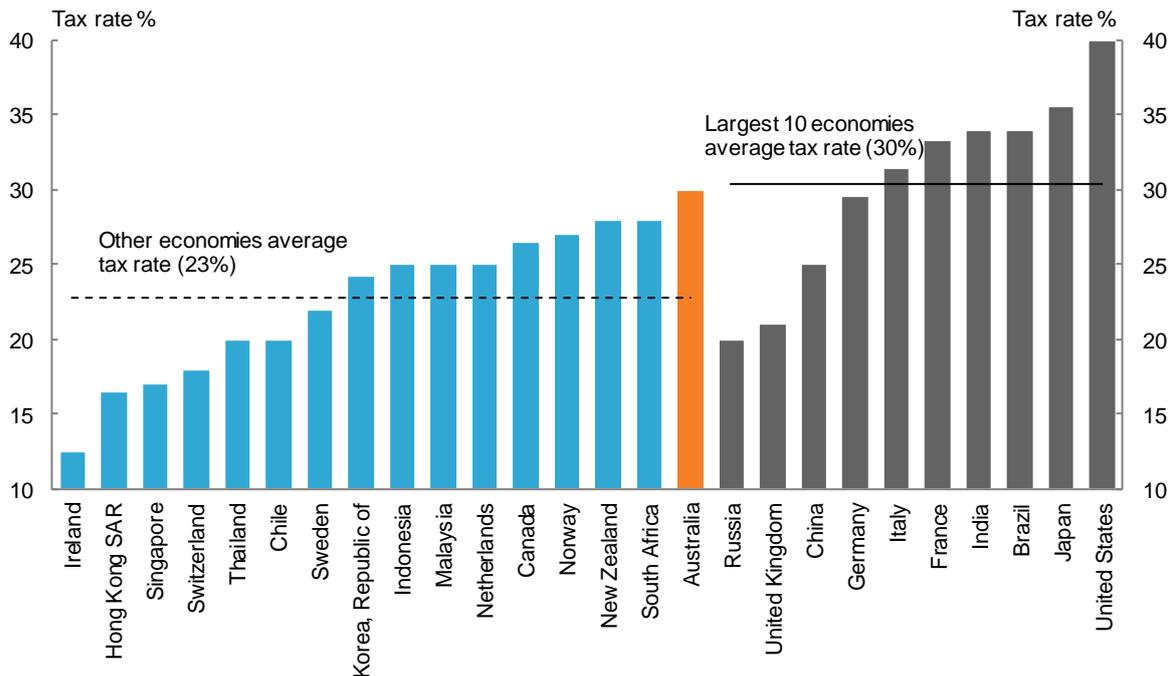
As economies become more open, barriers to investment can have a greater impact on economic growth and real wages growth. In response, corporate income tax rates have fallen worldwide in recent years. For example, since 2008, the United Kingdom, Canada and Singapore have all reduced their main corporate tax rate.

Chart 5.1 Trend in corporate tax rates in selected economies



Source: Organisation for Economic Co-operation and Development (OECD) 2014, *Tax Database — Taxation of Corporate and Capital Income*, OECD, Paris, viewed 5 December 2014: [www.oecd.org/ctp/tax-policy/Table%20II.1-May-2014.xlsx](http://www.oecd.org/ctp/tax-policy/Table%20II.1-May-2014.xlsx); KPMG 2014, *Corporate tax rates table*, viewed 5 December 2014: [www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx](http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx); and KPMG 2007, *Hong Kong Tax Competiveness Series: Corporate Tax Rates*, viewed 5 December 2014: [www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/corp-tax-rate-0707.pdf](http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/corp-tax-rate-0707.pdf); KPMG 2006, *KPMG's Corporate Tax Rate Survey, An international analysis of corporate tax rates from 1993 to 2006*, viewed on 21 January 2015: [www.lib.uwo.ca/files/business/KPMGCorporateTaxRateSurvey.pdf](http://www.lib.uwo.ca/files/business/KPMGCorporateTaxRateSurvey.pdf).

**Chart 5.2 Corporate tax rates, selected trading partners, 2014**



Note: Corporate tax rates in this chart are estimates as the effective tax rate can vary depending on the specific tax rules applied in each jurisdiction. Chart 5.2 uses a different data source to Chart 5.1 which may result in slight differences in the estimates. For example, the United States' corporate income tax rate is approximately 40 per cent. The estimate of this rate can vary depending on how corporate income taxes applied at the sub-central level (by state and local governments) are measured.

Note: The Indian Government announced in their 2015-16 budget that they would introduce a company tax cut from a base rate of 30 to 25 percent over four years, coupled with some reductions in tax concessions. The rate of 33.99% shown above includes various surcharges over the base rate.

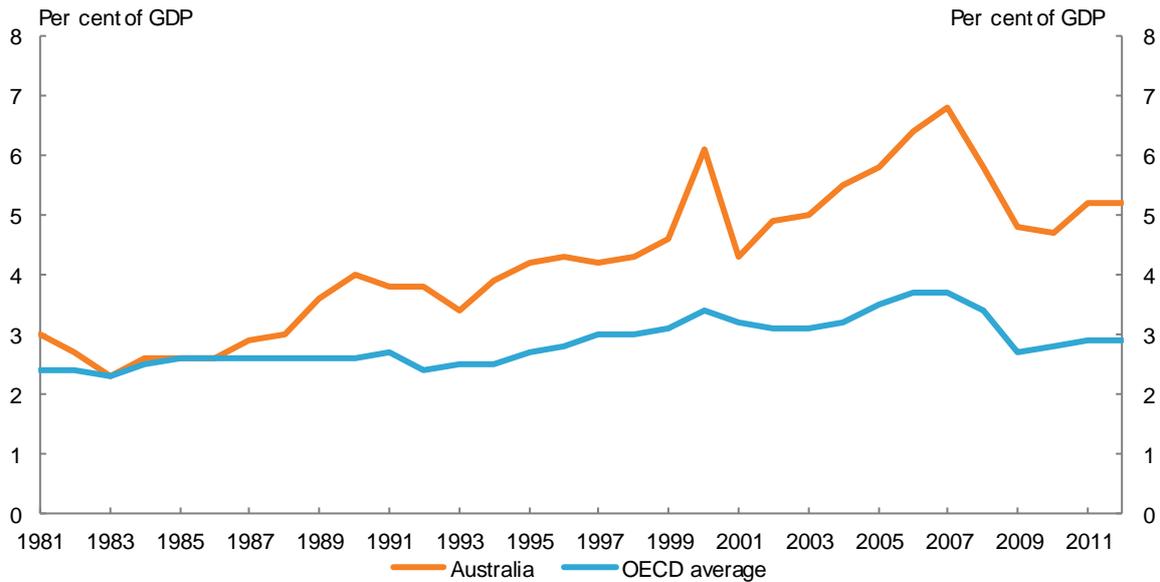
Source: KPMG 2014, *Corporate tax rates table*, viewed 10 December 2014:

[www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx](http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx).

## How important is corporate tax to Australia?

Australia relies more heavily on corporate income tax than most other countries. In 2012, Australia's corporate taxation was 5.2 per cent of GDP, while the OECD average was 2.9 per cent. A relatively heavy reliance on corporate tax has been a consistent feature of our tax system over several decades (Chart 5.3).

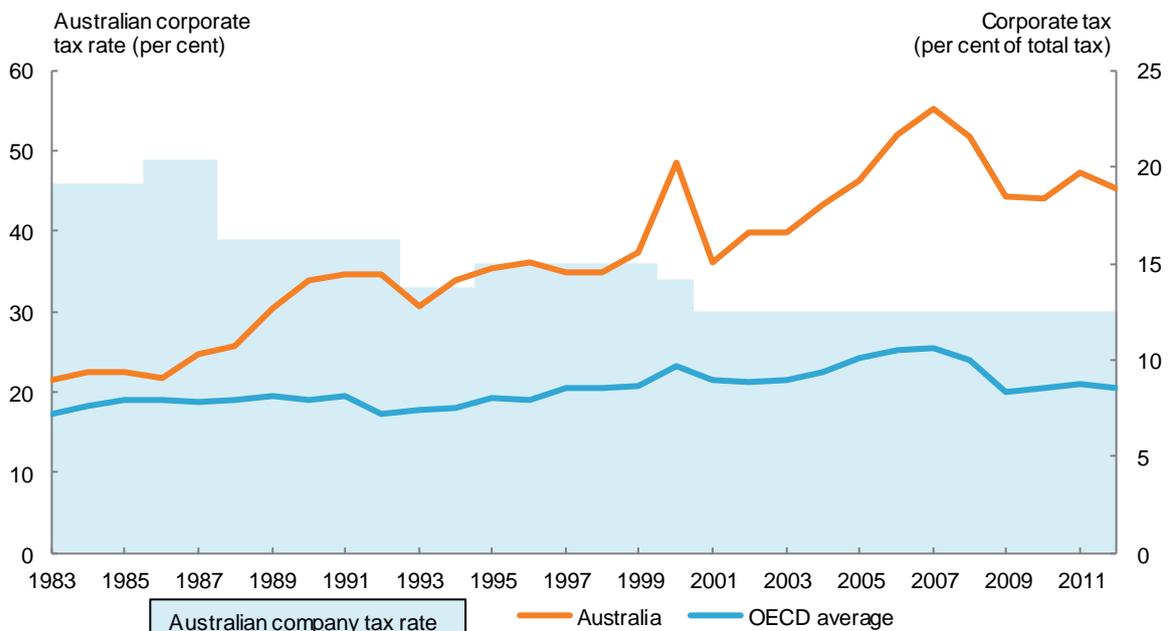
**Chart 5.3 Corporate tax revenue**



Source: OECD 2014, *Revenue Statistics 2014*, OECD, Paris.

