KPMG submission

House of Representatives Standing Committee on Economics

Inquiry into tax deductibility

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Executive Summary

Thank you for the opportunity to lodge a submission to this Inquiry on Tax Deductibility. KPMG believes tax reform is a very high priority for Australia and welcomes your interest in the reform agenda.

Our submission focuses on three issues: work related expenses, personal capital taxation which includes deductibility of interest on income producing assets and potentially limiting the deductibility of interest referable to business income. The KPMG Submission on Tax Reform made to Treasury in response to the *Re:Think Tax Discussion Paper* deals with the first two issues, so it is included as an attachment to this submission. Dealing with each of these issues:

- **Work related expenses**. Our view is that there should be a threshold under which no work related expenses should be claimed by individuals. Above the threshold, claims can be made on proof of expenditure, but subject to a cap. The cap should be fixed and the threshold indexed so that deductibility of work related expenses would be phased out over time. There should be no attempt to distinguish between good and bad work related expenses and no flow through to employers if similar payments were to be made by the employer. This is an example where simplicity should be paramount.
- **Personal capital taxation**. KPMG's view is that there should be consistent personal capital taxation with a 25% discount applied to interest income, interest expense for income producing assets, net rental income, capital gains and unfranked dividends. This brings the effective rate on different items of capital closer together and thus has fairness and efficiency benefits.
- **Limiting interest deductibility for businesses**. Our strong view is that a limitation on interest deductibility for business would inhibit businesses seeking growth through debt funding, certain infrastructure businesses, and foreign investment to the extent that the limitation fell below current thin capitalisation limits. There would also be significant issues flowing from a wholesale conversion of debt to equity to fall below any proposed limits. Equity markets would not have the capacity to absorb this change. There is the potential for a significant reduction of economic activity. Such a proposal also invites structuring to get around the rules which in turn would invite very complex rules to limit avoidance.

Detailed comments

1 General

1.1 KPMG lodged a submission to the Federal Government's *Re:Think Tax Discussion Paper*. It is attached to this submission. Our *Re:Think Tax Reform Submission* covers two areas of concern of this committee where we propose changes: work related expenses and personal capital taxation. It is our view that these changes should be considered having regard to the system as a whole.

1.2 Our *Re:Think Tax Reform Submission*, however, does not discuss limitations of interest deductions for domestic businesses or modification to the thin capitalisation rules. This is because we would oppose a limitation on domestic interest deductions for businesses. While there may be some scope for modifying the thin capitalisation rules, we would not see further restrictions as a basis for reducing the company tax rate. We have dealt with our view on the limitation of domestic interest deductions in some detail below.

2. Work related expenses

2.1 Put simply we believe that deductions for work related expenses should be replaced by lower personal tax rates.

2.2 To give effect to our recommendation, there should be a limitation on work related expenses up to a particular limit. Expenditure above that limit could be claimed with proof of expenditure, but with a cap. The cap could be a fixed amount and the threshold could be indexed to wage inflation such that work related expenses are fully "cashed out" over time. By "cashed out" we mean eliminated and converted into lower personal tax rates.

2.3 Tax systems are generally evaluated on fairness, efficiency and simplicity. Rarely does simplicity win out in the Australian tax system. This is ripe for simplicity. Trying to delineate between good and bad work related expenses and to provide non-deductibility for equivalent expenditure for businesses is fraught with complexity out of all proportion to the taxation impacts.

2.4 There is the question of where the threshold and the cap should be set. This is a balance between what is palatable with the community and the efficiency derived from "cashed out" work-related expenses. The threshold should be as high as possible and cap as low as possible.

3. Personal capital taxation

3.1 Our view is that personal capital income should be treated consistently with a 25% discount. This should apply to interest income, interest expense to acquire income-producing capital assets, net rental property income and expense, capital gains and losses without regard to an ownership period and unfranked dividend income.

3.2 The reason for this proposal is relatively simple. It brings the effective tax rate on personal capital taxation closer together. Thus, for example, a positively geared rental property is treated less detrimentally and a negatively geared property is treated less favourably.

3.3 The advantages are consistency, fairness and less distortionary behaviour. There are also benefits on gender equity as outlined in our *Re:Think Tax Reform Submission.* We believe there are considerable benefits from considering personal capital taxation as a whole and not "picking off" component parts.

4. Deductibility of interest incurred by business

4.1 Implicit in the terms of reference is consideration of a proposal to cap or indeed extinguish interest deductions for domestic business. There are already limitations on large foreign owned companies and Australian multinationals. They are our thin capitalisation rules. The thin capitalisation limitations address a different problem. They are concerned with Australia taking an inappropriate debt burden either in absolute terms or by reference to the gearing of a multinational group as a whole. This is a separate issue and is not specifically mentioned as a point of focus for the inquiry.

4.2 Underlying the proposal, is the widespread call for a reduction in the company tax rate. This call, which is supported by KPMG, is largely based on the fact that company tax is one of the most inefficient and distortionary taxes. Adopting the words of economists, it has a high marginal excess burden. It is argued that a reduction in the rate would lead to higher foreign direct investment, capital deepening, greater productivity and ultimately higher real wages. This would benefit a broad group in the economy.

