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Australian discussion paper outlines measures to fund a corporate tax rate cut

In brief

The Australian Business Tax Working Group (BTWG) recently released a discussion paper that canvassed ways to reduce the Australian company tax rate in a revenue neutral manner by 'broadening' the business tax revenue base. The paper's proposals broadly are designed to compensate the Australian government for its loss of tax revenue from a proposed corporate tax rate cut.

The discussion paper, issued on August 13, 2012, is the first in a series of discussion papers and reports outlined in the BTWG's consultation guide which was issued in June. The BTWG is due to provide its final report to the Australian government by December 31, 2012.

Currently, both the timing of the corporate tax rate cut and which proposed changes will be implemented is uncertain. The government recently announced a corporate tax rate reduction from 30% to 29% before subsequently withdrawing it in the 2012 Federal Budget.

Although a corporate tax rate reduction is welcome, some or all of the proposals to fund the tax cut may affect multinationals. Furthermore, the proposals may significantly impact certain industry sectors as follows.

- Proposed changes to reduce permitted debt levels and interest deductibility in Australia will affect all multinationals with debt-funded Australian operations, resulting in potentially increased Australian income tax liabilities.

- Proposed capital allowance changes are likely to slow the rate of depreciation/outright deduction for capital expenditure in the mining, oil and gas, primary production, and infrastructure industries. These measures could result in Australian entities (including subsidiaries of multinationals) paying income tax earlier in the life of a mine or other project than is currently forecast.

- Finally, the proposed scale back of research and development incentives represent a disappointing step backward for innovative companies undertaking R&D in Australia, and may cause multinationals to reconsider the benefits of investing in innovation in Australia.

Key proposals to fund a corporate tax rate cut

Interest deductibility and thin capitalization

The discussion paper outlines several reform options dealing with interest deductibility and the thin capitalization measures. In developing these measures, the BTWG noted that the Australian thin capitalization regime may currently be seen as "overly generous."

The proposals would:

1) remove the arm's length test and reduce safe harbor gearing levels (from 75% to 60% on a debt to total assets basis)
2) reduce safe harbor gearing levels (without removing the arm's length debt test)
3) reduce safe harbor gearing levels for financial institutions
4) cap interest deductions for all business taxpayers (excluding banks); this would involve removing the thin capitalization rules and capping interest deductibility by limiting the net interest expense to a set percentage of 'earnings before interest, taxes, depreciation and amortization' (EBITDA)
5) cap interest deductions for all business taxpayers (including banks).

The BTWG acknowledges that options four and five would involve a fundamental shift with respect to interest deductibility.

Depreciating assets and capital expenditure

The discussion paper outlines a number of options related to removing certain depreciation and capital expenditure benefits. The proposed changes result either in a reduction of the tax depreciation rate, or the removal of immediate deduction of certain expenditure types.

The proposals would:

1) reduce the diminishing value tax depreciation uplift rate from 200% to 150%
2) remove capped effective lives for certain assets, including those used in oil and gas extraction and petroleum and primary production; this is likely to slow the rate of tax depreciation deductions on these assets
3) remove or reduce the 'first use' and immediate deductions for exploration expenditure by mining companies
4) change capital works (building depreciation) deductions.

Research and development (R&D) tax incentive

The discussion paper also outlines options to mitigate the cost of the current 40% non-refundable R&D tax offset available to Australian companies with a turnover greater than A$20 million (a 45% offset is available for companies with a less than A$20 million turnover).

The options would:

1) abolish the 40% offset
2) impose a turnover above which the R&D tax incentive cannot be claimed
3) impose an annual cap on the amount of R&D tax incentive that can be claimed
4) reduce the R&D tax incentive offset to 37.5%.

Next steps

This is the first in a series of discussion papers that the BTWG plans to issue. The BTWG is due to provide a final report to government by December 31, 2012. Submissions on the discussion paper can be made until September 21, 2012.

Companies should consider the status and effects of the proposed changes in conjunction with any Australian tax planning.

We will continue to provide updates on the status of this and future discussion papers as more information becomes available.

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