Corporate tax as a share of total tax for all Australian Governments has increased in recent decades, from around 9 per cent of total tax in 1983 to around 19 per cent in 2012 (Chart 5.4). The main reasons for this increase include increased corporate profitability and efforts to broaden the corporate tax base (while lowering the rate). By contrast, the OECD average corporate tax revenue (as a percentage of total tax revenue) has remained relatively stable at around 8.5 per cent over the same period.

**Chart 5.4 Corporate tax revenue as a percentage of total tax revenue**



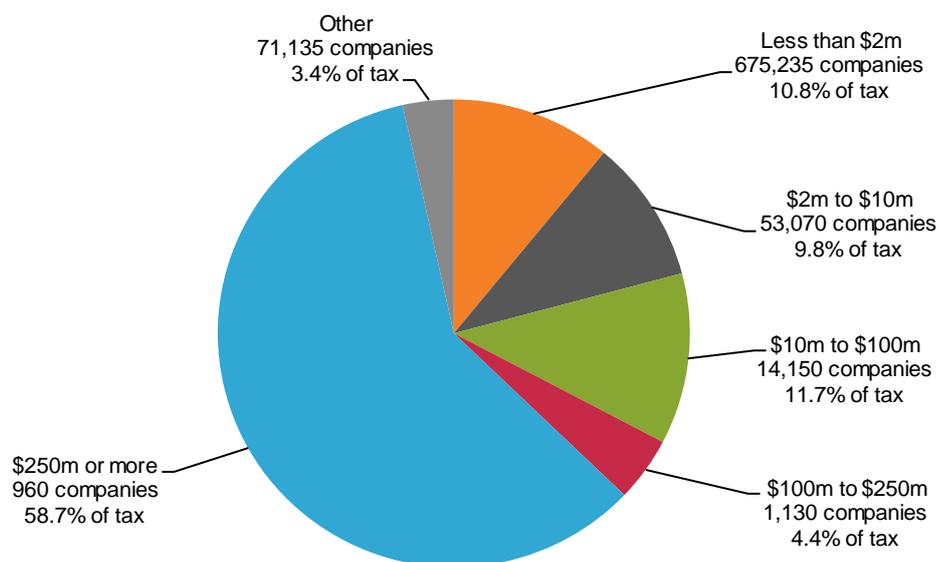
Source: OECD 2014, *Revenue Statistics 2014*, OECD, Paris.

## Who ultimately pays corporate tax?

Every resident company that derives taxable income (including capital gains) sourced from Australia or internationally is required to pay Australian corporate tax. Every non-resident company that derives taxable income from Australian sources is also required to pay tax in Australia.

While there are over 800,000 companies in Australia, most corporate income tax is paid by a relatively small group of large companies. Around 2,000 companies paid approximately two-thirds of company tax in 2011-12 (Chart 5.5).<sup>79</sup> The mining and financial services sectors are the largest contributors to corporate tax collections in Australia.

**Chart 5.5 Resident company income tax by company size, 2011-12**



Note: Total income is used as a measure of company size. 'Other' includes companies classified as a cooperative, registered organisation, non-profit, strata title, pooled development fund, limited partnership, corporate unit trust or a public trading unit trust.

Source: ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

For resident shareholders, corporate income tax is a withholding tax, or a pre-payment of individuals' income tax. Resident shareholders declare the dividends they receive from the company in their taxable income, and receive a credit for tax paid by the company for that dividend. Shareholders can use the credit to offset their income tax liability. If the dividend credit exceeds their income tax liability, the excess corporate tax paid may be refundable to the shareholder. However, for companies that choose to retain earnings, corporate tax reduces the funds available for reinvestment.

For non-resident shareholders, corporate income tax may be the final taxing point in Australia. Imputation credits for tax paid by the company for the dividend are not available for use by non-residents. Other jurisdictions may offer a full or partial credit for tax paid in Australia, or an exemption from further tax if tax is paid in Australia.

<sup>79</sup> Australian Taxation Office (ATO) 2014, *Taxation Statistics 2011-12*, ATO, Canberra.

While the legal incidence of corporate tax falls on companies, the economic burden of company tax is ultimately shared among its shareholders, consumers and employees. Empirical studies show that, in the long run, over half of the economic burden of corporate tax is likely to be shifted away from shareholders through lower wages for employees and higher prices for consumers.<sup>80</sup> Individuals who rely on labour income could be expected to be affected more significantly from lower wages growth associated with company tax.

This analysis does not take into account the behavioural responses to company tax that may be more relevant for closely-held companies with more control over when and how profits are distributed. For individual resident shareholders, the effectiveness of company tax as a withholding tax is reduced if dividend distributions are delayed until a period where the shareholders are subject to a relatively low marginal tax rate in the individuals income tax system (for example, in retirement).

## The impact of corporate tax on economic growth and living standards

Australia relies on domestic and foreign savings to finance additional investment in the Australian economy. This includes new capital assets like machinery, as well as training and research and development activities. Tax is only one of many factors that affect Australia's appeal as a destination for foreign investment. Nevertheless, tax can have a significant impact on investment decisions.

Corporate tax applies to the profits of companies, reducing the return from their investments. This reduces the level of investment in small, open, capital importing economies, such as Australia. This is because the marginal investor in Australia is likely to be a non-resident, who will invest in business opportunities in Australia only if they achieve an after-tax return that matches their target rate of return (see Box 5.1).

Tax on investments can influence decisions about where to invest, what to invest in, and how much to invest. Higher taxes on investment generally mean that fewer investments will be viable. This effect is more pronounced where the rate of corporate tax is higher than in other countries offering comparable investment opportunities. The types of investments that are made can also be distorted. Key features of the corporate tax system that affect investment decisions include the tax rate and the tax treatment of capital assets, losses and financing costs.

Reducing Australia's corporate tax rate would increase Australia's appeal as a place to do business. It would encourage higher levels of investment in Australia and lead to capital deepening, which promotes growth in productivity, innovation, employment and wages. In the near term, lower taxes would provide an increased incentive for non-residents to invest in Australia. In the long run, increased investment would benefit all Australians.

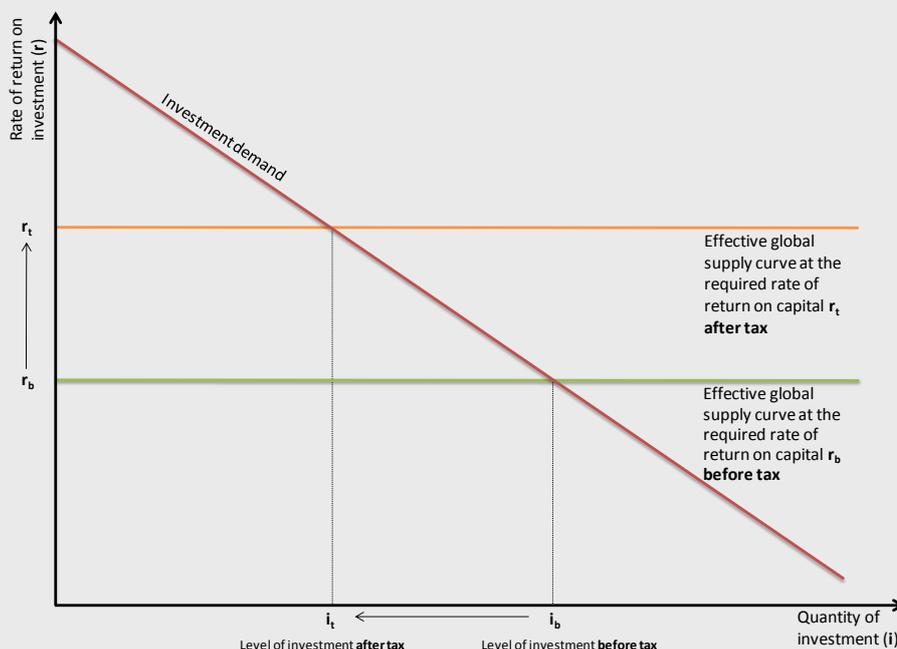
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80 Hassett, K A, and Mathur A 2006, *Taxes and Wages*, American Enterprise Institute for Public Policy Research working paper no. 128, American Enterprise Institute, Washington; Felix, R A 2007, *Passing the Burden: Corporate Tax Incidence in Open Economies*, regional research working paper no. 07-01, Federal Reserve Bank of Kansas City, Kansas; and Arulampalam W, Devereux M P, and Maffini G 2011, *The Direct Incidence of Corporate Income Tax on Wages*, working paper no. WP09/17, Oxford University Centre for Business Taxation, Oxford.

### Box 5.1: The impact of company tax on investment

All else being equal, an investment project will go ahead only if it delivers an adequate return, that is, if the internal rate of return<sup>81</sup> from the investment project is enough to compensate the investor for the capital they provided, taking into account the price of capital<sup>82</sup> and time value of money.<sup>83</sup> A more internationally competitive company tax rate should encourage higher levels of investment in Australia.

