Australia's Future Tax System Review

Joint submission by the Corporate Tax Association and Ernst & Young to the Review

30 April 2009

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Australia's Future Tax System Review
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To the Review Panel

Australia's Future Tax System Review
Supplementary Submission

The Corporate Tax Association and Ernst & Young are pleased to provide this further joint submission to the Review of Australia's Future Tax System (the Review) in response to the consultation paper issued in December 2008 (the consultation paper).

This further joint submission follows our original joint submission of 17 October 2008 (the 2008 submission) and we do not exhaustively repeat the issues covered in that submission. A summary of its suggested action points is attached as Appendix 1. References to the 2008 submission throughout this document correspond to those in Appendix 1.

In this submission we address certain comments in the consultation paper and comments contained in various speeches of Dr Ken Henry in his role as leader of the Review.

Desirable features of Australia's tax and transfer system and whether growth can enhance tax revenues (consultation questions 1.1 and 1.2)

Questions 1.1 and 1.2 of the consultation paper ask about desirable features of Australia's tax and transfer system and whether Australia can aim to reduce relative taxation imposts by promoting economic growth, not just public spending growth.

A key proposition of our 2008 submission (at section 2) was that Australia's tax and transfer system, with its many Federal-State interactions, needs to support Australia's growth and productivity. The system is currently overly complex, overly costly to administer for the community and for governments as well, and creates tax deadweights to Australia's growth. The tax and transfer system must be internationally competitive to enhance growth.

The consultation paper at section 6 notes ongoing changes in international tax systems which require action by Australia, with trends:

- to lower tax rates for businesses;
- to declining withholding tax rates on dividends, interest and royalty payments to non residents;

- away from dividend imputation (particularly for EU specific reasons) but continuing to provide relief to shareholders (for example the US relief to individual shareholders on dividend income);
- away from worldwide taxation of companies to the ability to bring in foreign earnings free of tax in the recipient's country;
- to not taxing foreign source income of non-residents derived through resident entities.

As noted by Treasurer Mr Wayne Swan, "our corporate tax rate was the ninth lowest in the OECD in 2001 – by last year it was the 22nd lowest"[1]. Chart 1.1 of the consultation paper shows clearly how Australia's full corporate tax rate of 30% is now higher than the unweighted OECD average. With the deleveraging of financial markets, businesses will be even more sensitive to the core tax treatment of their capital earnings, so Australia's relatively high corporate tax rate will continue to be an impediment.

As a separate but related matter, the CTA has (jointly with the Business Council of Australia (BCA)) commissioned some independent research into effective company income tax rates, both over time and in relation to a number of comparable countries. The results of this work suggest that when making international comparisons based on effective tax rates, Australia's competitive position is even worse than when using nominal rates. The principal reason for this finding, we suggest, is the significant base broadening that occurred as part of the Review of Business Taxation (the Ralph Review) a decade ago. The report on this research will be forwarded to the Review under separate cover by the CTA and the BCA.

The need for a competitive tax system is magnified by the global financial crisis. Many businesses now have major constraints on their capital formation and borrowing capacity, and are reviewing, restructuring, winding down or shutting down various parts of their operations in every country and location. Australia must be an internationally attractive location in which to employ people and to make investments of business capital, not only in "hard" assets such as machinery and equipment but also in "intangible" assets including copyrights, business processes and goodwill leading to growing and new businesses.

As noted in our 2008 submission (section 3.1), Australian climate change mitigation policies may differ from the policies in force in other countries. Therefore, Australia's tax system must support capital expenditure occurring in Australia, otherwise some businesses might decide that their marginal capital investment to deal with the new emissions environment might better be invested in overseas locations.

In this competitive environment, reform priorities for Australia's tax and transfer system are:
- achieving an internationally competitive business tax regime;
- simplifying a system which is currently overly complex;
- streamlining administration in a system which is currently overly costly to administer for governments and taxpayers alike; and
- addressing features which create blockages or tax dead weights affecting Australia's potential for growth in this globalised business community.

These issues are addressed in more detail; refer Appendix 1.

Business tax reform benefits all Australians

The report of the Review will need to clearly explain the benefits of tax reform, especially business tax reform, for growth and the welfare of all Australians. Otherwise, in this stressful time, the attention will be on populist handouts rather than reforms enhancing Australia's long-term structure and growth.

[1] Tax Reform for Prosperity, Productivity and Fairness, Wayne Swan Address to the Nation Tax Symposium (Community Tax Forum), National Press Club, Canberra, 25 February 2009

As explained at page 23 of the consultation paper, with lower business taxes

> "labour will receive at least part of the benefit in the form of higher wages. This is due to increased investments, and a larger capital stock, leading to a higher labour productivity. In particular, increased foreign direct investment can lead to higher labour productivity …These can generate spill over benefits for the rest of the economy, thereby increasing economic growth".

So the reform of business taxes is not a "zero sum game" which disadvantages individuals. Competitive business and corporate tax rates support investment, growth and the prosperity of all Australians. Distribution questions and other social justice concerns are always best addressed in a higher economic growth environment. Tax reform should not be seen as a contest between equity and growth.

The Revenue Mix: too many inefficient taxes (consultation question 3.1)

Question 3.1 of the consultation paper covers the revenue mix. Our 2008 submission addressed these issues at section 4.

As reinforced in the consultation paper,

> "as a share of total tax revenue, Australia has a relatively low reliance on tax revenue from labour income and consumption compared with other OECD countries, and a correspondingly high share of tax revenue derived from capital income (the highest in the OECD in 2005). A recent OECD study suggests that "taxes on capital income are more likely to have a detrimental impact on growth than taxes on property, labour income or consumption."

The overall mix of taxes in Australia on business and labour income, consumption transactions and assets leads to excessive complexity, and higher costs of compliance. Key priorities include:

a) reducing the absolute number of taxes payable in Australia. This requires eliminating the most inefficient state taxes or streamlining them (section 4.1 of the 2008 submission);

b) eliminating the most inefficient categories of stamp duty (section 4.3 of the 2008 submission); this is likely to lead to improved economic growth; and

c) undertaking a searching review of payroll tax, an impediment to the employment of Australians. Some research considers payroll tax to be a surrogate or proxy consumption tax. This should be comprehensively analysed by the Review, as the imposition of payroll tax onto Australian employment appears to represent a disadvantage to job creation in Australia.

   If payroll tax is to be retained, section 4.4 of our 2008 submission proposes consideration of a single uniform payroll tax statute to be applicable for all states and territories, as well as other reforms. A potential benefit of a unified payroll tax statute might be the appointment of one single revenue agency, potentially the Australian Taxation Office (ATO), to act as the administrator of the payroll taxes across Australia. We note that the Canadian Revenue Agency which consolidated the administration of provincial and federal taxation, might represent a useful model.

Dividend imputation system and competitiveness (consultation question 6.2)

Question 6.2 asks for input on changes to improve the effectiveness of Australian companies operating internationally, and options for integrating company and shareholder taxation. Our initial input was in section 2.2 of our 2008 submission.

The speech by Dr Ken Henry in February 2009[2], intended to stimulate discussion about the future of the imputation system, has resulted in various comments that the removal of dividend imputation would be the funding source for a drastic reduction in Australia's company tax system.

We provide further comments.

