PACIFIC BRANDS

Australia's Future Tax System

Submission 1:

Tax treatment of intangible assets

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Our ref Pacific Brands - intangible assets

By email

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Tax treatment of intangible assets

Pacific Brands welcomes the opportunity to make a submission to the *Australia's Future Tax System* ('AFTS') review. The AFTS review provides an opportunity to address long-term structural issues and to ensure that the tax system can support the Australian economy in meeting future challenges.

Our submission focuses on the specific area of the tax treatment of intangible assets which should be designed to assist the ownership and development of intellectual property as one of the key drivers of productivity and global competitiveness.

Our submission calls for the amortisation of purchased goodwill and other intangible assets over some predefined life of the asset, in a manner similar to that allowed for other forms of intellectual property such as patents and registered designs.

1 Summary

The broad policy reasons supporting our submission are:

1. The tax amortisation of goodwill will encourage the retention of intellectual property in Australia which will have flow on benefits resulting in the retention of and attracting the greatest minds to Australia.

2. Australia needs to be more competitive in this regard. Australia is one of only a handful of the thirty OECD countries that does not allow for some form of tax amortisation for goodwill.

3. Purchased goodwill and intangible assets are real economic outflows which should be treated in the same way as other assets acquired to ensure those businesses rich in these assets are not disadvantaged when compared to those which do not have such assets.

4 Now is an appropriate time to revisit this issue as the landscape has changed since the 1999 *Review of Business Taxation* ('the Ralph Report').

Each of these are discussed below in section 2.

In addition, we touch on other aspects of the taxation and commercial settings that are consistent with our submission. These are discussed in section 3.

Finally, we submit that if amortisation is not allowed for acquired goodwill and other intellectual property, at a minimum, a deduction should be allowed when these items are expensed in the accounts either as amortisation or impairment of the asset. This is discussed in section 4.

2 Broad policy reasons

2.1 Long term productivity and population goals

Intellectual property is vital to the long-term productivity of the economy. Our tax system should aim to foster both the development and retention of intellectual property in Australia. Goodwill and other intangible assets are linked to a specific business and therefore the most common method of transferring goodwill/other intangible assets offshore (to a more favourable tax regime) involves a transfer of some aspect of the connected business. Such businesses are often "high value" businesses in terms of intellectual property and may involve significant investment in the field of research and development.

The current tax regime confers a competitive advantage to the overseas owners of intellectual property compared with the Australian owners of intellectual property. There is a real cash flow disadvantage for Australian-resident owners of intellectual property, but a cash flow advantage for non-residents.

The Tax Office 2008 Compliance Program identified intellectual property as one of the specific areas of concern that it would be examining:

> *"The use of arrangements between related Australian and offshore entities to shift profits (and tax) from Australia to other countries, including restructuring of Australian-based operations to shift functions, assets and risks offshore, such as the sale of intellectual property at a nominal price in return for a royalty stream*[1]*"*

Conversely, an Australian tax regime more favourable to the treatment of intangible assets would provide more incentive for firms to relocate intellectual property to Australia together with the attendant research and development activities.

[1] Australian Taxation Office, Compliance Program 2008, p.52

A key concern in Australia is the attraction and retention of our greatest minds. If the tax system is designed to encourage ownership of intellectual property in Australia, this will more likely lead to the development of intellectual property in Australia rather than offshore. Accordingly, our population is retained, if not increased and our greatest minds will not need to relocate offshore to further develop our intellectual property.

There are currently about one million Australians living overseas. While Australians live overseas for a wide variety of reasons, many in the knowledge-based industries are doing so because the opportunities are more favourable to them in other countries. Part of the reason why these opportunities are more favourable overseas is that other countries are more attractive destinations for the development and ownership of intellectual property. If Australia had a more favourable environment for intellectual property, it would also be more desirable for the attraction and retention of a knowledge-based workforce.

In addition, the location of goodwill and intellectual property in Australia will provide a platform for our future generations to benefit. Where the intellectual property is further developed here it can be licensed to other jurisdictions and hence generate increased income flows into Australia. Any alternate system, such as the current, which does not attract the retention of intellectual property ownership within Australia encourages the converse and has the potential for long term negative impact on Australia both from revenue and population perspectives.