Investors often consider comparative returns for projects across countries when making investment decisions. Decisions will be based on the expected returns after tax as tax reduces the return from the investment. Therefore, the higher the company tax rate in a country, the higher the before-tax rate of return required to make an investment competitive.



The diagram illustrates the overall effect of company tax on investment in a small open economy like Australia, which has minimal effect on the global price of capital. As the price is set in the international market, the before-tax global required rate of return faced by firms is fixed (shown by the green line,  $r_b$ ).

As the amount of investment undertaken increases, the rate of return realised from investment will decline as less profitable investments are brought to market (shown by the demand for investment along the red line).

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- 81 Internal rate of return is the interest rate at which the net present value of all the cash flows (both positive and negative) from a project or investment equal zero.
- 82 The price of capital is primarily determined by the demand and supply of capital, which is affected by various factors, including investors' risk appetite, investment barriers etc.
- 83 Money available at the present time is worth more than the same amount in the future due to the potential of money today to generate future income.

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The level of investment undertaken will be  $i_b$  in the diagram, that is, where the investment opportunities line equals the global before-tax rate of return.

Company income tax drives a wedge between the before-tax rate of return and after-tax rate of return.

Firms would have to offer a higher rate of return in order to attract their investment. This reduces the demand for investment, because there are fewer investment opportunities available that generate the required higher rate of return (shown by the orange line,  $r_t$ ). Hence, the total amount of investment in the economy is less (shown by the move from  $i_b$  to  $i_t$ ) than would be in the absence of a company tax.

A lower level of investment—for example, in new machinery and more efficient technology—makes existing workers less productive<sup>84</sup> and, in doing so, reduces company profits, returns for shareholders, jobs and wages.

In considering changes to the company tax rate, there are a number of additional factors that need to be taken into account. For multinational companies, a lower corporate tax rate would reduce the incentive for tax planning and profit shifting from Australia. This would potentially reduce the revenue that is lost to tax planning and allow the resources devoted to tax planning and compliance activities to be used more productively in the economy.

On the other hand, a reduction in the corporate tax rate (in isolation) would exacerbate the existing disparity between the corporate rate and the highest marginal tax rate in the individuals income tax system. For closely-held companies, this would increase incentives to engage in tax planning (for example, portraying personal income as corporate income, or changing the timing of dividends to minimise additional individuals tax liability and maximise refunds of corporate tax for individuals with a marginal tax rate below the company tax rate).

A reduction in the corporate tax rate would also have a significant impact on tax revenues in the short term. This effect would be partially offset in the medium to long term, as increased economic activity from new investment generates additional tax revenue. For example, modelling undertaken by the UK Treasury Department indicates that, for the UK, between 45 and 60 per cent of the cost of a corporate rate cut will be reduced in this way.<sup>85</sup> While Australian estimates may differ, the UK study suggests the possible order of magnitude involved.

While new investors would benefit from a lower corporate tax rate, some of the benefit would accrue to existing investments. This would mostly benefit non-resident investors as Australian company tax is often the final tax for these investors. Australian investors would still pay tax at their marginal tax rate on company dividends through the imputation system and so would not benefit from a company tax cut to the same extent.

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84 There is less capital for each worker.

85 HM Revenue and Customs, and HM Treasury 2013, *Analysis of the dynamic effects of Corporation Tax reductions*, United Kingdom Government, London.

There may be alternative policy options that would effectively target new investment only, such as changing depreciation allowances for new assets. However, these approaches provide a continuing incentive to represent 'old' investments as 'new' investments and, unless carefully designed, would distort economic outcomes and increase tax system complexity.

Similarly, reducing the corporate tax rate would also decrease the tax paid by investments that would have taken place under the old tax rate. This may be seen as a particular concern, as it limits the ability of the general corporate tax system to tax excess returns when barriers to competition exist, such as a monopoly or ownership of valuable intellectual property. In practice, it can be difficult to identify excess returns, the degree of their mobility and what has created them. Consequently, the significance of this concern is not clear. There are other mechanisms to provide governments with a share of the value of some excess returns, most prominently royalties on minerals and royalty withholding tax on intangible assets.<sup>86</sup>

### Discussion questions:

24. How important is Australia's corporate tax rate in attracting foreign investment? How should Australia respond to the global trend of reduced corporate tax rates?

## Digitisation and globalisation

Digitisation and globalisation of the economy are positive developments that are reshaping the world. Digitisation has enabled businesses to innovate and increase productivity, while new businesses and new ways of doing business have flourished. Meanwhile, technological advances have enabled multinational companies to develop sophisticated value chains across multiple countries.

A globalised economy means that companies have greater choice about where to locate their activities and assets, including intangible assets. This has increased the opportunities for multinational companies to use legal means to minimise their tax liabilities, through multinational tax avoidance, also known as Base Erosion and Profit Shifting (BEPS). BEPS refers chiefly to situations where the interaction of different tax rules allows profits to be shifted away from the countries where the activities creating those profits take place, leading to low taxation or even no taxation.

The extent to which tax avoidance is currently affecting Australia's corporate tax base is unclear. The imputation system provides strong incentives for Australian-owned companies to pay tax in Australia. However, it is clear that the risks to the corporate tax base are increasing.

<sup>86</sup> The trend towards reduced withholding taxes on royalties may mean that the effectiveness of royalty withholding tax in taxing excess returns is declining.

To maintain the integrity and fairness of our tax system, it is important to ensure that companies that conduct business in Australia pay tax in Australia.

The issue of multinational tax avoidance is a key focus for governments around the world. As G20 president in 2014, Australia led the global response to tax avoidance.

The two-year G20/OECD BEPS Action Plan is designed to address deficiencies in the international tax system that create opportunities for tax avoidance. Its recommendations will be finalised by December 2015.

Furthermore, Australia already has some robust and sophisticated laws that deal with tax avoidance by multinational companies. These include comprehensive thin capitalisation rules, tough transfer pricing and controlled foreign company rules and an extensive general anti-avoidance rule.<sup>87</sup>

Recent reforms have tightened Australia's thin capitalisation rules to stop multinationals claiming excessive debt deductions and closed other loopholes in the tax system. The ATO also has several compliance programs specifically addressing global tax structuring arrangements by multinational companies. The Commissioner of Taxation is now also required to publish certain tax details of corporate taxpayers with total income of \$100 million or more for an income year.

Lowering our corporate tax rate would also reduce the underlying incentive for companies to engage in profit shifting, debt loading and tax avoidance.

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## 5.2: Key features of Australia's business tax system

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This section outlines some important features of Australia's business tax system and highlights some of their benefits and drawbacks. It is not intended to be an exhaustive list, or to narrow the scope of submissions on possible reform areas of business tax. The section focuses on the operation of the business tax system for large widely-held companies, with some additional perspectives noted where relevant.

### The dividend imputation system

Historically, Australia had a 'classical' system of dividend taxation that resulted in the double taxation of company profits when they were distributed to non-corporate shareholders as dividends. Dividend imputation was introduced in 1987 to relieve double taxation. The current imputation system was reformed in the early 2000s to make imputation credits refundable for some taxpayers.

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87 A comprehensive thin capitalisation regime aims to prevent excessive debt deductions by companies; tough transfer pricing legislation ensures cross-border related party payments are priced appropriately; controlled foreign company rules aim to prevent Australian companies shifting income offshore; and an extensive general anti-avoidance rule aims to capture arrangements designed to avoid paying Australian tax.

The objective of Australia's imputation system is to integrate the Australian corporate tax system with the taxation of resident shareholders. This is achieved by ensuring that distributed company profits face only one layer of tax, equal to the marginal tax rate of the resident shareholder that receives a share of the profits through dividends.

Under imputation, company tax acts as a withholding tax on Australian shareholders by collecting some of the tax that would be paid by the shareholder when they receive a dividend. Australian shareholders then receive a credit against their tax liability for the tax paid by the company. Individuals, superannuation funds and some tax-exempt entities, including charities, are entitled to a refund of any excess tax paid at the company level. As a result, the final tax on company profits reflects each shareholder's tax rate.

In recent years, the value of imputation credits claimed by individuals, superannuation funds and charities has been around \$19 billion per year. The value of imputation credits claimed by other Australian companies has been around \$10 billion per year. The remainder of the difference between company tax paid (which has been around \$65 billion) and imputation credits claimed is largely related to earnings retained by companies (rather than paying dividends) and imputation credits paid to non-resident shareholders who cannot utilise them to offset Australian company tax paid. An estimated \$12 billion (30 per cent) of the imputation credits distributed each year are received by non-resident shareholders.<sup>88</sup>

### Features of dividend imputation

The imputation system was introduced to reduce a number of existing biases in the tax system, particularly for widely-held companies with a significant domestic shareholding. It provides a more neutral tax treatment of incorporated and unincorporated businesses and reduces the bias towards debt (rather than equity) in company financing choices.

While the imputation system addresses some biases in the tax system, it leaves some issues unaddressed. As shown earlier in Box 5.1, company tax means that investments need to deliver a higher rate of return for all investors to attract non-resident investors. However, unlike non-resident investors, Australian investors do not face a higher tax burden from company tax, because of imputation. As a result, imputation effectively increases the rate of return for Australian investors.