1. We agree that Australia should have a lower company tax rate, but there is not a choice simply between a lower company tax rate in Australia (scrapping dividend imputation) and retaining dividend imputation in its present form. It is possible to retain an imputation system in Australia and to also reduce company tax rates over time. The funds for tax rate reductions can emerge from tax mix adjustments, the economic benefits of a more efficient tax system and reviewing outlays. We suggest that a more attractive tax environment would see additional economic activity in Australia, although the extent of such improvement is difficult to forecast. As well, we wonder if the simple "either lower tax rate or imputation" analyses consider the need for tax incentives for savings and capital income which are identified by the Review.

2. The imputation system is clearly an impediment to Australian companies which seek to remain headquartered in Australia with Australian investors, and invest overseas. This is recognised in Dr Henry's speech. This disincentive effect can be remedied without requiring the elimination of the dividend imputation system which has, since its introduction in the mid 1980s, provided a significant incentive to invest in Australian companies and has enhanced capital formation and savings in Australia.

That disincentive feature of the imputation system could be rectified in various ways:

a) One remedy, proposed in the Board of Taxation 2003 report into Australia's international tax arrangements, is to provide a partial imputation benefit in relation to foreign sourced income which is included in dividends paid to Australian shareholders. This was not adopted at that time by the Federal government pending other international tax reforms, but was not rejected outright.

b) Another solution would be to permit some dividend streaming mechanisms, to enable certain foreign income of Australian companies to be streamed to foreign shareholders. A similar proposal was put forward in a consultation document in New Zealand, published in August 2008[3].

c) A third approach would be to reduce the differential tax outcomes for investors in relation to dividends sourced from domestic fully-taxed income as compared with foreign income. For example, if partial franking credits or tax benefits were provided to Australian investors for all their dividend income from Australian companies irrespective of the source of the profits of the Australian companies, the disadvantages of global expansion by Australian-based companies would be reduced.

3. There may be reasons for Australia to move away over time from the imputation system, given that it has largely been eliminated in the European Community due to EC political requirements. If so, it is critical that Australia does not revert to the classical system of underlying company income being double-taxed, once in the company and again in the shareholder's hands without tax relief.

A reversion to a classical double taxation system without concessional treatment of dividends in shareholders' hands would cause major disturbance to Australia's capital markets and Australia's savings patterns with a major impact on the ability of Australian companies to raise their capital from Australian investors.

[2] "A tax system for Australia in the global economy" - Speech by Dr Ken Henry, Australian Business Tax Reform in Retrospect and Prospect colloquium, Sydney, 23 February 2009

[3] "Streaming and refundability of imputation credits: a government tax policy discussion document" published in August 2008 by the Policy Advice Division of Inland Revenue - http://taxpolicy.ird.govt.nz/index.php?view=619 - especially paragraphs 2.43 – 2.53.

So, any changes to the dividend imputation system would need to ensure that investment by Australian investors in Australian companies remains attractive and would need to be clearly signalled to Australian investors and the stock market, with sufficient lead time to understand the impact for Australian companies.

4. We highlight that this is not an issue just for listed companies. Private companies and their shareholders need an integrated tax system. This can be achieved for private companies, if not through an imputation system, by a flow through taxation system for private companies as has been suggested to the Review.

5. If Australia were to move away from the current dividend imputation system, an integrated or concessional treatment of company and shareholder taxation can be achieved over time in various ways including:

a) tax concessions to investors for their dividend income from companies, an approach used for example in the US (with lower tax rates on dividends) and the UK (with automatic de facto franking on all dividends).

b) other mechanisms for the concessional treatment of capital income more generally, adjusted to take account of the needs of companies. The Review is commissioning research on various such mechanisms, such as business expenditure taxes including ACE (allowance for corporate equity) and cash-flow taxes, as noted in Appendices D and E of the consultation paper, which are expected to be discussed in more detail in the June 2009 tax policy conference organised for the Review.

We do not comment on these alternative mechanisms in detail. We note that, after the June conference is held, we might provide further input to the Review and seek discussions in relation to this issue.

Taxing business and investment – low rates or concessions? (consultation question 6.1)

The consultation paper asks at question 6.1 whether the tax system can be structured to better attract investment to Australia in a way that increases its national income and if so how, and what are the relative merits of a more comprehensive income tax with a broader base and lower tax rate as distinct from a narrower income tax or expenditure tax with a narrower base and a higher rate.

We note, however, that other countries such as the UK are moving to lower corporate tax rates while preserving or enhancing their capital allowances which appear more favourable than Australia's. Australia's tax base is already quite broad due to having relatively few tax incentives for capital investment (in the form of depreciation and write-offs) as compared with other countries which offer more concessional treatment of capital investment.

We note again the joint CTA and BCA research to be provided under separate cover, that suggests that when making international comparisons based on effective tax rates, Australia's competitive position is even worse than when using nominal rates. This is due to the significant base broadening after the Review of Business Taxation.

If Australia had an even broader tax base then the tax rate would need to be very low, to counter the many tax incentives provided in other countries for capital investment in plant and equipment and in business investment in intangible assets.

Investment and risk taking biases (consultation question 6.3)

We highlight and elaborate on two issues in our 2008 submission – the need for reform in relation to interest withholding tax settings and the treatment of purchased intangible business assets and goodwill.

The consultation paper recognises submissions seeking reduction of interest withholding tax, in its discussion of taxing non-residents' portfolio investments at p.132.

Since our 2008 submission the economic environment has deteriorated even further in the area of lending capacity. As a result, it is even more critical now that the government acts to enable Australian corporates and financial institutions, in particular, to access foreign funds. Our 2008 submission identified at section 2.4.2 that:

- Australia should consider abolition of IWT;
- the tax policies in relation to withholding taxes in respect of lease payments made should be aligned to the tax treatment of IWT generally;
- If IWT is not eliminated entirely, then a broader IWT concession should replace the current section 128F IWT exemption; and
- Australia should consider broadening its double tax agreement exemptions from IWT

We strongly support an abolition of interest withholding tax, certainly in the area of banking and financial intermediaries but even more broadly. Consideration should be given to the total abolition of withholding tax for corporates generally. There has been significant evidence for example, that the foreign banks are retreating from Australia and thus there is significantly reduced competition for the corporate sector seeking to access commercial lending from Australian intermediaries.

The investment and risk taking discussion at section 6.4 of the consultation paper recognises points made in our 2008 submission about Australia's allowances for depreciation or the amortisation of certain tangible and intangible assets, the need to clarify tax classification of revenue/capital assets to enhance certainty and efficiency (especially for managed funds), the treatment of tax losses, the tax treatment of research and development expenditure and the compliance risks and costs imposed on taxpayers. Refer in particular to sections 2.3.1, 2.4.2, 2.5, and 3.1 of our 2008 submission.

We provide further material at Appendix 2 about the need for improved tax treatment for business capital investment in intellectual property (intangible assets). This is in addition to section 2.3.2 of our 2008 submission and are prompted by comments in the consultation paper on this issue, in particular:

- "….more generous arrangements could increase efficiency costs arising from distorting investment choices … true economic depreciation, which is the real decline in the value of assets as they age in use, is likely to vary significantly across the different types and uses of depreciating assets … intangible assets pose even greater difficulties in estimating appropriate rates of economic depreciation (or in many cases, appreciation … as intangibles exhibit different rates of economic depreciation (or in many cases, appreciation)" (pages 144 and 145).