2.2 Australia compared

The existing Australian tax treatment of intangible assets is unfavourable to the ownership and development of intellectual property in Australia. In some cases, Australian taxpayers might be providing tax expenditures under the Research & Development tax concession or similar schemes to support the development of intellectual property that subsequently relocates to another more favourable jurisdiction for tax reasons.

The 2006 *International Comparison of Australia's Taxes*[2] (the 'Warburton-Hendy Report') noted that in comparing Australia's corporate tax base:

> *"Australia's treatment of depreciation, losses and goodwill is generally less favourable"*[3]

than other developed economies. A majority of the ten OECD countries compared with Australia in the Warburton-Hendy Report allow the amortisation of goodwill, which Australia does not permit. These countries (with broadly similar economies) included Canada, Japan, the Netherlands, Spain, Switzerland, the United Kingdom and the United States. The exceptions were Australia, New Zealand and Ireland. New Zealand does not have a capital gains tax

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[2] Warburton R & Hendy P, *International Comparison of Australia's Taxes*, 2006

[3] ibid, p.xvi

regime whilst Ireland is an attractive destination for business operations with its 12.5% corporate tax rate.

Further, Australia is only one of a handful of OECD countries that does not provide for tax allowance for goodwill. To be competitive, our system needs to be at least as favourable as that of our trading partners. To the extent our regime for taxing intangible assets is more favourable, Australia will become a more attractive destination for global business to hold and develop intellectual property and, therefore, contribute to the population matters described above.

Additional information on the comparative treatment of goodwill is set out in Appendix A.

2.3 Purchased goodwill and other intellectual property acquired are real outflows

Purchased goodwill and intangible assets are real economic outflows when acquired from another entity.

The current tax system penalises Australian entities which acquire these types of assets by not providing tax relief when compared to entities which acquire other forms of more intensive and tangible plant and equipment which are subject to tax relief.

In order to ensure that there is comparability between all industries and that those with high levels of acquired goodwill/intellectual property are not disadvantaged, the tax system should provide some form of equality and not differentiate between the two. This will have flow on benefits by ensuring that tax does not impact the allocation of resources away from industries highly dependent on intangible assets.

3 Other

3.1 Other forms of intellectual property

Australia’s depreciation regime allows for the amortisation of other forms of intellectual property including software, patents, registered designs, copyrights, licences and telecommunication site access rights.

There appears to be no fundamental policy reason as to why goodwill and other intellectual property such as trade marks and brand names which are clearly distinct intellectual property assets in their own right should not also be subject to the tax amortisation regime.

3.2 Goodwill is generally considered an active asset

As a general rule, the Australian tax regime treats goodwill as a “beneficial” or “non-mischievous” asset. For example, in Subdivision 768-G, goodwill is considered as an active asset for the purposes of the active foreign business asset percentage test.

Under the proposed changes to the thin capitalisation rules, where goodwill is impaired for accounting purposes, the gross value of goodwill is allowed to be taken into account in determining a company's gross assets.

Thus, again, there appears to be no essential rationale for excluding goodwill from the depreciation / amortisation regime by virtue of the fact it is clearly an active business asset as recognised in other parts of the tax law and not an asset that causes some form of mischief.

4 Accounting treatment inconsistency

Should our submission in relation to a "pure" amortisation regime not be accepted, as an alternate measure we would argue strongly for a regime where tax deductions for intellectual property such as goodwill, customer contracts, and client lists etc. are allowed where an expense is recognised for accounting purposes.

This would be consistent with the current trend of simplification and the alignment of tax and accounting in some areas of the tax law, for example, TOFA.