Australian investors therefore have an incentive to invest more of their savings in Australian shares rather than other investments (such as foreign companies). Further, because imputation does not offer relief from underlying foreign corporate taxes, it creates a bias against Australian-owned companies investing in foreign companies or engaging in foreign business activities.

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88 ATO 2014, *Taxation Statistics 2011-12*, ATO, Canberra. The residual amount of around \$24 billion represents the tax paid on company retained earnings and differences between accounting profit and taxable income.

For many companies, imputation reduces the bias that exists in some classical tax systems towards companies retaining their profits, rather than distributing them to shareholders as dividends.<sup>89</sup> In addition, by encouraging greater use of equity financing, the imputation system may also improve the stability of the economy. This may have contributed to the strength of the Australian corporate sector through the recent financial crisis.<sup>90</sup>

The imputation system also has integrity benefits. Tax avoidance by Australian companies reduces their ability to pay franked dividends, so any Australian tax avoided by the company is recaptured at the shareholder level when the company pays unfranked dividends to Australian shareholders. This reduces incentives for Australian companies with Australian shareholders to avoid Australian tax.

To the extent that dividends are distributed, the imputation system also reduces the effectiveness of tax concessions, such as the research and development (R&D) tax incentive for Australian resident shareholders. An Australian resident shareholder who receives a dividend paid out of corporate profits that were partially exempt from tax (for example, due to the company receiving the R&D concession) may receive a lower tax credit on that dividend. This may make them subject to an offsetting increase in personal tax.

On the other hand, a non-resident shareholder may benefit from a lower corporate tax liability (due to the R&D incentive) as unfranked dividends are only subject to dividend withholding tax, typically at a rate much lower than the corporate tax rate (under Australia's tax treaties). As such, there remains an incentive for foreign equity to flow to companies with more tax concessions.

These biases may be undesirable in an increasingly open and globalised world economy. The final report of the Australia's Future Tax System Review in 2010 stated

... the benefits of dividend imputation have declined as the Australian economy has become more integrated into the global economy. In particular, benefits in relation to financing neutrality between debt and equity financing have fallen, while the bias for households to over-invest in certain domestic shares has increased.<sup>91</sup>

The imputation system has also increased the complexity of the tax system. Complex rules have been introduced to address integrity concerns arising from the imputation system. For example, specific rules address practices like franking credit trading, which involves franking credits being transferred to other entities that have not borne the economic risk associated with those credits, and dividend streaming, which involves franking credits being distributed to only the shareholders that value them.

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89 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra.

90 Davis, K 2011, *The Australian Financial System in the 2000s, Dodging the Bullet*, viewed 16 October 2014: [www.rba.gov.au/publications/confs/2011/pdf/davis.pdf](http://www.rba.gov.au/publications/confs/2011/pdf/davis.pdf), page 341.

91 Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra, page 198.

## International comparison

Other countries currently use a number of alternative approaches to relieve the impact of double taxation of corporate dividends (Table 5.1). Many European countries (including the UK, Germany, Finland and Norway) discontinued their imputation systems during the 2000s to comply with EU free trade laws. There is now only a small group of OECD countries that operate a full dividend imputation system (including Australia). However, many OECD countries provide other forms of shareholder relief that seek a similar outcome. Many of these systems provide partial relief from double taxation of dividend income, regardless of whether the income stems from domestic or foreign sources or how much tax was paid at the company level on that income.

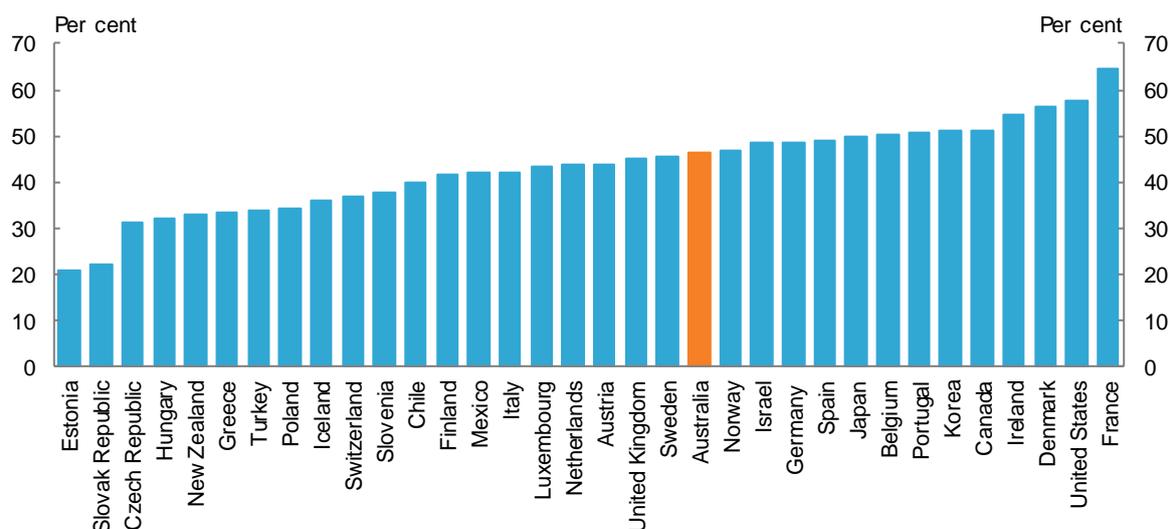
**Table 5.1 Treatment of domestic dividends received by resident individuals in selected OECD countries, 2014**

System	Description of treatment	Countries
Double taxation (classical system)	Dividend income is taxed at the shareholder's personal tax rate in the same way as other types of capital income (such as interest income). For some of these countries, the tax rate for capital income is lower than the tax rate for labour income. There is no relief for underlying company tax paid, so company profits are taxed again.	Germany, Austria, Belgium, Czech Republic, Greece, Iceland, Ireland, Israel, Netherlands, Slovenia, Sweden
Partial double taxation (some shareholder relief)	Dividend income is taxed again at preferential rates (for example, compared to interest income) at the shareholder level.	United States, Denmark, Japan, Poland, Portugal, Spain, Switzerland
	Dividend tax credit provided at shareholder level at a lower rate than the corporate rate.	United Kingdom, South Korea
	A portion of the dividend is taxed again at the shareholder level.	France, Finland, Italy, Luxembourg, Turkey
No double taxation	Imputation — dividend tax credit at shareholder level for underlying domestic corporate profits tax. No credit is available for underlying foreign tax paid.	Australia, New Zealand, Chile, Mexico
	Dividend tax credit at shareholder level for notional domestic corporate profits tax (whether or not domestic corporate tax has been paid).	Canada
Exemption	No shareholder taxation of dividends.	Estonia, Slovak Republic
	No shareholder taxation of the risk-free return.	Norway

Source: OECD 2014, *Tax Database, Corporate and capital income taxes*, OECD, Paris, viewed 9 December 2014: [www.oecd.org/ctp/tax-policy/tax-database.htm#C\\_CorporateCapital](http://www.oecd.org/ctp/tax-policy/tax-database.htm#C_CorporateCapital)

Despite the diversity of dividend taxation practices, the overall taxation of a dividend received from an Australian company, by a resident individual shareholder on the top personal tax rate is comparable with many other OECD countries (refer to Chart 5.6). A key question is whether Australia's imputation system imposes more compliance costs to achieve similar outcomes to other jurisdictions.

**Chart 5.6 Overall taxation (percentage) of resident individuals who receive dividends from domestic corporations in OECD countries, 2014**



Note: Overall taxation comprises corporate and personal taxation of dividends. Assumes that the dividend is paid by a domestic company to a resident individual on the highest marginal rate. These rates do not include the Temporary Budget Repair Levy of 2 per cent or the 0.5 percentage point increase in the Medicare Levy Surcharge which took effect on 1 July 2014.

Source: OECD 2014, *Tax Database, Corporate and capital income taxes*, OECD, Paris, viewed 9 December 2014: [www.oecd.org/ctp/tax-policy/tax-database.htm#C\\_CorporateCapital](http://www.oecd.org/ctp/tax-policy/tax-database.htm#C_CorporateCapital).

## Refundability of imputation credits

As noted above, imputation credits are refundable for resident individuals, superannuation funds and some tax exempt entities, including charities. ATO data shows that around \$4.6 billion in imputation credits were refunded to taxpayers for the 2012-13 income year.<sup>92</sup>

Refundability ensures that the final tax on company profits reflects each shareholder's tax rate at the time that the profits are distributed. Arguably, this provides for greater neutrality between different types of investments and removes a penalty that would otherwise apply to shareholders who have a lower tax rate (for example, retiree shareholders on relatively low incomes). However, as noted above, domestic shareholders may receive higher returns on domestic shares compared to global rates of returns on equities, because of imputation.

There are some revenue concerns with the refundability of imputation credits. As mentioned earlier in this chapter, it provides a greater incentive for shareholders of closely-held companies to delay distributions until a time when individual owners are subject to a relatively low tax rate, to receive a refund of tax paid by the company. A similar incentive also exists under classical systems.

## Effect of imputation on foreign investment in Australia

The imputation system reduces the cost of investing in Australian companies for Australian residents. However, it provides little benefit for non-resident shareholders in Australian companies, other than exempting the dividend from dividend withholding tax, because

<sup>92</sup> 2012-13 ATO data.

Australian imputation credits do not reduce their tax liability in their home country. A franked dividend paid to a foreign investor is exempt from dividend withholding tax which currently varies between 30 per cent to 0 per cent, subject to the terms of a tax treaty.