- "For other intangibles, such as acquired goodwill, there are no provisions to allow taxpayers to deduct or amortise these amounts … However, in other respects the tax system provides for a more generous treatment of intangibles than appropriate … expenditures incurred to build goodwill and certain other intangibles are immediately expensed, without the value of the asset generated being recognised … where acquired goodwill declines in value, the expenditures required to maintain goodwill are typically immediately deductible. The deduction for expenditure sufficient to maintain to the level of goodwill means that the investment in acquired goodwill has access to deductions equivalent to allowing write offs based on economic depreciation" (page 146).

We submit that these comments do not address all the issues in relation to tax reform for purchased intangible assets. Our comments in Appendix 2 highlight the real issues and the need for reform.

Reform is needed in the 21st century environment of globally connected businesses which focus increasingly on adding value and building on knowledge, processes and other intangible assets.

Complexity and excessive cost in tax compliance (consultation question 8.1)

Question 8.1 seeks to identify the taxes or transfers which are most complex and impose the greatest costs, and how these costs could be reduced.

Our 2008 submission (at sections 4 and 6), identified significant state and territory reforms for attention. These include the potential for adoption of a single revenue agency to collect many state taxes. We note that the Canadian Revenue Authority includes provincial representatives and has authority for the collection of provincial taxes.

We highlight that Commonwealth taxes are relevant also in reducing compliance costs and complexity.

The Fringe Benefits Tax (FBT) imposes compliance costs in excess of the economic benefit and base broadening achieved. As noted in our 2008 submission at section 6.2, FBT compliance tasks represent a significant deadweight compliance cost.

For example, almost every employer which provides motor vehicles to employees must track the benefit attributable to car parking benefits provided to employees, by reference to prices charged by commercial car park operators within one kilometre of each workplace. 14 pages of law - Division 10A—Car parking fringe benefits in the FBT Assessment Act (FBTAA) - deal with this simple issue[4]. This requires a constant monitoring process to obtain information about what commercial car parks have been developed or shut down nearby, their parking fees and to apply these to relevant employees. This inefficient process is not appropriate where car parking is provided by many employers in outer suburbs and remote areas in situations where no public transport is available, and represents quite inappropriate compliance costs.

Similarly, the cost of incidental benefits provided to employees involves extensive judgements, record keeping, for form filling and exchanges of information between employer and employee[5].

The FBT should be focused to apply only to benefits included in employment contracts as salary package components, we submit. The FBT rate should also be addressed, as it is quite inappropriate to impose FBT at a rate based on the highest marginal personal tax rate in situations where employees on low tax rates are receiving fringe benefits.

Improving administration of Australia's tax and transfer system (consultation question 8.2)

Question 8.2 asks how to improve governance of the tax-transfer system to reduce complexity, uncertainty and cost, and to improve transparency, understanding and support for the system.

We recognise the comments by Dr. Henry in his speech 'Confidence in the operation of the tax system' to the TIA conference in Sydney on 13 March 2009, noting that the ATO has various levels of accountability to government and to Australia as a whole and inviting further input to identify the problems to enable proper consideration of this issue.

[4] s.39A of the FBTAA is the most relevant section
[5] See for example s.58P of FBTAA dealing with minor benefits, and over 30 pages in Division 13—Miscellaneous exempt benefits

We provide further information in two areas, to highlight the need for:

- better governance of the ATO as a government agency; and
- better ATO management of disputes.

Governance of the ATO: why additional governance is desirable

We submit that the existing ATO governance processes do not address all relevant issues:

- Existing parliamentary review processes do not involve deep analysis or questioning of the ATO. In particular, many taxpayers with unique issues with the ATO are unwilling to be identified or to have their circumstances discussed publicly for fear of retribution, so parliamentary processes do not involve analysis of many issues;
- The existing ATO consultative processes identify problems and interpretative and compliance priorities, but operate only as inputs to ATO decision processes, without any governance of the ATO's response;
- The Ombudsman role has not developed to provide real oversight over the ATO and indeed many ombudsmen have been former ATO officers;
- While we are not aware of the precise detail, we suggest that the Treasurer and Assistant Treasurer of the day and the Treasury can do no more than provide inputs without assisting in the governance of the ATO's own functions. This was a driver of the appointment of the Inspector-General of Taxation (IGOT); and
- The Board of Taxation, while a very valuable contributor to the tax policy process in Australia, does not have ATO oversight responsibilities or powers. Nor should it, with its current staffing.

There are long standing comments, made publicly, about the tendency of ATO officers to make "U-turns" in their advisory or interpretative approaches, to be unresponsive to business needs, and to inadequately use their administrative powers to deal effectively with ambiguity in legislation.

The review currently being undertaken by the IGOT into allegations of ATO U-turns, which will be conducted throughout 2009, will identify various situations in which the ATO has been involved in:

- interpretative advice which has contradicted earlier publicly available interpretative advice;
- interpretations which counter earlier "generally accepted" understandings, even if these have not been communicated in a formal legally binding manner;
- lack of guidance in relation to new legislation, causing ambiguity and delays for some years; and
- the retrospective application of changed ATO views.

Because the IGOT review will be available publicly later in 2009, and the Review can consult with the IGOT, we do not outline detailed instances of such U-turns in this submission. U-turns raised in various forums have included ATO:

- proposals to change the identification of revenue or capital assets so far as investments by managed funds and Australian taxpayers are concerned, with potential major damage to Australia's financial markets;
- proposals to apply transfer pricing to 'overwrite' Australia's thin capitalisation laws;
- changes of view in relation to the imposition of royalty withholding taxes in relation to copyrights;
- treatment of labour costs in relation to improvements to capital assets;
- treatment of earnout payments under contracts for the purchase of businesses;
- treatment of costs and revenues in relation to trading stock;
- treatment of distributions from discretionary trusts; and
- the deductibility of financing costs by taxpayers generating foreign source dividends and other forms of non-assessable and non-exempt income.

These have common threads of:

- ATO positions being developed potentially as a result of particular taxpayers' tax controversies;
- application of positions to all taxpayers, inappropriately, giving rise to commercial damage or inappropriate outcomes;
- perceptions of uncommercial outcomes; and
- perceptions of a culture focused on revenue collection and, in the views of many, revenue maximisation.

We submit that these interpretative challenges suggest some of the major management and administrative challenges for the ATO, to reconcile:

- continuing to collect the revenue lawfully payable by taxpayers;
- appropriately focusing compliance activities on non-compliant taxpayers in order to enhance their compliance practices;
- providing clear and effective interpretive material to the broader community so as to reduce uncertainty;
- having due regard for the policy implications of particular interpretative decisions and consulting with Treasury on those policy matters where appropriate; and
- seeking judicial interpretation on complex issues, to add to the Australian tax law while ensuring that the compliance processes are efficient and cost effective in Australia.

The ATO challenges here include:

- ATO bidding for appropriate resources;
- Proper prioritisation of ATO activities as between the many competing priorities;
- Ensuring that the technical resources of the ATO are brought efficiently to bear on tax disputes and also the provision of guidance material; and
- Ensuring a culture of efficient management of their responsibilities is instilled into ATO officers.