5 Time for review

The Ralph Report recommended that the existing treatment of goodwill should be retained, but also suggested that the issue should be re-visited:

> *"… the Review has decided that the existing treatment be retained. It does so with the proviso 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.*
>
> *In coming to this conclusion, the Review recognises that 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. This has become more significant with the change in accounting standards referred to above."*[4]

Since the Ralph Report, the Australian tax system has experienced highly revenue positive levels of corporate tax receipts. In the 1999 Federal Budget corporate tax raised less than $24 billion and represented less than 15% of revenue and 3.7% of GDP. The 2008 Federal Budget projects corporate tax receipts of more than $73 billion, representing over 24% of revenue and 6.4% of GDP. We contend that the revenue positive circumstances foreshadowed in the Ralph Report clearly exist for the re-examination of the tax treatment of goodwill.

Almost a decade after the Review of Business Taxation it is now appropriate to reconsider the tax treatment of intangible assets. We need to be competitive with tax policy developments

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[4] Review of Business Taxation, 1999, p.332

incomparable economies, alert to concerns expressed by the Tax Office and address key issues of consistency with existing tax law and the accounting treatment.

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The AFTS Review provides policy-makers with the opportunity to revisit the tax policy settings for intellectual property. In doing so it can create a tax regime that enhances productivity through the development and retention of intellectual property in Australia and benefits the Australian population through the attraction and repatriation of a knowledge-based workforce. The AFTS Review provides us as a nation with opportunity to add significant value for the long term benefit of Australia. We submit that providing tax amortisation for goodwill and other intellectual property is an important measure in achieving these aims.

I advise that Pacific Brands' taxation advisers are KPMG and PricewaterhouseCoopers.

Please do not hesitate to contact me on 03 8803 1446 should you wish to discuss these issues further.

Yours sincerely,

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Appendix A – tax treatment of intangible assets compared

Australia

Intangibles are non-deductible and intangible assets should generally be depreciated on the basis of their effective life as determined by the Tax Office or Treasury. *The 2006* International Comparison of Australia's Taxes[5] *(the 'Warburton-Hendy Report')* noted that in comparing Australia's corporate tax base, "Australia's treatment of depreciation, losses and goodwill is generally less favourable"[6] than other developed economies. Over half of the ten OECD countries compared with Australia allow the amortisation of goodwill, which Australia does not permit.

International comparisons

Canada

Certain intangible assets such as patents, franchises, concessions and licences for a limited period can be amortised over the life of the asset on a straight-line basis. Alternatively, taxpayers may choose to amortise the cost of patents or rights to use patent information using the diminishing value method at a rate of 25%.

Other intangible assets such as purchased goodwill, franchises, concessions and licenses for an unlimited period can be amortised under the eligible capital expenditure system. In this case, 75% of the cost can be amortised at a maximum rate of 7% per year on a declining balance basis.

United Kingdom

The United Kingdom introduced a new regime for the taxation of intangible assets with effect from 1 April 2002. The reform followed a review of the taxation of such assets and was introduced in recognition of the important role of intangible assets in today's knowledge driven economy. The reforms were also considered necessary for the UK to compete with jurisdictions such as Germany, the Netherlands and the United States of America.[7]

Under the new regime, the taxation of intangible assets for the corporate sector is aligned to the accounting treatment. Broadly:[8]

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[5] Warburton R & Hendy P, *International Comparison of Australia's Taxes*, 2006

[6] Ibid, p.xvi

[7] See Reform Of The Taxation Of Intellectual Property Goodwill And Other Intangible Assets: A Technical Note By The Inland Revenue available at http://www.hmrc.gov.uk/consult/ct_reform.htm; Reform of the Taxation of Intellectual Property, Goodwill and Other Intangible Assets: The Next State available at http://www.hmrc.gov.uk/consult_new/ct_reform2.pdf.

[8] See, 'Corporate Intangibles, Research & Development' available at http://www.hmrc.gov.uk/manuals/cirdmanual/cird00501.htm.