Most countries exempt dividends from overseas companies or apply a classical system where dividends are taxed again in the home country of the investor (some credit for foreign tax paid may be available, up to the local tax rate). In either case, Australian company tax generally affects the final return to foreign investors.<sup>93</sup> It reduces the dividend received by foreign shareholders and there is no imputation credit allowed for Australian company tax paid. This suggests that the imputation system does not help attract new investment into Australia.

The merit of Australia and New Zealand recognising each other's imputation credits has been considered in a number of previous reviews.<sup>94</sup> Mutual recognition would involve Australian shareholders being eligible to receive a credit (against their Australian taxable income) for New Zealand company income tax paid. A similar arrangement would apply for New Zealand shareholders.

Mutual recognition might improve the allocation of investments between the two countries.<sup>95</sup> However, it would likely impose higher revenue costs on Australia than on New Zealand and result in an overall cost to Australian GDP,<sup>96</sup> due to the higher levels of investment by Australian companies in New Zealand. Mutual recognition would also create additional complexity and increase administration and compliance costs.

### Discussion questions:

25. Is the dividend imputation system continuing to serve Australia well as our economy becomes increasingly open? Could the taxation of dividends be improved?
26. To what extent would Australia benefit from the mutual recognition of imputation credits between Australia and New Zealand?

93 The exception to this is countries where the dividend is taxed and the domestic rate is higher than Australia's (which is the case for non-portfolio investors from the United States).

94 Productivity Commissions of Australia and New Zealand 2012, *Strengthening Economic Relations between Australia and New Zealand: Supplementary Paper F: Mutual Recognition of Imputation Credits*, pages 133-141 viewed 16 October 2014: [www.pc.gov.au/\\_\\_data/assets/pdf\\_file/0020/136802/15-trans-tasman-supplementaryf.pdf](http://www.pc.gov.au/__data/assets/pdf_file/0020/136802/15-trans-tasman-supplementaryf.pdf); Australian Government 2010, *Australia's Future Tax System Review (Henry Tax Review)*, Australian Government, Canberra; New Zealand institute of Economics Research and the Centre for International Economics 2012, *The costs and benefits of mutual recognition of imputation and franking credits*.

95 Productivity Commissions of Australia and New Zealand 2012, *Strengthening Economic Relations between Australia and New Zealand: Supplementary Paper F: Mutual Recognition of Imputation Credits*, viewed 16 October 2014: [www.pc.gov.au/\\_\\_data/assets/pdf\\_file/0020/136802/15-trans-tasman-supplementaryf.pdf](http://www.pc.gov.au/__data/assets/pdf_file/0020/136802/15-trans-tasman-supplementaryf.pdf)

96 Productivity Commissions of Australia and New Zealand 2012, *Strengthening Economic Relations between Australia and New Zealand: Supplementary Paper F: Mutual Recognition of Imputation Credits*, viewed 16 October 2014: [www.pc.gov.au/\\_\\_data/assets/pdf\\_file/0020/136802/15-trans-tasman-supplementaryf.pdf](http://www.pc.gov.au/__data/assets/pdf_file/0020/136802/15-trans-tasman-supplementaryf.pdf), page 20.

## Depreciation of capital assets

Effective life depreciation, introduced as part of the 1999 Review of Business Taxation (Ralph Review) reforms, aimed to align tax depreciation more closely with economic depreciation. More recently, the diminishing value<sup>97</sup> rate for depreciation deductions was increased from 150 per cent to 200 per cent, to better reflect the pattern of economic depreciation for most assets. This was intended to address concerns that the depreciation system could distort investment decisions by taxing some assets more heavily than others.

The life of some assets for tax purposes is deemed to be lower than their true economic life, including assets involved in transport, oil and gas production and distribution and primary production. This is referred to as a 'statutory cap' and it reduces the effective rate of tax on those assets as depreciation deductions can be claimed earlier.

In addition, the requirements for tax and accounting depreciation differ. For example, different depreciation methods and periods may need to be used. As a result, most taxpayers need to keep separate records of their depreciating assets for tax and accounting purposes and this can increase compliance costs.

### Discussion questions:

27. To what extent does the tax treatment of capital assets affect the level or composition of investment? Would alternative approaches be preferable and, if so, why?
28. How complex is the tax treatment of capital assets and are the costs of compliance significant?

## Losses

The tax treatment of losses was explored extensively by the Business Tax Working Group in 2012.

Most governments, including Australia's, do not pay the value of losses for income tax purposes to taxpayers on an accruals basis. Rather, the Government in certain circumstances allows tax losses to be carried forward and deducted against assessable income in future years. The real value of tax losses that are carried forward decreases over time, as they are not indexed. The longer a loss is carried forward, the greater the reduction in its real value. However, losses generated by one member of a tax consolidated group can generally be used against profits earned by other members of the same group.

A neutral tax system would have a similar impact on projects that incur expenses up-front and income later, and projects that incur expenses and income at the same time. It would also treat low-risk and high-risk economic activity neutrally. Perfect alignment would involve making losses refundable at the same rate and at the same time that profits are taxed. This

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97 The diminishing value method of depreciation provides most of the depreciation deductions in the earlier years of an asset's life.

would reduce the complexity of the tax system and improve its ability to stabilise the economy during a downturn. However, refundability would reduce the amount and increase the volatility of tax revenue and may encourage tax avoidance.

Losses carried forward are subject to integrity rules that restrict the use of those losses where there is a substantial change in company ownership (the continuity of ownership test) and the type of activity undertaken by the business (the same business test). These rules seek to prevent 'loss trading', whereby a company that is stripped of all of its assets, except its tax losses, is sold to another company. The rules also prevent inter-entity 'loss multiplication' that occurs where a group of companies benefit from a single economic loss more than once, by artificially duplicating the loss through a chain of interposed entities.

These rules can lead to losses being 'trapped' or never able to be used. This may disadvantage small businesses and businesses that undertake higher-risk investments. Aspects of these integrity rules may also hinder the legitimate restructuring of some businesses. For example, the current rules do not determine whether a change to a company's ownership was motivated by a tax avoidance purpose rather than commercial considerations. The same business test may be difficult to determine in advance and may too narrowly prescribe the range of activities that a company can engage in without risking forfeiture of its losses.

These concerns with the tax treatment of losses may be less relevant today because of the tax consolidation regime and the dividend imputation system. The Business Tax Working Group recommended a review of loss integrity rules (particularly the same business test) to ensure the right balance between supporting appropriate risk taking and innovation, and maintaining appropriate integrity.

### Discussion questions:

29. To what extent does the tax treatment of losses discourage risk-taking and innovation and hinder businesses restructuring? Would alternative approaches be preferable and, if so, why?

## Intangible assets

Changes in the economy, including globalisation and digitisation, have elevated the importance of intangible assets. Investment in intangibles has been growing at around 1.3 times the rate of tangibles since 1974-75.<sup>98</sup>

Investment in creating goodwill and other intangibles is taxed more concessionally than investment in most tangible assets, such as plant and equipment. Expenditures incurred to create 'new' goodwill or intangible assets, such as marketing expenses incurred to develop a brand, are immediately deductible for tax purposes, while the economic benefits persist over

98 Productivity Commission Staff Working Paper 2009, *Investments in Intangible Assets and Australia's Productivity Growth*, Productivity Commission, Canberra.

time. Conversely, acquired goodwill and other intangibles cannot be depreciated for tax purposes. Gains or losses on these acquired intangible assets are taxed only when the asset is sold.

These taxation arrangements may distort investment in these assets in Australia by encouraging intangible assets to be developed in-house but discouraging the subsequent sale of those assets to other parties. Furthermore, intangible assets are very difficult to value because many intangibles are unique, proprietary and rarely traded. This can create significant challenges for tax administrators who seek to ensure that intangible assets are valued appropriately, particularly when they are transferred between international related parties.

### Discussion questions:

30. How could the current tax treatment of intangible assets be improved?

## Inbound investments

There is a range of different tax treatments of inbound investment depending on the precise nature of income derived. One driver of these differences is the distinction between active and passive investment, which is an inherent feature of the international tax framework. This distinction is intended to share taxing rights between jurisdictions and avoid double taxation on international investment, while balancing the competing policy objectives of capital export and capital import neutrality.

Capital export neutrality aims for neutrality in international investment decisions and is achieved where an investor from a particular country faces the same effective tax rate on an investment regardless of the country of investment. Capital import neutrality is achieved when an investment has the same effective tax rate (and therefore after-tax return) for both domestic and foreign investors. Generally, it is not possible to achieve capital import neutrality and export neutrality at the same time as it is unrealistic for every jurisdiction to have the same tax base and the same rate.<sup>99</sup>

Active income is typically taxed in the source country (that is, where the business activity takes place), whereas passive income is primarily taxed in the investor's country of residence (with a lower amount of tax payable in the source country, for example, through withholding taxes). A possible rationale for this is that passive investment is more mobile and therefore a closer alignment with the benchmark of capital export neutrality is appropriate. Bilateral tax treaties add further complexity to this allocation of taxing rights by imposing different rates of tax on different types of income between countries.

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<sup>99</sup> Australian Treasury 2013, *Base Erosion and Profit Shifting scoping paper*, Australian Treasury, Canberra, pages 5-6.