The improved governance model – adjusted corporate-style or advisory board?

The precise details of additional governance needs careful analysis beyond the scope of this submission. The US National Commission on Restructuring of the Internal Revenue Service[6] undertook a year of work, with 12 days of public hearings, hundreds of hours of private meetings and meeting with 500 individuals, including senior IRS employees. It delivered an 82-page report which led to the IRS Restructuring and Reform Act of 1998 which created the US IRS Oversight Board.

One potential governance model would be to have a Board of directors, or equivalent, for the ATO in a manner somewhat similar to that of a Board in a corporate environment, but expressly adjusted to government requirements (adjusted corporate board model). Such models apply in the US, UK and Canada.

Such an adjusted corporate board model includes the country's chief tax administrator as an executive member (as occurs in the US, UK and Canada) potentially with other tax administrator executives as directors (as in the UK and Canada). As well, the Board could include non-executive directors, whether from the business community or (as in the case of Canada), representing the interests of the Government.

[6] http://www.house.gov/natcommirs/main.htm

To resolve any misconceptions about its role, the US IRS Oversight Board states that it

> "operates much like a corporate board of directors, **but is tailored to fit a public sector organization**. The Board provides the IRS with long-term guidance and direction, and applies its private-sector experience and expertise in evaluating the IRS' progress in improving its service. It reviews and approves IRS strategic plans and its budget requests, and evaluates IRS efforts to monitor its own performance. The Board reviews the evaluation and compensation of senior IRS officials. It also **recommends candidates to the President** to serve as IRS Commissioner, and can recommend a commissioner's removal."[7] (emphasis added)

Another model is a Board with an advisory role, such as those which operate in the Reserve Bank, the APRA Risk Management and Audit Committee which provides independent assurance and assistance to the APRA executives on the risk, control and compliance framework and its external accountability responsibilities and the ASIC External Advisory Panel. For example, the Reserve Bank Board[8] does not have, we understand, the responsibility to appoint the Governor of the Reserve Bank, but rather its role is, within the limits of its powers, to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia in specified ways[9]. Such advisory boards provide valuable input in the proper focussing, strategy and execution of the role of the administrator.

A board, of whatever model, would add significant value to Australia's tax and transfer system, and to our economy, in addition to all the existing consultation and government governance processes. It would assist to address the challenges described above.

We do not propose this governance model to be adversarial, or to frustrate or damage the ATO. Rather, we see it as an opportunity for the ATO to benefit from input from senior business people who are experienced in the governance of large organisations, to enhance the processes, culture formation and operations of the ATO, and indeed to act as champions for the ATO in its interactions with the government of the day.

Effective management of ATO process issues – separating ATO mechanisms to manage uncertainty and disputes from the audit function

Another reform proposed, at section 6.3.1 (b) of our 2008 submission, is to streamline the resolution of uncertain issues as between the ATO and business, by introducing a capacity for an independent review of tax disputes between the ATO and taxpayers before the ATO issues an assessment which must be disclosed in the financial statements of reporting entities.

We suggest that ATO tax audits of larger businesses are increasingly seeing ATO audit teams, having reached a provisional settlement on the tax audit with taxpayers, referring the issues upwards for internal approval and finding new issues raised at that stage, causing a renewal or recommencement of audit activities. The new issues are frequently novel, cannot be accepted by the taxpayers involved, and are leading to tax disputation to resolve the uncertainty. The primary forum to resolve novel issues raised in controversies between senior ATO officers and taxpayers is judicial review, which has the potential to take a very long time and involve huge expenditure of money, with major penalty exposures for taxpayers.

Australia's tax administration would benefit from an independent internal review of tax controversies, prior to the issue of assessments and tax litigation, by a panel which is independent of the ATO audit team. This would enhance the administration of the tax system in Australia.

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[7] http://www.treas.gov/irsob/faqs.shtml

[8] http://www.rba.gov.au/abouttherba/governance_and_accountability_of_the_rba.html#consultation_with_government

[9] Reserve Bank Act 1959, Part II, Division 2, notably sections 10 and 11

If you need any further information, please contact

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Yours sincerely

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Appendix 1

Action points raised in the Corporate Tax Association and Ernst & Young 2008 submission

1. An internationally competitive business tax system is needed for Australia's development and future

1.1 An internationally competitive, lower, corporate tax

Australia's corporate tax rate needs to be reduced. The rate should be competitive with relevant countries including the higher-growth OECD countries and the more developed Asian economies.

As well, the data on comparative company tax rates should be updated to include forward-looking company tax rates announced and planned by other countries.

The UK company tax rate of 28% introduced in the 2008 Budget is an appropriate first step for consideration. The UK lower company tax rate retained attractive broadband depreciation rates, albeit somewhat reduced.

1.2 Aligning dividend imputation to a global capital market and global activity by Australian companies

The imputation system needs adjustment to protect Australia's competitiveness.

Imputation credits should attach to dividends paid by Australian companies to Australian shareholders from foreign earnings: partial franking, at least, should apply as recommended by the 2003 Board of Taxation report. The previous government implemented many major international tax reforms, however this measure requires action to overcome the disadvantage to Australian companies retaining Australia as their base.

a) Australian companies with global shareholders could be permitted to stream foreign income to the foreign shareholders while retaining franking credits for Australian shareholders, at least to some extent, as NZ is considering. If unlimited streaming is considered inappropriate, then there might be some specific level of streaming which reconciles international competitiveness and revenue maximisation objectives.

b) The current approaches of the ATO in relation to corporate capital management appear inconsistent with the legislative policy. As well, the strategic competitiveness issues should be considered in relation to the Board of Taxation report into Australia's off-market share buy-back tax rules, which we understand has been presented to government. Tax-efficient off-market share buy-backs enhance the capital strength of Australian based companies, to retain the benefit of their franking credits to strengthen the companies. Restrictions on the use of off-market share buy-backs will impair Australian companies' efficient capital management.

c) The imputation system needs some inappropriate policy issues removed. For example why, today, should a company which overfranks its dividend by more than 10% and pays franking deficits tax lose 30% of the offset?

d) There is no need to remove dividend imputation to allow tax reform or internationally competitive tax settings. Major tax architecture improvements can be achieved, including a lower company tax rate and improved treatment of capital expenditure by business, without having to eliminate or drastically alter the dividend imputation system. If it were thought necessary to review or adjust the imputation system, this would require careful analysis and consultation to avoid disturbing Australia's capital markets and Australian companies' financial health and competitiveness. We can discuss our views on these issues with this Review further.

1.3 An internationally competitive tax system for capital investment in Australia

1.3.1 *Investment in plant and equipment and infrastructure*

Our recommendations for attention, which are discussed at Appendix A in more detail, include:

a) Replacing Australia's uncompetitive and complex effective life regime with an internationally competitive capital allowance scheme with "broadbanding" rules and attractive capital allowances rates.

b) Eliminating the tax disadvantage for improvements and technological updates of Australian capital equipment.

c) Eliminating a feature which causes assets under the diminishing value capital allowance rules to never be fully depreciated.

d) Limiting the excessively long effective lives for long-lived assets and infrastructure.

e) Reviewing the Buildings capital allowances.

f) The 'black holes' capital allowances have retained black holes and should be adjusted.

g) Addressing tax problems for managed funds investing in infrastructure assets.