- In most cases the tax relief is based on the amortisation reflected in the company's accounts. There is also provision for tax allowances at a fixed rate of 4% per annum to provide for relief in the case of indefinite or longer life assets.
- The new rules apply to expenditure on the creation, acquisition and enhancement of intangible assets (including abortive expenditure), as well as expenditure on their preservation and maintenance. Relief under the new regime is therefore available for the cost of internal development, as well as acquisition, of intangible assets.
- Payments for the use of intangibles are also within the scope of the new regime. The charge on income rules no longer applies to royalty payments and relief is given in line with the accounting treatment. The taxation of royalty receipts also follows the accounts.
- Disposals of intangible assets are taxed on an income basis under the new regime. A roll-over relief applies where disposal proceeds are reinvested in new intangible assets within the regime.
- Intangible assets that companies hold at commencement will generally be taxed under current law, subject to the changes in roll-over relief described below.
- Capital gains on the disposal of intangible assets held at commencement will qualify, where appropriate, for roll-over relief under the new arrangements for intangible assets.

United States

The taxation of intangible assets is dealt with by section 197 of the Internal Revenue Code. Under that section, the following assets must be amortised over a period of 180 months (fifteen years):

(a) Goodwill.

(b) Going concern value.

(c) Workforce in place.

(d) Business books and records, operating systems, or any other information base, including lists or other information concerning current or prospective customers.

(e) A patent, copyright, formula, process, design, pattern, know-how, format, or similar item.

(f) A customer-based intangible.

(g) A supplier-based intangible.

(h) Any item similar to the items (c) through (g).

(i) A license, permit, or other right granted by a governmental unit or agency (including issuances and renewals).

(j) A covenant not to compete entered into in connection with the acquisition of an interest in a trade or business.

(k) Any franchise, trademark, or trade name.

(l) A contract for the use of, or a term interest in, any item in this list.

However, for items (a) to (h), amortisation is not available for assets that are created rather than acquired unless they are created in acquiring assets that make up a trade or business or a substantial part of a trade or business.

PACIFIC BRANDS

Australia's Future Tax System

Submission 2:

Individual taxation issues

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By email

16 October 2008

Individual taxation issues

Pacific Brands welcomes the opportunity to make a submission to the *Australia's Future Tax System* ('AFTS') review in respect of the taxation of individuals. The AFTS review provides an opportunity to address long-term structural issues and to ensure that the tax system can support the Australian economy in meeting future challenges.

Our submission focuses on the areas of individual taxation which we believe have a significant impact on employee welfare and participation levels within the Australian workforce. Pacific Brands employs over six thousand Australians. We consider some of the key issues affecting them are childcare affordability, the cost of higher education and the heavy taxation on single income families.

Summary

In summary, our submissions are:

1. Childcare – enhancing female workforce participation through salary sacrifice arrangements and exempting childcare costs from FBT.

2. Education – removing Higher Education Loan Program (HELP) fees to encourage greater student participation, develop our brightest minds and ultimately build a more competitive economy.

3. Income splitting – providing the option to income split. This addresses the inequity where a single income family may pay a greater proportion of tax when compared to a double income family.

Each of these proposals is discussed below.

1 Childcare

The provision of childcare is a key barrier to increasing participation by women in the workforce and with many family relationships in which the responsibility for children is shared between parents; it can also constrain the productivity of the other partner. The OECD noted in introducing its recent *'Babies and Bosses'*[1] research:

> *If parents cannot achieve their desired work/family life balance, not only is their welfare lower but economic development is also curtailed through reduced labour supply by parents. A reduction of birth rates has obvious implications for future labour supply as well as for the financial sustainability of social protection systems. As parenting is also crucial to child development, and thus the shape of future societies, policy makers have many reasons to want to help parents find a better work/family balance.*[2]

Childcare has immediate consequences for female participation in the workforce and arguably for population issues over the longer term. Pacific Brands is acutely aware of the issues associated with female participation in the workforce and the issues of childcare. Almost two-thirds of our employees at Pacific Brands are women and about one third of them, or more than 20 per cent, are of child bearing age. By comparison, the most recent Australian Bureau of Statistics data[3] reveals that the national average for female employment is much lower at about 45 per cent of the workforce. We typically have up to sixty women on maternity leave at any given time and our experience has been that about 40 per cent of women who take maternity leave are unable to return to their jobs because of a lack of access to suitable and affordable childcare.