The distinction between active and passive investments also forms the basis of targeted concessions designed to increase Australia's international tax competitiveness (for example, the reduced withholding rate on certain passive income derived by non-resident investors through a managed investment trust). The distinction also seeks to protect Australia's corporate tax base and to ensure that Australian active businesses are not at a competitive disadvantage.

A contemporary policy issue in this area relates to the international expansion of Australia's financial services sector. A 2009 report by the Australian Financial Centre Forum found that while Australia's managed funds sector is highly sophisticated, the export of financial services is low by international standards.<sup>100</sup> The removal of tax obstacles and greater clarity on the tax treatment of foreign investors could strengthen Australia's international competitiveness in this area.

The Government considers that there is a case for extending the range of collective investment vehicles that can be offered by Australian funds managers. This is an issue that has been raised in the context of the report by the Australian Financial Centre Forum,<sup>101</sup> the final report of the financial system inquiry<sup>102</sup> and by the Board of Taxation. A broader range of collective investment vehicles will assist the export of financial services, by allowing Australian funds managers to offer products that are familiar to overseas investors. While a lot of work has already been done in this area, there are still a number of difficult taxation and regulatory issues that need to be worked through. The Treasury will consult with industry stakeholders in coming months with a view to developing proposals for inclusion in the Options Paper.

The different tax treatment of various forms of income (see Table 5.2 below) could result in an inefficient allocation of investment because similar economic activities can be subject to very different tax outcomes. This may affect the activities that non-residents choose to invest in and the vehicles that they use to invest through. It may also create difficulties for tax administrations and add complexity to the tax system.

These issues raise questions about the extent to which it is desirable to provide more attractive tax settings for investments perceived as being more likely to be internationally mobile.

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100 Australian Financial Centre Forum 2009, *Australia as a Financial Centre: building our strengths (Johnson Report)*, Australian Financial Centre Forum, Canberra, page 7.

101 Australian Financial Centre Forum 2009, *Australia as a Financial Centre: building our strengths (Johnson Report)*, Australian Financial Centre Forum, Canberra.

102 Australian Government 2014, *Financial System Inquiry: Final Report (Murray Inquiry)*, Australian Government, Canberra.

**Table 5.2 Summary of tax rates applying to the Australian-source income of foreign residents**

Type of income	Foreign resident
Business income from corporate tax entities <sup>103</sup>	Assessable at 30 per cent of taxable income
Dividends	<p>Franked dividends: 30 per cent (effectively) as they have been subject to Australian company tax</p> <p>Unfranked dividends:</p> <ul style="list-style-type: none"> <li>• No treaty — 30 per cent; or</li> <li>• Treaty — generally 15 per cent but can vary between 0 and 25 per cent</li> </ul>
Royalties	<p>30 per cent for non-treaty countries</p> <p>For treaty countries, generally 5 to 15 per cent, but in some cases up to 25 per cent</p>
Interest income	<p>10 per cent; or 0 to 10 per cent depending on treaty rates</p> <p>Exempt if debt satisfies the public offer test</p>
Capital gain from land or land rich assets, or permanent establishment (PE) business assets	30 per cent <sup>104</sup>
Other capital gains	Exempt
Rental income received through a managed investment trust (MIT)	15 per cent (or 10 per cent for newly constructed energy efficient commercial buildings, known as clean MITs)
Gains from disposal received through a MIT	15 per cent or 10 per cent (if a clean MIT)
Foreign source income received through a MIT	Exempt
Gains from disposal received through a foreign fund under the Investment Manager Regime (IMR) <sup>105</sup>	Exempt

### Discussion questions:

31. To what extent should the tax system be designed to attract particular forms of inbound investment (for example, by distinguishing between active and passive or portfolio and non-portfolio)? If so, what principles should inform this?

103 Business income of foreign residents derived from corporate tax entities. MITs can only invest in passive activities.

104 A 30 per cent rate applies to entities; the rate is at least 32.5 per cent for non-resident individuals.

105 In respect of IMR income only.

## Outbound investments

As noted above, imputation may act to discourage Australian taxpayers from investing in foreign companies. The taxation of foreign income may further distort decisions.

Australian resident companies are taxed on their worldwide income. Foreign income may be taxed in both Australia and the country from which it is received. To avoid double taxation, some foreign income is exempt from tax in Australia. The treatment of different types of income is outlined in Table 5.3. Where foreign income is subject to tax in Australia, foreign tax credits may be available for foreign tax paid.

Another avenue used by tax authorities to avoid double taxation is tax treaties. Australia has tax treaties with over 40 countries. These treaties set out which country has the right to tax various forms of income as well as allowing the exchange of information between the parties to the treaty. Tax treaties limit the tax rate that one country can impose on some forms of income (particularly dividends, interest and royalties) derived by residents of the other country. The actual treaty rate limit is determined by bilateral negotiation, having regard to the domestic laws and tax treaty policies of the two countries. Consequently, the operation of the tax treaties could result in the same form of investment being taxed differently depending on where it is located.

**Table 5.3 Summary of tax treatment of foreign income earned by Australian resident companies**

Type of income	Tax treatment
Passive income including interest, royalties, rent and portfolio dividends (interest of less than 10%)	Assessable
Non-portfolio dividends (interests of more than 10%)	Exempt (subject to certain conditions)
Attributed income from foreign entities	Assessable
Dividends paid from previously attributed income	Exempt (subject to certain conditions)
Foreign branch profits	Exempt (subject to certain conditions)
Foreign income from the sale of goods and services that is not branch profits	Assessable
Most capital gains	Assessable
Foreign branch gains of an Australian company	Exempt (subject to certain conditions)
Capital gains on the sale of shares in foreign companies with underlying active assets	Exempt (subject to certain conditions)

### Discussion questions:

32. To what extent does the tax treatment of foreign income distort investment decisions?
33. To what extent should the tax system be designed to encourage particular forms of outbound investment (for example, by distinguishing between active and passive or portfolio and non-portfolio)? If so, what principles should inform this?

## Transfer pricing

Differences in corporate tax rates around the world provide incentives for companies with operations in several countries to shift their profits into low tax jurisdictions. One way of achieving this is by manipulating the prices that multinational companies pay to offshore related parties for goods and services. For example, a foreign entity charging a high price to an Australian entity means less profit will be earned in Australia and more in the foreign company where the tax rate may be lower.

Australia's transfer pricing rules counter the underpayment of Australian tax by requiring entities to price their international related party transactions at a price that independent parties dealing at arm's length would consider reasonable.

Australia has recently strengthened its transfer pricing rules to counter corporate tax evasion and to bring them into closer alignment with international best practice, as represented by the *OECD Transfer Pricing Guidelines*. The new rules also encourage taxpayers to keep detailed records of their international related party transactions to avoid higher penalties in cases of non-compliance.

The OECD is currently reviewing its guidelines as part of its two year Action Plan to counter Base Erosion and Profit Shifting (BEPS). The new guidelines are expected to be finalised at the end of 2015.

### Discussion question:

34. How can tax avoidance practices such as transfer pricing be addressed without imposing an excessive regulatory burden and discouraging investment?

## Business financing arrangements (debt/equity)

Firms can raise capital to finance investment by issuing equity or debt, or by using retained earnings.<sup>106</sup> Similar to most foreign jurisdictions, under Australia's tax system, interest payments are tax deductible while returns on equity are not. This means that the primary location of the tax liability for foreign debt investors is overseas, while foreign equity investors are primarily taxed in Australia. Australia's relatively high corporate tax rate contributes to the bias for foreign investment to occur through debt funding.

The economic costs of a tax-induced bias toward debt finance could potentially be significant. The allocation of taxing rights means that a bias towards debt can have the effect of eroding Australia's corporate tax base, particularly in the international context where interest deductions are being claimed in Australia while interest income is being taxed overseas. Thin capitalisation rules seek to limit the extent of the potential erosion. In addition,

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<sup>106</sup> In practice, the distinction between debt and equity can be blurred for hybrid instruments that combine debt and equity features, such as non-cumulative preference capital.

overreliance on debt makes companies more vulnerable to insolvency and to economic shocks, which may impact on macroeconomic stability.<sup>107</sup>

Financing decisions may also be distorted by other tax treatments in the system. For example, investments financed by retained earnings can be favoured over new equity due to the concessional treatment of capital gains. The tax system may therefore provide a tax advantage to more mature firms and discourage the entry of new firms (which rarely make profits in early years). In addition, providing a deduction for debt and not equity introduces biases against small businesses and knowledge-based industries, which often face difficulties in accessing debt finance.

The imputation system partially offsets the debt bias in Australia by creating an incentive for domestic investors to fund local companies through equity.

Interest withholding tax may also help reduce the tax bias, in respect of international capital, in favour of debt over equity. On the other hand, interest withholding tax can increase the cost of funding from overseas, which may lead to lower investment in Australia. The impact of interest withholding tax is discussed in more detail in the final report of the Financial System Inquiry.<sup>108</sup>

Different tax treatment of these financing arrangements leads to complexities in the tax system and creates incentives for tax planning. This has been compounded over recent decades with the increased innovation in complex financial products that exhibit features of both debt and equity. Because of this innovation, the traditional distinction between debt and equity has become even less clear, and its interaction with other regulatory requirements, such as prudential requirements and accounting standards, has further complicated firms' financing decisions.