1.3.2 *Business capital investment in intellectual property (intangible assets)*

Australia needs to explore again an internationally comparable tax amortisation regime for intangible property acquired in the course of an acquisition of a business or company carrying on a business, as recognised in the Ralph review. The amortisation could be over an effective life of 15 years or, at the taxpayer's option, over the life adopted in a taxpayer's audited financial statements. The UK and US provide models for the approach, which should cover business intangible property in the course of an acquisition of a business or company carrying on a business and could include the goodwill of the target business recorded under accounting standards.

1.4 Ensuring competitive tax rules for international transactions

1.4.1 *Board of Taxation international tax review*

On the basis that the recommendations and suggestions made by the Board of Taxation in its Review of International Anti Tax Deferral Rules are consistent with its public discussion papers, targeting international competitiveness, the recommendations should be implemented to ensure that Australia's rules for controlled foreign companies and foreign investment funds remain internationally competitive.

1.4.2 *Reducing withholding taxes on the use of foreign borrowings for use in Australia, given the cost and competitiveness issues*

First, Australia should consider abolition of IWT. This policy needs urgent consideration and should not wait for this Review to report in 2009. whilst we acknowledge the Canadian initiative, we note that an IWT removal for Australia should apply also to interest paid to associates which are merely conduits for foreign-sourced debt.

Second, the tax policies in relation to withholding taxes in respect of lease payments made should be aligned to the tax treatment of IWT generally, and not just in recent renegotiation of US and UK treaties. The current 'drip feed' of concessions through treaty renegotiations is inefficient and requires domestic tax reform.

Third, if IWT is not eliminated entirely, then a broader IWT concession should replace the current section 128F IWT exemption for interest on certain publicly offered company debentures or debt interests. The s.128F exemption should be adjusted to remove the requirement for public offering.

Fourth, Australia should consider broadening its double tax agreement exemptions from IWT.

1.5 Ensuring that Australia's tax loss rules are competitive at a time of heightened uncertainty and capital mobility

First, Australia should introduce loss carry back rules.

Second, remaining problems with the company loss recoupment tests must be addressed, including the issues listed in the backlog of unlegislated measures presented in the 2008 Budget.

Third, significant problems with the operation of the same business test (SBT) must also be addressed. The test is designed as a fall back where the COT is failed, to allow the continued use of losses where there is no trafficking in those losses. However the harsh interpretation of the SBT rules by the ATO and a limited interpretation of the rules in recent court decisions means this test needs to be amended. The SBT should have a purpose test, so that it applies only where a company was acquired for a non-incidental purpose of using its losses.

Fourth, the interaction of the loss rules with new tax regimes including tax consolidation should be examined to ensure the policy to allow continued use of losses has not been over diluted. In particular the tax consolidation regime has resulted in further difficulties for groups seeking to apply the SBT. Restrictions on the use of losses of acquired entities under the available fraction rules should also be recognised in this context.

Fifth, Australia quarantines losses incurred on capital assets (capital losses) for offset only against capital gains. The definition of capital gains and capital losses is highly problematical for businesses and needs statutory clarification as discussed at section 7.1.

Sixth, the use of consortium, joint venture and other structures by companies in undertaking infrastructure and other major projects present particular problems in passing the loss tests, which can be a disincentive to investment. Amendments to the application of the SBT to such arrangements and further concessions to the loss rules, including for example flow through of losses in some circumstances, should be examined.

2. Consistency of the tax and transfer system with broader government policy objectives

2.1 Ensuring that Australia's tax policies for capital investment arising from greenhouse gas policies and businesses do not result in business investments bypassing Australia

The first action, at this strategic time, is to ensure that Australia's tax rules dealing with capital expenditure on capital equipment are internationally competitive as discussed at section 2.3.

As well, this Review needs to consider whether the CPRS and its mechanisms need to be augmented by tax incentives to encourage businesses to make the necessary expenditures on capital equipment and innovation to proactively deal with energy pricing and emissions reduction policy objectives.

In responding to the Green Paper, the CTA and Ernst & Young submitted that business needed to have appropriate tax incentives to facilitate significant capital investment to deal with the CPRS, especially in the initial transitional phase. The March 2008 joint report of Ernst & Young and the Institute of Chartered Accountants "Australia's Proposed Emissions Trading Scheme – The Tax Policy Dimension"10 highlighted potential incentives. Some might target enhancing Australian climate-related innovation and R&D by adjusting the R&D concession, including R&D in foreign locations to benefit the Australian economy. Additionally they might target the tax outcomes of costly capital expenditures to replace existing equipment or alter equipment - potential incentives include increasing depreciation rates for capital expenditure that can be demonstrated to reduce carbon emissions, introducing an emission reduction investment allowance deduction, specific concessions in the tax loss rules for companies in emissions-intensive industries and considering outright deductibility of certain expenditures.

[10] Ernst & Young and Institute of Chartered Accountants joint paper, authored by Ernst & Young, "Australia's Proposed Emissions Trading Scheme – The Tax Policy Dimensions" issued in March 2008, available from http://www.ey.com/global/Content.nsf/Australia/Climate_Change

2.2 Alignments with other key sectoral and economic development policies

Government needs to ensure that appropriate formal mechanisms are in place to ensure that tax policy informs the debate on and contributes to the development of industry and economic policy.

This integration with other policies should be part of the improved tax governance process which we discuss at section 6.1.

3. Removing inefficient taxes and reducing inefficiency

3.1 Eliminating the most inefficient state taxes or streamlining them

The first strategy is to consider elimination of various heads of state taxes. This will require addressing vertical fiscal imbalance, noted at section 5, below.

For the taxes to be retained, each should be implemented in one single uniform statute instead of up to eight legislative instruments across the states and territories.

A less effective alternative is to unify the laws with consistent definitions, rates and thresholds across the entire nation. Earlier this year, on 29 March 2008, the state and territory treasurers announced a national overhaul of payroll tax partially along those lines, discussed at section 4.3 below.

3.2 Stamp duties on business restructures should be reformed

A significant priority should be an aligned, consistent approach to the grant of relief from conveyance duties for business restructures. Ideally, there should be a single agency responsible for the applications.

3.3 The most inefficient stamp duties should be removed or reformed

The prime candidates for elimination are:

- Stamp duties and conveyance duties on business restructures;
- Stamp duties on insurance, and fire services levies;
- Stamp duties on asset transfers;
- Stamp duty on leases and non-residential conveyances; and
- Stamp duty on security granted over loans.

3.4 Elimination or harmonisation of payroll tax

This Review should consider abolishing payroll tax. This would require compensating the states appropriately.

If payroll tax cannot be eliminated then, the strategy should be as follows.

First, the tax free thresholds for employers could be eliminated, to simplify and broaden payroll tax, and lead to lower rates. This action will also reduce structural distortions which adversely affect business pricing, competitiveness and efficiency. We support providing financial assistance to small business11, however the support could be provided through grants, thereby removing the complex payroll tax threshold rules.

Australia could eventually replace the various statutes with one single uniform statute.

