Grant Thornton
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Dear Sir/Madam

BUSINESS TAX WORKING GROUP DISCUSSION PAPER

Grant Thornton Australia Limited (Grant Thornton) appreciates the opportunity to provide comments to the Business Tax Working Group (the Working Group) on the discussion paper "Business Tax Working Group Discussion Paper" dated 13 August 2012.

Grant Thornton's response reflects our position as leading advisors to listed companies and privately held companies and businesses as well as to smaller firms assisting the corporate sector.

Our submission outlines Grant Thornton's view on the various options tabled by the Working Group on how a reduction in the corporate tax rate could be funded with responses to certain specific questions detailed in the Discussion Paper.

Should you have any queries in relation to these matters, please contact me on 02 9286 5491 or vince.tropiano@au.gt.com

Yours faithfully
GRANT THORNTON AUSTRALIA LIMITED

Vince Tropiano
Partner - Tax

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A reduction in the corporate tax rate should be a positive step for Australian taxpayers

We agree that in principle, a reduction in the corporate tax rate as set out in the discussion paper could support growth in the Australian economy, both in terms of increasing Australia's attraction of foreign investment and increasing domestic productivity.

However, we are concerned that seeking to implement a reduction in the corporate tax rate from a revenue neutral perspective may result in arbitrary outcomes for different taxpayers and further complicate the tax system. It is our view that by limiting the scope to a revenue neutral approach, businesses both domestic and international investing in Australia, will not receive the wide-reaching benefits possible if a company tax rate reduction was coupled with a reduced tax burden. Further, we note that the terms of reference for the Working Group specifically exclude considering GST. We believe that any base broadening proposals should include consideration of the wider tax regime including indirect taxes suffered by both domestic and international businesses investing in Australia. We would also urge the Government and Treasury to introduce a programme working with the business community to reduce the 'red tape' associated with the significant and multi-faceted compliance burden faced by those doing business in Australia - in the World Bank's Doing Business 2012, Australia ranked 59th in their measure of the financial and administrative burden of taxes and 15th in their 'Ease of Doing Business' rankings.

We believe that when assessing how to fund a reduced company tax rate particular attention must be had to ensure the options pursued have a positive impact on the wider community, encouraging investment in Australia. The benefits of a company tax rate reduction would risk being lost if the withdrawal of related concessions results in a larger detrimental effect. Further, potential complication of the tax system and resulting compliance costs must be taken into account when assessing how to fund a company tax rate reduction. The following recognised principles should be considered when assessing the most appropriate options for a company tax reduction in Australia:

1 **Simplicity** - The taxation system should be such that taxpayers can understand the rules simply and can comply with them without undue complexity. Any changes introduced cannot simply adopt a short-sighted tax cut focus if it will make the life of taxpayers more onerous in terms of understanding, applying and administrating the tax system.

2 **Economic Growth and Efficiency** - The taxation system should not impede or reduce the performance of the economy. Key macro-economic goals such as the rate of economic growth, capital mobility, capital formation and international competitiveness should not be undermined by the taxation system.

3 **Neutrality** - The impact of taxation on a taxpayer's decision to undertake different forms of economic activity should be kept to a minimum. We believe that certain options tabled by the Working Group which we will discuss further, will have an impact on the neutrality of the tax system.

4 **Flexibility** - The taxation system should be sufficiently flexible and dynamic to keep pace with technological and commercial developments taking place across the economy.

We are also concerned that there may be a number of taxpayers affected by a reduction in tax concessions who will not be in a position to benefit from a company tax rate reduction. Many small businesses operating in Australia do not operate under a company structure. Given Australia's current patchwork economy, many of these businesses will require further Government assistance over the coming years. These businesses will not directly receive any benefit from a company tax rate reduction, and further, they may be adversely affected by the cut in tax concessions in order to fund the rate reduction.

We have detailed comments on the various base broadening options outlined by the Working Group below. We suggest that further analysis of these options is imperative in order to determine the long term effect on the tax system and economy.

Interest Deductibility and thin capitalisation

The effect of changes to the taxation of debt or equity funding should be thoroughly researched prior to any decisions being made. We believe that the tax system must act neutrally in determining how an entity funds its corporate structure.

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

Subject to the comments below, the current arm's length test should be retained on the basis that it acts as an alternative to the generic safe harbour gearing levels. We believe that the arm's length test provides an appropriate alternative for businesses of varying size, structure or industry where the safe harbour test may result in arbitrary outcomes in relation to the choice of funding.

However we propose that the arm's length test should be modified from its current form. Presently the test is overly complicated in its application which we believe results in significant compliance costs. We believe that the test could be simplified and adapted to better align with Australia's Transfer Pricing regime. Modification of the current arm's length test warrants further investigation and discussion with the business community to determine any possible long term effects.