While acknowledging that much is being done to assist the provision of childcare in the form of tax rebates, we feel that this could be enhanced. Specifically, we propose that an alternative to the current childcare tax rebates regime would be to enable employees to salary sacrifice childcare fees levied by approved childcare facilities that were not located at the workplace. Work, commuting and travel patterns vary considerably among our employees and a clear preference would be to have considerable flexibility in the location of childcare facilities. Salary sacrifice arrangements would also offer a more immediate benefit than the quarterly childcare tax rebates. Based on experience with our own workforce, we believe that a flexible ability to salary sacrifice childcare charges would have a significant long-term impact on increasing participation in the workforce after the birth of a child. We therefore suggest that employees should have the option of accessing either the current childcare tax rebate or utilising a salary sacrifice arrangement.

The current Fringe Benefits Tax (FBT) exemption for childcare applies to organisations that provide the childcare on their own premises. While some major employers have been able to provide childcare on their premises and have reportedly increased their post-maternity leave return to work rates to above 80 per cent, the FBT exemption effectively discriminates against

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[1] Organisation for Economic Cooperation and Development, *Babies and Bosses; reconciling work and family life*, 2007

[2] http://www.oecd.org/document/45/0,3343,en_2649_34819_39651501_1_1_1_1,00.html

[3] Australian Bureau of Statistics, *Labour Force 6202.0*, September 2008

small to medium enterprises and ignores the fact that many businesses have no desire to own, operate and bear the risk of running childcare centres. Further, the FBT exemption implies that the childcare should be provided at the workplace, irrespective of the fact that employees may desire different arrangements, such as childcare provided closer to home. We therefore propose that in addition to the salary sacrifice option proposed above, that the existing FBT exemption for childcare should be widened in order to make it available for all childcare costs.

Much of the emphasis on childcare issues is focussed on women as the primary caregivers and increasing female participation in the workforce, there are also many families in which these responsibilities are shared more widely between parents. In the case of such families the provision of childcare should also lead to an increase in the workforce participation rate by men.

2 Education

Education is an important driver of future productivity in the Australian economy and deepens our understanding of community issues. Higher education benefits individuals, companies, communities and the nation. We need to develop our people by upgrading their skills and knowledge by providing higher education for people from all backgrounds.

To further support higher education, Pacific Brands propose the abolition of HELP (formerly HECS) fees for the first degree/course so that higher education is free for all Australian citizens who meet the entry requirements.

We feel that removing the economic burden from higher education will encourage greater student participation, develop our brightest minds and ultimately build a more competitive economy. In addition, the initial cost of free higher education is more than compensated by the higher wages and increased taxes that the individual pays over their employment life.

3 Income splitting

At present, a single income couple earning the same amount as a two-income couple would get just one tax-free threshold and could pay a higher tax rate on the remaining income. This inequity could be remedied by a system that allows for income splitting.

Joint or family taxation arrangements exist in some form in about a third of OECD economies including the major economies of France, Ireland, Switzerland and the United States.

We suggest that the Review should consider a possible option for families to income split. This would involve changing the way a family is taxed. For example, a single income family would be taxed such that the single income would be split between the taxpayer and his/her spouse equally. In most instances each individual would benefit from the current tax-free thresholds and reduced levels of taxation.

The tax splitting (averaging) of dual income families would also result in more equitable taxation by recognising the shared allocation of responsibilities within the family or income earning unit.

By providing families with the option to be taxed in this way, each family would be able to assess what is in its best interests and hence the tax and transfer system would work in manner that suits all recipients.

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The AFTS Review provides an opportunity to address issues relevant to individual Australians in the tax and transfer system that can lead to increased participation, increase productivity and have benefits for the population over the longer term. We suggest that using the tax system to enhance the provision of childcare, encouraging higher education and giving Australians an option to income split will help to achieve these goals.

I advise that Pacific Brands' taxation advisers are KPMG and PricewaterhouseCoopers.

Please do not hesitate to contact me on 03 8803 1446 should you wish to discuss these issues further.

Yours sincerely,

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