A less effective alternative is to unify the laws with consistent definitions, rates and thresholds across the entire nation. Earlier this year, on 29 March 2008, the state and territory treasurers announced a national overhaul of payroll tax arrangements in which the states and territories agreed to adopt common provisions and definitions for 8 key payroll tax areas but to retain control over individual rates and thresholds. This is not enough, as there will continue to be differences in thresholds, rates and administration. This issue is discussed in relation to other state taxes at section 4.1.

Additional reforms, to reduce business compliance costs, could include single payments, lodgement of one return with Australia wide employees of a group, only one registration, a central

[11] For example, $37,380 is the value of the current tax free threshold for payroll tax in NSW, based on the NSW 6% payroll tax rate, calculated on the maximum exemption threshold of $623,000.

Commonwealth body responsible for administration and collection to reduce compliance costs, and for the Commonwealth to pass payroll tax on the states based on break up of state by state payrolls provided with the one tax return.

6. Reducing tax and transfer complexity, to enhance growth

6.1 Improving tax policy processes and governance

Australia needs stronger governance over tax policy development in Australia to ensure that our system remains competitive. A Tax Policy Oversight board might be modelled on the approach of the Reserve Bank of Australia board. This board might provide counsel or input to the government and to Federal Treasury in relation to strategic issues around business tax competitiveness in Australia, the sequencing priority and direction to be adopted for the Australian tax systems, and consider periodic competitiveness reviews.

The existing Board of Taxation is used occasionally to assist in specific policy design but has no formal strategic or statutory role. The Board of Taxation might be developed strategically in this direction.

6.2 Priorities for reducing complexity in tax legislation

6.2.1 *Reducing complexity in the fringe benefits tax*

First, the application of FBT must be narrowed. FBT should only apply to benefits included in employment contracts as salary package components which have been converted into benefits. This could be supported by an integrity measure using the ‘reasonable to conclude’ basis as introduced in one recent FBT amendment[12]. We suggest this would deal appropriately with cars, loans and housing, the major benefits. The minor benefits such as entertainment, minor benefits and other in-house benefits such as in-house travel, which are hugely compliance intensive, should either not be taxed at all or have some standard, flat, FBT values with minimal compliance.

Second, the FBT rate should be addressed. FBT is currently imposed at, essentially, the top marginal tax rate even where employees are at middle or lower rates. We suggest exploration of a mechanism to use lower rates for employees on rates below the top marginal tax rate.

Additionally, FBT grouping would also assist some businesses.

6.2.2 *Streamlining the employee share scheme rules*

The employee share scheme rules are a fertile area for review in the medium term, to ensure that the rules encourage employee share participation for the Australian workforce with streamlined compliance and design of the rules.

6.2.3 *Reducing tax complexity by increased use of audited financial statements*

First, the tax law could allow taxpayers at their option to use financial statements as a basis for their income tax returns, for at least some taxpayers.

Second, the tax laws could provide for express use of financial statements as shortcuts or mechanisms to drive tax compliance in particular areas, such as the existing use of financial statements for thin capitalisation purposes, tax consolidation purposes and for four optional methods under TOFA stages 3 and 4 (TOFA 3&4).

Such financial statements shortcuts might include allowing the tax treatment of cost or market valuation of trading stock to follow the financial statements. There is currently a long-running discussion with the ATO in relation to the differences in cost of trading stock for accounting purposes and cost for tax purposes. It would be far less complex and more productive for taxpayers to use the costs of trading stock in audited accounts for tax purposes.

As well, in relation to TOFA 3&4, financial statements shortcuts could be used in relation to the accruals method, in addition to the specific areas where they are currently proposed to be used.

[12] Tax Laws Amendment (2008 Measures No. 5) Bill 2008, Schedule 4, items 8,22,31 and 40. See also - Explanatory Memorandum Para 4.10.

Third, the tax law should state a general policy willingness to accept the values in audited financial statements for purposes of compliance shortcuts and authorise the ATO to permit the development of compliance shortcuts using financial statements, without requiring further legislative changes. This would send a signal to the ATO to consider proactively adopting such shortcuts where appropriate, to significantly reduce compliance costs and complexity.

6.2.4 *Reducing complexity by harmonisation of various state and Federal taxes imposed on similar tax bases*

Australia should consider harmonised definitions across multiple taxes, starting with payroll tax.

Other core concepts to be harmonised could be developed along similar lines, perhaps including definitions of income or other elements of business indirect and direct taxation.

6.2.5 *Reducing complexity by ATO use of discretions in favour of taxpayers*

6.3 Reducing complexity in tax administration

6.3.1 *Addressing governance and controversy management in the ATO*

a) Consider adjusted governance of the ATO activities, using Reserve Bank, US, UK and Canadian models

In the same way as business has governance arrangements over its executives by virtue of its board of directors, consideration could be given to the ATO having a governance mechanism involving a Board, which can provide significant counsel and oversight to the ATO in its activities. Other countries use this approach; the US[13,] Canada[14] and the UK[15] all have boards appointed by government which perform an oversight function of the relevant Revenue authority, with governance over budgeting and strategic planning, with the boards comprised of internal and external representatives from a range of different backgrounds. Some Australian government agencies have boards which make significant input into the activities or strategy, for example that of the Reserve Bank and the ASIC Advisory Board.

A board for the ATO might benefit both the ATO and the community by strategic input and governance over ATO relationships and strategies for improving the effectiveness and efficiency of its activities, including international competitiveness issues.

b) Separating ATO mechanisms to manage uncertainty and disputes from the audit function

To resolve the strategic blockage in the resolution of uncertain issues as between the ATO and business, Australia should introduce a capacity for an independent review of a dispute, before the ATO issues an assessment which must be disclosed in the financial statements of a business.

There are many precedents for independent review or advice, available to this review in other government contexts. Even the ATO uses a general anti-avoidance rules panel ("GAAR panel") in relation to matters involving the tax avoidance rules of Part IVA and similar rules, which includes various external business people and professionals. However the GAAR panel is solely advisory and the decisions are made by the ATO.

In the near term a mechanism could be developed for an independent review of an ATO dispute with a taxpayer by an independent review panel, potentially involving external representatives but quite separate from the ATO auditors. The internal review panel could operate in a quasi-judicial manner, with appearances by taxpayers and ATO officers, and could review the issue, its

[13] The IRS Oversight Board is a 9 member independent body charged to oversee the IRS in its administration, management, conduct, direction, and supervision of the execution and application of the internal revenue laws and to provide experience, independence, and stability to the IRS so that it may move forward in a cogent, focused direction. 7 members, confirmed by the Senate, have professional experience or expertise in key business and tax administration areas. The Secretary of Treasury and the Commissioner of Internal Revenue are also members of the Board. See http://www.treas.gov/irsob/

[14] Canada's Board of Management consists of 15 members, 11 nominated by the provinces and territories. It oversees the organization and management of the CRA, including the development of the Corporate Business Plan, and the management of policies related to resources, services, property and personnel. It does not have administer and enforce legislation or access confidential client information. .See http://www.cra-arc.gc.ca/gncy/brd/bm-bkgrd-eng.html

[15] The Board of HM Revenue & Customs has a non-HMRC chair, 3 non-executive directors and 4 non-HMRC advisers. See http://www.hmrc.gov.uk/board/index.htm

alignment with policy, and whether the matters should be settled by the ATO before an assessment is raised.