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

We have a number of concerns about this option outlined below. We also question the appropriateness of comparison to the approach adopted by other economies, such as Germany. The Australian economy is vastly different to that in Germany and we may not benefit from such comparisons. We are concerned that the Government may have its sights set on this option without considering the potential ramifications and differing economic environments of comparison countries. We strongly recommend that further analysis is conducted on reducing the safe harbour gearing levels prior to any decision being made. As such, our concerns include:

- Reducing thin capitalisation levels may risk Australia's ability in attracting and retaining new investment. Treasury should review how adversely affected foreign investment will be with reduced safe harbour tests before changes are made.

- If the approach in other economies is to be used as a measure of the appropriateness of any option being proposed, this would require deeper analysis and comparison of the respective economic trends and markets.

Option A.3 – Reduce safe harbours for financial institutions

There are a number of factors that suggest this option could be effective.

- Australian financial institutions performed strongly during the GFC and continue to perform strongly in Australia's current patchwork economy.
- Further, reductions to safe harbour ratios for financial institutions will increase security around Australia's financial system. As stated in the discussion paper, these will reflect changes in the minimum capital requirements in the regulatory banking environment.

Option A.4 & A.5 – Cap interest deductions for all business taxpayers (excluding banks)

Thin capitalisation restrictions were introduced to protect Australia's revenue base from multinational companies loading their Australian operations with excess debt. We believe these options would have arbitrary effects on domestic taxpayers and influence how corporate decisions are made through the introduction of capping interest deductions. Furthermore such caps may reduce the neutrality between debt and equity, with the potential for equity funding to appear more favourable. As such we would strongly disagree with the introduction of capped interest deductions to facilitate a reduction in the corporate tax rate.

Depreciating assets and capital expenditure

We agree with the Working Group that accounting depreciation should be closely aligned with tax depreciation. This reinforces the principle of neutrality that tax consequences should not influence business decisions.

Option B.1 – Reduce the diminishing value rate for depreciation to 150%

Reducing the diminishing value rate for depreciation may be a viable option as it will only have a timing difference effect on tax payable. However we believe that assets with differing economic life spans will be affected differently by such a change and therefore the effect of this option on key sectors in the Australian economy should be fully analysed prior to adoption.

- Further analysis is required to ensure this option aligns tax and economic depreciation.
- Given that the Government wants to fund a current day rate reduction, it appears sensible that a reduction is made to current day deductions.

Options B.2 to B.6

We believe the Working Group needs to further consult the relevant members of the business community to determine the effect of these options.

Options B.7 to B.11

In relation to Options B7 to B11, our comments below focus on the potentially detrimental effect on the mining sector however we believe that further analysis of the effects of such changes on key sectors in the Australian economy is required prior to any changes being implemented.

Generally the Working Group raised concerns regarding the effectiveness of an immediate deduction for exploration expenditure. The Australian Taxation Office has recently focused on the interpretation of the provisions governing the immediate deductibility of exploration expenditure. We believe this focus sufficiently addresses concerns that the provisions should not be abused by companies and that legislative changes are not required to remedy these concerns.

Further the mining industry has for a number of years lobbied for incentives to be introduced to encourage exploration (e.g. a system where tax deductions for exploration expenditure are pass through to shareholders) as it was important for the long term stability and growth of the industry and the Australian economy. These proposed measures are contradictory to what the industry has been lobbying to introduce, will adversely affect the industry and could have a detrimental effect on the Australian economy.

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

We believe the proposed removal of the immediate deduction for depreciating assets that are first used in exploration may result in a disincentive for Australian explorers and investors to target prospective mineral resources in Australia. Given the capital intensive nature of exploration activities, the proposal to depreciate assets over their effective life may reduce the incentive to undertake commercial risk, particularly with greenfield exploration.

Further, the proposed reduction of the immediate deduction to a five year write down is also likely to impact project related investment decisions. Converting an exploration project to production requires high levels of risk and capital. The shelter of future profits with losses created from the immediate deduction of exploration expenditure is crucial when reviewing the feasibility of proceeding to production.

We consider the proposal to remove or reduce the deduction is likely to have a disproportionately adverse impact on emerging miners, particularly those undertaking higher commercial risk by seeking new deposits. Given the percentage of total exploration expenditure for new deposits in Australia has decreased from approximately 40% in 2004 to 32% in 2012,[1] tax policies to remove exploration incentives at this time is likely to exacerbate this significantly declining trend.

Option B.8 – First use exploration deduction – intangibles

We believe the proposed removal of the immediate deduction for interests in tenements that are first used in exploration may result in a disincentive for Australian explorers and investors to target prospective mineral resources in Australia. Any disincentive to test the

[1] Data supported by the Department of Mines and Petroleum of Western Australia.

prospectivity of tenements may further encourage miners to invest in offshore projects in jurisdictions which offer attractive tax concessions in addition to lower labour costs.

The proposed reduction of the immediate deduction to a five year write down is also likely to impact on investment decisions. Given the inherent uncertainty of investing in exploration tenements, a five year write down would disproportionately penalise miners and investors where no discovery is made inside five years. In this regard, it is essential that a compensating balancing adjustment on the early abandonment or disposal of a tenement is retained in any modification to the existing law. This is particularly important for a number of companies in the industry as they focus on proving up resources on exploration tenements and selling the tenement rather than deciding to proceed to production.