Increased globalisation has also expanded opportunities for tax arbitrage, particularly where countries have different views as to whether a particular instrument qualifies as debt or equity.<sup>109</sup> These inconsistencies between countries are a focus of the BEPS project that the OECD is currently undertaking.

The Board of Taxation is currently undertaking a Post-Implementation Review of the Debt-Equity regime, which is due to report in March 2015.<sup>110</sup>

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107 International Monetary Fund (IMF) staff discussion note 2011, *Tax Biases to Debt Finance, Assessing the problem, Finding Solutions*, IMF, Washington, p. 4.

108 Australian Government 2014, *Financial System Inquiry: Final Report (Murray Inquiry)*, Australian Government, Canberra.

109 By way of example, unlike Australia's substance approach to characterise debt and equity, New Zealand, the UK and Canada follow a legal form approach.

110 Board of Taxation 2014, *Post-Implementation Review of the Debt-Equity rules: discussion paper*, Australian Government, Canberra, viewed 8 December 2014:  
[www.taxboard.gov.au/content/content.aspx?doc=reviews\\_and\\_consultations/debt\\_and\\_equity/default.htm&pageid=007](http://www.taxboard.gov.au/content/content.aspx?doc=reviews_and_consultations/debt_and_equity/default.htm&pageid=007).

## Discussion questions:

35. Should the tax system provide a more neutral treatment of different financing arrangements (debt, equity and retained earnings), and if so, how? What principles should inform the approaches?

## Revenue/capital distinction

The distinction between revenue and capital in the income tax law arises from a distinction in trust law between income beneficiaries and capital beneficiaries. Under Australia's business taxation system, taxpayers may generate income that is classified as revenue (held on revenue account) or capital (held on capital account). Income generated from realising a capital gain is potentially given concessional tax treatment for non-resident investors.

Expenses incurred in carrying on a business will generally qualify for an immediate deduction. However, an expense that is of a capital nature will not be immediately deductible but will be recognised at a later point in time. For example, the cost of acquiring a depreciating asset will generally be recognised over the effective life of the asset. The cost of acquiring some other assets, such as shares, will generally be recognised at the time the asset is sold.

The distinction between revenue and capital is often unclear, even in simple business transactions.<sup>111</sup> In more complex cases, the characterisation of revenue and capital income for tax purposes depends on fine distinctions in the circumstances of a transaction and the taxpayer's investment activities. The resulting reliance on case law and ATO determinations can create uncertainty and complexity, and may encourage taxpayers to adopt complicated tax structures in order to receive concessional treatment.

In the large business context, the boundary between capital income and revenue income is particularly significant for non-resident investors. Non-resident investors are taxed on revenue income from all Australian sources, while they are taxed on capital income only if it arises from a narrow list of Australian sources (for example, real property).

Australian resident companies cannot access the capital gains tax (CGT) discount, which means that capital income is taxed at the corporate level in much the same way as revenue income (other than the quarantining of capital losses against capital gains).

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<sup>111</sup> For example, expenditure on salary or wages to construct and upgrade depreciating assets has been found to be capital expenditure and is not deductible. See ATO ID 2011/42.

**Discussion questions:**

36. Should the tax system provide a more neutral treatment of income earned on revenue account and capital account? Does the distinction create significant compliance costs for business and, if so, how could it be simplified?

**Tax consolidation and Taxation of Financial Arrangements (TOFA)**

Australia has developed complex rules for the taxation of consolidated groups and for the taxation of certain financial arrangements. These regimes were designed, in part, to reduce compliance costs for businesses by better aligning the tax system with how large businesses operate in practice (that is, as groups of companies). The regimes also aimed to ensure that tax outcomes reflect the commercial substance of the financial arrangements that they undertake. However, the consolidation and TOFA rules are contained within a very large and complex set of legislation, rulings and ATO guidance material which create their own uncertainties and complexities.

The simplification of these regimes requires detailed consideration. This is being undertaken through separate review processes which the Government has already announced,<sup>112</sup> rather than through the Tax White Paper process. These reviews are a high priority for the Government, reflecting its election commitment to reduce unnecessary or inefficient regulation imposed on individuals, business and community organisations.

The Treasury has started the TOFA review process and is consulting with major industry groups and representatives about possible reform directions in this area, following advice from the Board of Taxation on the scope of the review. The Consolidation review will commence in the second half of 2015 and will focus on implementing key recommendations made by the Board of Taxation in its recent reviews of the consolidation regime.

**Discussion question:**

37. Are there other important issues in the business tax system, not covered in this section, which should be considered as part of the Tax White Paper process?

112 Assistant Treasurer Senator the Hon Arthur Sinodinos AO, Media Release, 14 December 2013, *Integrity restored to Australia's taxation system*, viewed 8 December 2014: <http://axs.ministers.treasury.gov.au/media-release/008-2013/>.

## Specialised industries

Due to the specialised or unique nature of certain businesses, special tax provisions may apply.

Agriculture or 'primary producers', due to the variability of their earnings, are able to use tax averaging to ensure they do not pay more tax over a number of years than taxpayers on comparable but steady incomes. There are also rules that apply to calculate the value of livestock. Specific provisions for small businesses are considered in Chapter 6.

Life insurance companies are also subject to special rules to take into account the different characteristics of their underlying business. For example, special rules ensure that, while taxable income relating to ordinary business is taxed at the corporate tax rate (currently 30 per cent), taxable income relating to superannuation business is taxed at the superannuation fund rate (currently 15 per cent) and income relating to annuity business is exempt from tax.

### Discussion questions:

38. In what circumstances is it appropriate for certain types of businesses to be subject to special provisions? How can special treatment be balanced with the goal of a fair and simple tax system?

## Tax and accounting definitions of income

Taxpayers in Australia must calculate their profit for tax purposes using rules that are, in some cases, significantly different from those that apply to the calculation of profit for accounting purposes. For more than a decade, policy consideration has been given to greater alignment of the calculation of 'profit' between tax and accounting systems. For example, the Ralph Review recommended the adoption of the Tax Value Method, which is a principle-based framework that works out the taxable income (or tax loss) of a taxpayer with a focus on the changing value of assets and liabilities. This approach is consistent with current accounting concepts.

The convergence of accounting and tax calculations of profit would potentially reduce complexity and compliance costs. This is because businesses may not need to maintain separate records of financial information for accounting and tax purposes.

One challenge that would require consideration is the inherent conservatism and use of judgement in accounting, with a requirement to recognise losses and outgoings as soon as possible, but to recognise gains only when they are nearly certain.

A shift to greater reliance on accounting standards may further encourage companies to under-report their earnings to gain a tax advantage, which may have broader implications for corporate governance. However, there is a 'natural hedge' against this behaviour in that the management of large widely-held companies is often keen to demonstrate strong financial

performance to shareholders. It is also arguable that many of the incentives to under-report income already exist in our current tax laws.

Some European countries (such as France, Germany and Sweden) have closer links between accounting and tax principles than Australia. However, there has been a shift towards more independence between accounting and taxation as the adoption of international accounting standards has reduced the ability of countries to tailor their accounting standards to accommodate their domestic tax systems.<sup>113</sup>

The tax system is also used by governments as a delivery mechanism for some policy objectives (for example, R&D tax incentives). If these objectives continue to be delivered through the tax system, calculations based on accounting standards would require adjustment, which may reduce the benefits of closer alignment with accounting standards. Alternatively, some other delivery mechanisms for these policies could be considered.

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## 5.3: Entrepreneurship and innovation

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Innovation is commonly defined as the implementation of a new or significantly improved product, service or work method.<sup>114</sup> The economic benefits of innovation are well recognised, including productivity enhancements, job creation<sup>115</sup> and ultimately, improvements in living standards. The benefits from innovation are not constrained to one firm. Performance improvements in one firm following successful innovation impose competitive pressures that force other firms to improve their own performance. Innovative firms introducing new-to-the-world products or processes bring further benefits through the dissemination of new knowledge, technologies and processes that may spread throughout the economy.

Encouraging more business innovation is one of the four ambitions of the Government's Industry Innovation and Competitiveness Agenda. The Agenda includes grant programs to assist businesses to collaborate with researchers, build their management skills and undertake early stage commercialisation activities.

While these programs involve spending, a number of elements of the tax system seek to encourage entrepreneurship and innovating businesses. The R&D tax incentive is a particular element of the tax system that supports innovation in the Australian economy.

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113 Hoogendoorn, M N 1996, 'Accounting and taxation in Europe — A comparative overview' *The European Accounting Review*, vol. 5, supplement 1, page 786, viewed 10 December 2014: [www.tandfonline.com/doi/abs/10.1080/09638189600000050](http://www.tandfonline.com/doi/abs/10.1080/09638189600000050).

114 OECD 2005, *Guidelines for Collecting and Interpreting Innovation Data*, Third edition, (Oslo Manual) OECD and European Commission, Paris.

115 Canberra data suggest that firms engaged in innovative activities are more than twice as likely to report increases in the total number of positions compared to the previous year, as shown in Australian Bureau of Statistics (ABS) 2014, *Innovation in Australian Business 2012-13*, cat. no. 8158.0, ABS, Canberra.

## Research and development

R&D is often a critical step in innovation. The incentives for businesses to invest in R&D and exploit or commercialise their innovations can be affected by commercial risks such as public spillovers from R&D. They can also be distorted by the tax system; for example through the treatment of losses (losses are inherent in risky activity such as R&D).