A longer-term issue is whether the GAAR panel should be statutorily permitted to make decisions in relation to GAAR matters rather than merely providing advisory input to the ATO.

6.3.2 *Reducing administrative complexity by a single revenue collection agency to administer state and territory taxes*

A national agency taking over all state taxes for all states should be explored as a strategy. The implementation might be gradual, on a tax by tax basis; for example the national agency might commence with payroll tax.

This single agency might be the ATO or, to create some competitive efficiency tension, a new agency assembled from elements of the existing state Revenue Offices, or another agency.

7. Minimising distortions

7.1 Reducing distortions from the revenue-capital distinction

A high priority tax reform is to clarify the distinction between capital and income in the tax law, with specific holding period rules (as are used in other countries) to replace the present uncertain position. Such rules would significantly reduce inefficiencies and enhance compliance.

In the medium to long term, the CGT law could be streamlined to reduce its bulk.

7.2 Enhancing superannuation and retirement savings

7.3 Reduce distortions and tax aspects impeding workforce participation

First, more analysis is needed to establish whether Australia’s personal tax rates are internationally competitive, identifying impacts for individuals on twice average weekly earnings (AWE), three times AWE and higher. These individuals, with marketable and valuable skills in the workforce, need to be retained in the workforce in Australia and they should not have to pay a higher, top rate, tax than their peers in other countries.

Second, Australia’s personal tax strategy will need to attract expatriates back to Australia, given the demographic challenges and the greater number of young Australians leaving Australia for some years and enjoying working in other countries with very competitive tax environments. Further incentives to repatriate Australians who are overseas should be explored, such as concessions similar to those given to temporary residents for a limited time after their return (the relief could be tapered to ease them back into what will still likely be a higher taxing regime in Australia).

7.4 Encouraging Australian savings by an improved treatment of capital income

Australia should consider reducing the tax which is imposed on interest income, in order to encourage savings by Australians. A preferred strategy is using a lower, schedular, tax rate on interest income. A schedular concession exists in many OECD countries, as noted in the TAP. A further alternative is a final withholding tax regime, used in some other countries.

Such concessions on interest income will need to be appropriately targeted to encourage savings for Australian households, for example by limiting the concession to interest on savings of say $200,000 (indexed annually) deposited in designated accounts, or to an amount of say $20,000 (indexed annually). The levels should be set to encourage savings by Australian salary and wage earners. [16]

[16] Canada introduced in 2008 a new Tax-Free Savings Account, a flexible savings vehicle that allows Canadians to contribute up to $5,000 a year to the account with all investment income, including capital gains, and withdrawals being tax-free. This amount is too low, in our view.. See http://www.budget.gc.ca/2008/plan/chap3b-eng.asp

Appendix 2

Tax deductions for purchased goodwill and intangible assets (question 6.2)

We provide further clarification of section 2.3.2 of our 2008 submission, about the need for improved tax treatment for business capital investment in intellectual property (intangible assets).

The consultation paper touches on this issue and makes various broad comments at pages 144, 145 and 146. These comments are set out at page 5 of our submission.

We are concerned that those comment suggest there is not a case for reform in relation to purchased intangible assets.

We reiterate the points made in our 2008 submission that:

a) the treatment of purchased intangible assets, acquired together with a business from a previous business owner, is inequitable when compared with the treatment of acquired plant and equipment
b) the Australian treatment is not internationally competitive;
c) this leads to an inappropriately broad tax base and higher tax liability for the business purchaser; imposes a tax deadweight which impedes Australian companies seeking to grow by purchasing businesses with strong IP; and
d) this systemic problem in the Australian system of taxing businesses is becoming ever more significant with the increasing significance of IP as a component of business value.

We submit that more detailed attention is needed by the Review to the long term impact of this issue for Australia, as a small open economy seeking to become more involved in the development of businesses based on intellectual property. Business assets comprise 'hard assets' and so-called intangible assets. The use of intangible assets has increased in the 21st century, with digital information supplies and with globally-networked and connected businesses and supply chains.

The Australian tax system and its treatment of purchased intangible property is confusing and not well integrated, and this expenditure is treated inequitably when compared with expenditure on 'hard' assets such as plant and equipment which is typically eligible for depreciation under the capital allowance rules of Division 40 of ITAA 1997. And buildings are eligible for amortisation under Division 43 of ITAA 1997.

The Australian Federal Government agency, IP Australia[17] lists the following categories of IP as requiring management because they have commercial value and significance in a business:

Identifiable intangible assets	Unidentifiable intangible assets
• Patents, trade marks and brand names	• Quality of the management team
• Copyrights and industrial designs	• Know-how
• Franchises and licences	• Marketing expertise/market profile
• Distribution agreements	• Management expertise
• Newspaper mastheads and publishing rights	• Distribution network
• Government quotas	• Economies of scale
• Covenants not to compete	• Technical skills
• Secret processes and formulas	• Program rights
• Information databases	
• Computer systems software	
• Core technology	

[17] http://www.iptoolbox.gov.au/default.asp?action=article&ID=179 IP Australia is the Australian Government agency responsible for administering patents, trade marks, designs and plant breeder's rights.

Identifiable intangible assets, for this purpose, are those that can be measured and quantified and have a separate identity and existence of their own independent of the business as a whole. Unidentifiable intangible assets are those that cannot exist independently of the business as a whole; but they are business assets.

Only some of these intangible assets are eligible for capital allowances:

a) certain expenditures by existing businesses on development of their own intangible assets are eligible for Division 40 amortisation[18], namely mining, quarrying or prospecting rights, mining, quarrying or prospecting information, in-house software, IRUs, spectrum licences, datacasting transmitter licences, telecommunications site access rights and rights as licensee or owner of copyrights, patents or registered designs.

b) An existing business is entitled to deductions for much expenditure involved in developing and enhancing its own business either as an ordinary tax deduction, or as a deduction over five years under section 40-880, provided that the complex conditions of that measure are satisfied.

c) However, when a business purchases another business (the target business) whether the target business is in a target company or acquired as an asset transaction, the acquirer is not entitled to a deduction for the business goodwill or trademarks under the capital allowance rules. Unless the assets constitute depreciable intangible assets they will broadly not be eligible for deductions under depreciation, amortisation or other rules while they are owned. This is because:

   I. purchased IP will, unless it is of insignificant size and extent compared with the existing business, be treated as capital and ineligible for deduction under the ordinary deduction rules.

   II. The "blackhole" rules introduced in 2005, which provide a five year amortisation of certain business expenditure[19], expressly prohibit that five year deduction in relation to expenditure to the extent that it:

> "*(a) it forms part of the *cost of a *depreciating asset that you *hold, used to hold or will hold;* or
> (b) you can deduct an amount for it under a provision of this Act other than this section; or
> *(c) it forms part of the cost of land; or*
> (d) it is in relation to a lease or other legal or equitable right; or
> *(e) it would, apart from this section, be taken into account in working out:*
> *(i) a profit that is included in your assessable income (for example, under section 6-5 or 15-15); or*
> *(ii) a loss that you can deduct (for example, under section 8-1 or 25-40); or*
> *(f) it could, apart from this section, be taken into account in working out the amount of a *capital gain or *capital loss from a *CGT event; or*
> *(g) a provision of this Act other than this section would expressly make the expenditure non-deductible if it were not of a capital nature; or*
> *(h) a provision of this Act other than this section expressly prevents the expenditure being taken into account as described in paragraphs (a) to (f) for a reason other than the expenditure being of a capital nature; … (emphasis added).*

The many exclusions mean that, when a business asset is acquired, much of the intangible property is not eligible for any write off.