4.3 This is a long term picture. At the present time, however, the world appears to be flush with cash without an investment home. Much of this capital is timid, preferring to invest in debt instruments carrying very low interest rates while demanding relatively high rates of return for equity investment. This environment is likely to change and a lower company tax rate would stand Australia in very good stead when it does.

4.4 A basic axiom of tax policy is that it is best to lower the rate and broaden the base. This is implicitly recognised in the terms of this inquiry. The reason is that this leads to less distortionary behaviour, a better allocation of resources and thus higher growth.

4.5 Capping the deductibility of interest for domestic business is not base broadening in this sense. In a trade-off involving capping, or indeed eliminating, interest deductions for domestic businesses in exchange for a reduction in the company tax rate, the effective tax rate remains unchanged. It is just calculated differently but with the benefit of a lower headline rate.

4.6 In another sense, however, it creates its own distortions and detrimental disincentives and this is what is problematic about the proposal. Those disincentives particularly impact growing businesses relying more heavily on debt capital for funding, which would become more expensive under the proposal. At the present time, where the difference between the cost of debt and the cost of capital is substantial, the problem is particularly acute.

4.7 The essential problem with an interest deduction cap – company tax rate reduction trade-off is as follows:

a) It impedes growth industries that rely predominantly on debt funding for expansion;

b) It impedes infrastructure growth where projects rely largely on high levels of debt funding. These projects involve stable cash flows, often based on an "availability charge", which enable higher gearing. The cost of the project falls because the cost of debt is significantly lower than the cost of equity and the gearing is high. In fact in this sector the real incidence of the trade-off would be on Government through higher infrastructure costs as tender prices become less favourable to the public sector;

c) It would present huge disruption as companies reduce debt (from banks) to the deductible limit and seek equity funding (from equity markets) which would be stretched beyond capacity. The debt-equity switch would not give rise to new investment. Indeed it would "crowd out" new equity investment as equity markets would be stretched to the limit. Moreover, existing investment could contract as equity markets are not able to fill the hole met by current bank borrowings. This could lead to a reduced economy in the long run;

d) It invites planning particularly through the use of multiple companies that are not consolidated for tax purposes, which in turn invites rules of substantial complexity. A simple example which subverts an interest cap limitation is provided in the Appendix. The solution to this problem involves bringing in the debt of associated entities into a company's debt limitation calculation, then somehow allocating debt deductions under the "group limit" to all associate entities. This is highly impractical and the antithesis of simplicity. Other planning may involve, say, long dated payment for trading stock or other assets that gives rise to bi-furcation of an interest component, which is subject to interest deduction limitation rules and a remaining component; and

e) If the limitation was to fall below the current safe harbour thin capitalisation limit for foreign companies (that is 1.5 : 1 debt to equity), then it would present a significant detriment for foreign investment. This is because for foreign investment into Australia the cost of debt is much cheaper than the cost of equity. The further denial of interest deductions beyond the current limits would adversely impact investment decisions.

4.8 The companies that may be positively impacted by the proposal are lowly geared Australian companies, leaving aside the very significant issue of the equity disruption. Also the proposal would promote lower gearing. However, Australian companies are already lowly geared by international standards. This is at least in part due to our imputation system which lowers the cost of domestic equity capital, thereby reducing the differential with the cost of debt.

4.9 For the theoretical average company, the trade-off does not present a real economic benefit as a true base broadening exercise might. The benefit is impressionistic only, with a lower headline rate for company tax, but the same effective tax rate.

4.10 Two remaining points. Firstly, there is an adage that an old tax is a good one. This is because the passage of time has allowed for smoothing out problems. This proposal would involve a very significant number of problems that would need to be smoothed out, because it is so fundamental. Secondly, it is not without accident that there is no similar OECD country with a widespread domestic limitation on debt deductions. Australia has not had a happy experience of venturing out on its own in taxation matters, for example the Taxation of Financial Arrangements. There would be benefit from taking "advice" from international experience or lack of it.

4.11 We wish you well in your deliberations. Should you wish to contact us regarding the submission, please feel free to do so.

Appendix

1. Current position without deduction limitation – gearing 1.5 to 1

Old A Co			
Business asset	200	Bank debt	120
		Equity	80
	200	Total	200

$120 debt on which interest is deductible

2. Debt deduction limitation rule based on gearing of 1 : 1

Old A Co			
Business asset	200	Bank debt	120
		Equity	80
	200	Total	200

$80 debt on which interest is deductible

3. Revised after converting $20 debt to equity

New Sole A Co			
Business asset	200	Bank debt	100
		Equity	100
	200	Total	200

$100 debt on which interest is deductible

4. Restructured after incorporating a subsidiary B Co

New Parent A Co			
Shares in Sub	160	Bank debt	80
		Equity	80
	160	Total	160

$80 debt on which interest is deductible in Parent Co

Subsidiary			
Business asset	200	Bank debt	40
		Equity	160
	200	Total	200

$40 debt on which interest is deductible in Sub Co

Combined A & Subsidiary Co			
Business asset	200	Bank debt	120
		Equity	80
	200	Total	200

$120 debt on which interest is deductible in Combined

Rules could force tax consolidation in item 4 (adding complexity) but limiting debt deductions to $80 and not $120. Where the subsidiary was not 100% owned, complex rules on associated entity debt would need to be put in place. This would add significantly to the complexity.