Knowledge or technology produced by R&D activities can have spillover benefits that freely accrue to other businesses or to the public generally. The existence of these spillovers may reduce the incentives for businesses to bear the private costs of R&D. Non-tax policies relating to intellectual property seek to balance private and public interest in the creation and dissemination of knowledge.

Distortions introduced by the tax system exacerbate the impact of commercial risks on investment in R&D. Expenditure on R&D activities can contribute to a business' tax losses which can only be claimed once the business is making a profit. This may affect the incentives of businesses to pay the upfront costs of R&D, particularly where there is a lengthy time-lag in the benefits of R&D being realised. While profits are subject to corporate tax at the time that the profits are realised, tax losses must be carried forward and therefore lose value over time. Large businesses may be able to utilise their tax losses sooner, as they may already be profitable.

The existence of these commercial risks and tax distortions means that the amount of R&D that a business chooses to undertake may be less than optimal in the absence of corrective Government intervention. Policy intervention through the tax system is often used to address these perceived distortions, encourage R&D activities that would not otherwise occur and generate positive spillover benefits for the public.

### R&D tax incentive

The R&D tax incentive is the primary mechanism by which the Government seeks to encourage companies to undertake R&D activities in Australia. The R&D tax incentive is intended to encourage R&D activity that would not otherwise occur, and to improve the incentives for smaller companies to engage in R&D. It may also attract new investment in R&D activities, including from foreign investors.

The R&D tax incentive currently provides:

- a 45 per cent refundable tax offset for eligible entities with an annual aggregated turnover of less than \$20 million, and which are not controlled by income-tax exempt entities, for expenditure on eligible R&D activities in Australia; and
- a 40 per cent non-refundable tax offset for all other eligible entities for eligible R&D expenditure.

In the 2014-15 Budget, the Government announced that the refundable and non-refundable tax offset rates would be reduced by 1.5 percentage points, from 45 per cent to 43.5 per cent and from 40 per cent to 38.5 per cent, respectively. The proposed changes would take effect for income years commencing on or after 1 July 2014.

On 12 February 2015, the Parliament enacted the *Tax Laws Amendment (Research and Development) Act 2015*, which introduces a limit of \$100 million on the amount of R&D expenditure that companies can claim at the standard offset rate. For amounts above \$100 million, companies will be able to claim a tax offset at the company tax rate. The changes take effect for income years beginning on or after 1 July 2014.

Many countries, including the majority of OECD countries, provide incentives for R&D through their tax systems, in addition to grants and other forms of direct assistance. However, the nature and degree of tax support for R&D varies significantly by country. Tax support for R&D activities can take the form of volume-based or incremental tax credits (generally equivalent to an offset in Australia), enhanced tax deductions and accelerated depreciation for R&D capital expenditure.

As reported by the OECD,<sup>116</sup> volume-based R&D tax credits (offered by countries including Australia, Japan, Korea and Norway) can be claimed for all eligible or qualifying R&D expenditure, while incremental R&D tax credits (offered by countries including Japan and Korea) can only be claimed for any additional R&D expenditure beyond a certain baseline amount. Some countries allow R&D tax credits to be carried forward or refunded, while other countries impose caps on the amount of R&D expenditure that can be claimed under the tax incentive.

## Review of the R&D tax incentive

The Government intends to review the operation of the R&D tax incentive through the Tax White Paper, within the broader context of reviewing the effectiveness of existing tax incentives for innovation, industry-funded research and collaboration with public research institutions.<sup>117</sup>

The R&D tax incentive was introduced in 2011 to replace the former R&D tax concession. The R&D tax incentive is a simpler and more generous programme, offering eligible companies a refundable or non-refundable tax offset for expenditure on R&D activities.

Given the R&D tax incentive is the primary policy mechanism by which the Government encourages innovation, it is appropriate that the Government periodically review the operation of the incentive, evaluate its effectiveness and assess the extent to which it is meeting the intended policy objectives.

As the R&D tax incentive has now been in operation for more than three years, stakeholders are expected to be well-placed to provide informed perspectives on the R&D tax incentive, in relation to its policy design, administration and effectiveness.

The R&D tax incentive does not target particular sectors of the economy. Instead, it is a market-based programme which is open to companies in all sectors of the economy. Some of the many sectors that benefit from the R&D tax incentive include information technology,

<sup>116</sup> OECD 2014, *Summary description of research and development tax incentive schemes for OECD countries and selected economies*, 2013, OECD, Paris.

<sup>117</sup> Department of Education and Department of Industry 2014, *Boosting the Commercial Returns from Research*, Australian Government, Canberra.

communications, biotechnology, energy and food processing. Companies, however, are generally required to have R&D expenditure of at least \$20,000 to be eligible for the R&D tax incentive, which reflects the fact that a certain amount of investment in R&D is necessary to generate significant innovation outcomes.

The R&D tax incentive aims to support specifically-defined R&D activities that are conducted for the purpose of acquiring new knowledge (including knowledge or information concerning the creation of new or improved materials, products, devices, processes or services).

The R&D tax incentive is claimed by an increasing number of companies each year. As at 30 June 2014, 11,936 companies had registered to claim the R&D tax incentive for the 2012-13 income period. As at 29 August 2014, the R&D tax incentive had a reported cost to the Budget of around \$2.5 billion for the 2012-13 income period.<sup>118</sup>

### Discussion questions:

39. Does the R&D tax incentive encourage companies to conduct R&D activities that would otherwise not be conducted in the absence of government support? Would alternative approaches better achieve this objective and, if so, how?

## Employee Share Schemes

Employee share schemes allow employers to provide shares (an ownership stake in the company) or options (the right to acquire shares in the company at a later date) to their employees at a discount to the market price.

This helps to align the interests of employers and their employees, and can be beneficial for both parties. Employees can realise a benefit if the firm performs well, as they have a financial share in the potential upside of the company. For employers, employee share schemes are often an attractive way of remunerating employees, particularly in the early stages of development where cash flow may not always be available. Employee share schemes can have many benefits, including encouraging positive working relationships, boosting productivity and reducing staff turnover, as employees have a direct interest in the performance of the firm.

Changes in 2009 to the way that employee share schemes are taxed mean that the discount component of shares or options issued under an employee share scheme is currently taxed when the employee receives those shares or options. This often means that employees have to pay tax on their options before they can take any action to realise a financial benefit from those options (for example, by converting them to shares and selling the underlying shares).

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118 Department of Industry 2014, *2014-15 Science, Research and Innovation Budget Tables*, Australian Government, Canberra, viewed 10 December 2014: [www.industry.gov.au/innovation/reportsandstudies/Pages/SRIBudget](http://www.industry.gov.au/innovation/reportsandstudies/Pages/SRIBudget); and Department of Industry 2014, *Information Bulletin July 2014*, Australian Government, Canberra, viewed 10 December 2014: [www.industry.gov.au/innovation/reportsandstudies/Pages/SRIBudget](http://www.industry.gov.au/innovation/reportsandstudies/Pages/SRIBudget).

Consultations with a range of industry and government stakeholders suggested that firms, particularly small start-up firms, have been reluctant to issue options under employee share schemes since 2009, as employees would be taxed on something that is difficult to value and that may never result in any financial benefit. Businesses have claimed that this reduces the number of people they can employ and sometimes drives firms offshore, where more favourable tax conditions exist.

Consultations also revealed that it can be very difficult to set up and maintain an employee share scheme, imposing unnecessary red tape on businesses, especially small businesses.

In response to these concerns, as part of the Industry Innovation and Competitiveness Agenda, the Government announced that it will reform the tax treatment of employee share schemes. These changes are designed to boost entrepreneurship in Australia and support innovative start-up companies.<sup>119</sup>

The Government will change the taxing point for options, so that employees (of all companies) will generally not be taxed on their options until they have converted them into shares.

Employees of eligible start-ups will be given an additional concession, which will mean that tax will not generally be payable up-front on shares or options that are provided by eligible employers to their employees at a small discount, as long as they are held by the employee for at least three years. Options, under certain conditions, will have taxation deferred until sale. Shares (issued at a small discount) will have that discount exempt from tax.

Criteria to define eligibility for this concessional tax treatment will include the company having aggregate turnover of not more than \$50 million per year, it being unlisted and being incorporated for less than 10 years. Furthermore, to give start-ups more time to be competitive and succeed, the maximum time for tax deferral will be extended from seven to 15 years.

The announced changes are designed to make Australia's taxation of employee share schemes more competitive by international standards. These changes will seek to make Australia a more attractive investment destination, particularly for innovative start-up firms, by making employee share schemes easier to access and administer for employers and their workers. These changes will bring Australia's taxing point into line with other nations such as the UK, USA, Singapore, India, China and Hong Kong.

In addition, the ATO will work with industry to develop standardised documentation and a 'safe harbour' valuation method for unlisted shares, which will streamline the process of establishing and maintaining an employee share scheme.

The Government has been consulting on the implementation of these changes to bring them into effect for new shares and options issued from 1 July 2015.

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<sup>119</sup> Minister for Industry the Hon Ian Macfarlane MP, Media Release, 14 October 2014, *Encouraging employee share ownership and entrepreneurship*, viewed 10 December 2014: <http://minister.industry.gov.au/node/497>.

**Discussion questions:**

40. What other taxation incentives, including changes to existing measures, are appropriate to encourage investment in innovation and entrepreneurship?