We are concerned that this proposal is likely to have a disproportionately adverse impact on the Australian exploration industry and may lead to investors pursuing offshore projects in preference to investing their wealth and expertise in the Australian economy.

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

Given the commercial reality that exploration is generally high risk in nature, it is improbable that in the first instance, an 'effective life' estimate is achievable on the basis that a project (i.e. without historical reserves) is unlikely to be defined. Before considering this option further we would urge that further research on the impact on the mining sector should be undertaken.

Our concern with the alternate proposal for a five year write down on exploration expenditure is that it may disproportionately penalise emerging miners; whereby they are likely to hold a portfolio of exploration tenements with varying degrees of prospectivity. Given exploration companies' cost accounting practices also vary by way of 'areas of interest', 'projects' or 'tenements', this option would add further complexity in tracking the exploration costs over a five year period and consequently increase the compliance costs associated with the measurement of the differences in accounting and tax treatments.

We are concerned that the proposals may have a particularly detrimental effect for emerging miners where no discovery is made as it appears that there would be no compensating balancing adjustment available preceding the five year timeframe. In addition, with regard to greenfield tenements, any self-assessment of a project's effective life is likely to be highly subjective and therefore open to manipulation and uncertainty.

Given the complexities arising from the recent farm-out tax rulings, we believe that adding a further layer of complexity to the timing of deductions for exploration related expenditure, will result in greater timing mismatches with consequences for cash flows and the viability of marginal projects.

Option B.11 – Exclude feasibility studies from exploration expenditures

The proposal to exclude feasibility studies from deductible exploration expenditure risks contradicting the long standing principle of treating exploration expenditure incurred before the decision to mine as immediately deductible.

Given feasibility studies are a fundamental process in defining and evaluating the commercial viability of a project, the removal of an immediate deduction for these activities is likely to decrease the incentive for miners and investors to pursue marginal projects due to increasing costs of exploration in Australia.

Option B.12, B.13 & B.14 – Depreciation deduction

We agree that the existing building depreciation rules should be reviewed. Depending on use and other circumstance, the expected life of a building can vary significantly and it is unlikely that the use of a generic fixed rate of depreciation would represent a building's true economic 'wear and tear'. We have considered the various options further below:

- **Removal of building depreciation.** We would be concerned that such measures would adversely affect investment decisions by both domestic and international investors in property and infrastructure. Taxpayers in the real estate and construction sector, that are not investing through a company structure would not benefit from a corporate tax rate cut, however they would lose the benefit of tax concessions and therefore be disadvantaged. Removal of the capital allowance on buildings would ignore that buildings, like all assets have economic lives as they deteriorate and/or become obsolete.
- **Depreciate buildings over their effective useful lives**. We believe this option may warrant further investigation given it attempts to align the economic depreciation and tax depreciation of a building.

Further analysis of the effects of these options, on the real estate and construction industry and its investors, would be required before considering any changes.

The R&D Tax Incentive

We believe that the new R&D Tax Incentive (which replaced the R&D Tax concession from 1 July 2011) is a critical part of Australia's overall innovation strategy and should be retained. The recent changes brought about by the R&D Incentive have been targeted at:

- Encouraging innovation within smaller domestic firms, and
- Attracting new foreign R&D investment

Both of which expand Australia's overall innovation capacity and generate spill-over benefits to the Australian economy.

We believe that savings in this area will be only at the expense of genuine R&D, undermining a key component of Australia's innovation strategy reform.

Option C.1 – Abolish the 40% non-refundable tax offset

We acknowledge that much of R&D carried out by large corporations is likely to continue without public support, however whether local or foreign owned R&D, much of this activity is likely to be shifted to other lower cost jurisdictions such as India and Singapore. This would result in the immediate loss of economic benefits and reduce Australia's innovation capacity in the medium to long term.

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

We believe that this approach would be effective in maintaining support for R&D in some of Australia's large and successful knowledge intensive companies but represents a backward looking approach to R&D. A significant proportion of Australian owned R&D is Applied Research, where a company conducts R&D to solve practical problems within their business. For these companies there is little correlation between turn-over and R&D Investment. The R&D Incentive is frequently a significant factor in the decision to embark on a "riskier" R&D program rather than a "safer" option of purchasing often inferior solutions from overseas.

Several multinational corporations have established research centres and centres of excellence in Australia. We believe that removing R&D support for these corporations could place ongoing and future investment opportunities in serious jeopardy, even if a turnover threshold of between $10 billion and $20 billion is imposed.

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

We believe that this approach would be effective in maintaining support for small to medium companies conducting R&D, but at the expense of future benefits arising from successful R&D companies, as the cap would simply encourage successful companies to move offshore, resulting in a loss of the spill over benefits. In addition this would be a severe disincentive to foreign investment in R&D.

Option C.4 – Cut the rate of the non-refundable tax offset to 37.5%

We believe that reducing the support for R&D in this way would have similar, but less severe effects to those for option C1, C2 and C3.