[18] under s.40-30(2)
[19] Section 40-880 of ITAA 1997

This was confirmed in an ATO interpretive decision[20], dealing with a company acquiring franchise assets, knowledge and intellectual property from another:

> "The fact that the sale agreement describes confidential information, trade secrets and know-how as a separate item within the business format and attributes a part of the purchase price to it does not determine the character of the transaction…. the purchase price necessarily relates to the assets that comprise the various rights that enable the taxpayer to carry on the business.
>
> Consequently, the Commissioner considers that the purchase price, provided by the taxpayer as consideration for the acquisition of the business, is provided for all of the rights in relation to the trade marks, business names, domain names, patents, registered designs, copyrights, maintaining confidentiality and conducting the business. The price paid to acquire the business is, therefore, properly and wholly referable to those rights and not in any part referable to mere information which is neither real nor personal property. The rights held under copyrights, patents and registered designs are items of intellectual property for the purposes of the income tax law and are included in the definition of a depreciating asset under paragraph 40-30(2)(c). **The remaining assets listed above are CGT assets pursuant to paragraph 108-5(1)(b).**
>
> **A deduction under section 40-880 is not allowed to the extent that the capital expenditure is taken into account in some way elsewhere in the income tax law.** The capital expenditure incurred on acquiring the depreciating assets listed above forms part of the cost of the depreciating assets and is, therefore, excluded from deduction under section 40-880 by the operation of paragraph 40-880(5)(a). The expenditure incurred on acquiring the CGT assets listed above could be taken into account in working out the amount of a capital gain or capital loss from a CGT event because the expenditure forms part of the cost base of those assets. The expenditure will, therefore, be excluded from deduction under section 40-880 by the operation of paragraph 40-880(5)(f). " (emphasis added)

So the ATO states the acquisition of substantial intellectual property in the course of a business acquisition is ineligible for amortisation over five years under section 40-880 (as it is taken into account for capital gains tax cost bases purposes only). There is no other write off or amortisation available in Australia.

This tax treatment of intangible property is asymmetric when the acquirer acquires a business – unlike the position where 'hard' assets such as plant and equipment are acquired.

In particular:

a) the target, or investors in the target, receive enhanced capital proceeds from the transaction (to the extent that goodwill has been created in the target which has increased the price paid for it) which are subject to tax;
b) Australian taxation on those proceeds recoups any implicit tax expenditure which has been provided to the target or its investors through earlier tax deductions for the goodwill-building activities;
c) however, if the acquirer is not permitted to amortise the expenditure for Australian tax purposes (other than patents copyrights, registered designs and mining information), a deadweight cost is imposed for Australian tax purposes.

An Australian potential acquirer is disadvantaged by this uncompetitive tax policy as compared with a potential acquirer from the US, UK, Germany, Netherlands or other more competitive locations, when Australian companies are bidding to acquire other businesses which are rich in intellectual property. For example, an Australian company, which might be considering acquisition of a target which has significant business processes and knowledge which are simply a patent or copyright, will not be able to achieve the same write offs as would a competing bidder from the US or UK.

[20] ATO ID2009/3 at http://law.ato.gov.au/atolaw/view.htm?rank=find&criteria=AND~ato~basic~exact:::AND~ID~basic~exact:::AND~2009%2F3~basic~exact&target=JA&style=java&sdocid=AID/AID20093/00001&recStart=1&PiT=99991231235958&recnum=1&tot=2&pn=ALL:::ALL The ATOID involved an acquisition from an associated company, but nothing in the ATOID restricts the interpretation only to transactions involving affiliated companies.

This Australian tax policy setting remains just as uncompetitive as it was when the Ralph Review of Business Taxation (RBT) examined this issue in 1999. Despite its terms of reference preventing the RBT from recommending this reform outright, the RBT recommended that:

> "…the scope for amortisation treatment be re-examined should the current reforms prove to be more revenue positive than the estimates included in this report…. this treatment disadvantages Australian entities in competitive takeover situations where they are competing with bidders based in jurisdictions that provide taxation depreciation for acquired goodwill…."

The consultation paper suggests that "intangibles exhibit different rates of economic depreciation (or appreciation)". However, that is no reason not to undertake this necessary reform:

- that is why, in other countries providing a write-off for goodwill assets of this type, a generic long life is used. For example the US adopts a 15 year life for this purpose and the UK adopts a life broadly aligned to the amortisation of goodwill in the accounts of the acquirer or a fallback 25 year life.

- The lack of specific lives for particular assets is not a problem in making policy. The 2.5% Div. 43 allowance for buildings is provided notwithstanding that some buildings last for less or more than 40 years. The commercial life of a standard patent might be less or more than 20 years but that life is prescribed, and a standard 15 year life is prescribed for registered designs.

Action required

Australia needs an internationally comparable tax amortisation regime for purchased intangible property of businesses, to cover purchases made after an introduction date. The amortisation should be over an effective life of 15 years or, at the taxpayer's option, over the life adopted in a taxpayer's audited financial statements. Eligible business intangible assets would include the following assets, where they are acquired in the course of an acquisition of a business or company carrying on a business:

- Goodwill of the target business which is recorded under accounting standards;
- Intangible assets including the going concern value, amounts recognised as intangible assets in respect of workforce including its composition and terms and conditions (contractual or otherwise) of its employment, business books and records, operating systems, or any other information base;
- Any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item, any customer-based intangible, any supplier-based intangible, any franchise, trademark, or trade name and any other similar item;
- Any licence, permit, or other right granted by a governmental unit, agency or instrumentality; and
- Any covenant not to compete (or other arrangement with substantially the same effect) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business.

Such a reform would enhance Australian buyers' position in acquiring companies with knowledge-based businesses and:

- Reduce the current tax disincentive to invest in intangible assets;
- Increase the willingness of business to invest in development in business processes; and
- Enhance the scale, and retention, of ideas developed in Australia.

This is a manageable reform. The process used by then-Chancellor Mr Gordon Brown in the UK, which saw reform as recently as 2002, involved:

- the suggestion that the tax rules should be updated and harmonised being first set out in a consultation document issued on Budget Day 1998[21];
- consultation documents issued in July 1999, June and November 2000 and in March 2001;
- exposure draft law in November 2001[22]; and
- law introduced in the Finance Act 2002[23] , with a commencement date of 1st April 2002.

* * * * *

[21] http://www.hm-treasury.gov.uk/bud_bud98_index.htm The Budget theme was 'New Ambitions for Britain"
[22] http://www.hmrc.gov.uk/consult/index.htm
[23] http://www.hm-treasury.gov.uk/financebill_2002_index.htm - Clause 83 and Schedules 29 and 30 introduced a corporation tax regime for intangible assets (including intellectual property and goodwill). In particular, the proposed provisions permit a company to obtain tax relief for the cost of intangible assets, normally at the rate they are depreciated in its accounts. The explanatory materials are at http://www.hm-treasury.gov.uk/d/finance_bill02_83opt.pdf