



## Australian Private Equity & Venture Capital Association Limited

15 January 2016

Committee Secretary  
Standing Committee on Economics  
PO Box 6021  
Parliament House  
Canberra ACT 2600

Email: [economics.reps@aph.gov.au](mailto:economics.reps@aph.gov.au)

Dear Sir / Madam,

### **Submission on the Standing Committee on Economics Inquiry into Tax Deductibility**

The Australian Private Equity and Venture Capital Association Limited (AVCAL) appreciates the opportunity to make a submission to the above inquiry by the Standing Committee on Economics.

AVCAL is the national association representing the private equity (PE) and venture capital (VC) industries in Australia, with \$28 billion in funds under management. VC and PE are key sources of capital investment for Australian companies of all sizes, to enable their growth and realise their potential. Our members invest in a range of enterprises with high growth potential, ranging from startups. SMEs to management buyouts of large established companies.

It is worth noting that for many years, AVCAL has been an advocate for taxation reform which helps to make our economy more competitive by stimulating new investment into Australian businesses and new employment opportunities.

Any taxation reform which has the effect of changing the incidence of taxation on businesses has to be calibrated against key factors such as the mobility of capital and international integration and competition. As a net capital importing jurisdiction, the Australian economy cannot – and should not – put in place policies which diminish our capacity to attract investment from offshore. The future of Australia's economic prosperity relies to a very large extent on our ability to grow and expand our foreign direct, and indirect, investment base.

In the sections below, we have set out our views on key aspects of the Committee's work as part of this inquiry. The Committee should be aware that our views relate only to the impact of tax policy changes in respect of businesses.

#### **1. Interest deductibility is a vital building block for growth**

The existing corporate income tax model, which provides for the deductibility of interest costs against assessable income, is a core foundation of our taxation system.

AVCAL is not aware of any compelling broad-based evidence to support a conclusion that this core principle of our tax system is artificially distorting business decision-making across our economy.

Some of the key points supporting this argument are:

- **Relief for interest payments is a significant part of nearly all corporate tax systems around the world.** The availability and extent of such relief is important not just for financing business operations. It is also routinely considered within the context of decision-making by investors on the merits of investing in a particular business. The availability of deductions for interest costs is therefore fundamental to the overall competitiveness of the Australian business sector.
- **Limiting interest deductibility will result in higher borrowing costs for Australian businesses,** and hinder their capacity to fund further expansion, innovation and job creation.
- **Debt, including convertible instruments which may be classified as debt for tax purposes, is important for attracting capital to firms with new technologies or uncertain prospects.** The use of such instruments is common in early stage financing. Removing their deductibility status would have a negative effect on the ability of startups to attract funding.
- **Limiting interest deductibility to fund corporate tax reductions will likely reduce net long-run economic growth.** Economic modelling by EY for the US economy shows that a rate reduction financed by limiting interest expense deductions would result in a 9.6% increase in the marginal effective tax rate on new investment in the corporate sector, a fall in GDP by 0.2% over the long run, a fall in investment by 0.3%, a fall in economic welfare (measured by household consumption and leisure) by 0.4%, and a fall in employee compensation by 0.05%.<sup>1</sup>
- **Equity and debt financing are not functionally equivalent, hence concerns about so-called “debt bias” does not justify removing interest deductibility.** Debt and equity are not substitutes for each other. Differences in attached rights and obligations, expected returns, terms, tenures and risks mean different tax treatments are warranted.

## 2. Importance of investment certainty and global benchmarking for the corporate tax framework

AVCAL believes that it is important that Australia provides to local and international investors an efficient and competitive environment for the financing and funding of investments.

Investors need certainty regarding the national laws and regulations – especially in relation to tax – before they will put significant capital to work in specific jurisdictions over a long-term period.

It is therefore vital that the Inquiry gives consideration to the important role of corporate interest deductions – including the thin capitalisation framework – in the competitiveness and investment risk profile of Australian businesses.

For example, the current thin capitalisation regime is designed to ensure that multinationals do not allocate an excessive amount of debt to their Australian operations. The regime operates by limiting the otherwise deductible borrowing expenses where the debt allocated to Australian operations.

Investors and businesses need to operate within this framework with the understanding and certainty that any future reforms will not be enacted without appropriate grandfathering or transitional arrangements.

Unfortunately, changes to the thin capitalisation rules in recent years – such as the reduction in the safe harbour thresholds – have already had significant negative effects on a number of Australian businesses and their investors. The lack of appropriate transitional provisions has forced these businesses to review and restructure their financing operations, at substantial cost. In some cases they have had to retrospectively apply the alternative arm's length debt test if they did not meet the new safe harbour thresholds. This has had a significant negative impact on the financial return of these businesses.

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<sup>1</sup> EY, *Macroeconomic analysis of a revenue-neutral reduction in the corporate income tax rate financed by an across-the-board limitation on corporate interest expenses*, July 2013.

For investors in these businesses, the lack of transitional measures imposes a huge regulatory risk on their investments as it may not be possible to refinance investee entity balance sheets within the reduced thin capitalisation ratios. This is particularly problematic where interest withholding tax continues to be collected on interest which is denied deductibility. Such double taxation does not sit well within the context of fair and equitable tax reform, and puts Australia on a heightened regulatory risk level with foreign investors.

It is within this context that AVCAL is of the view that for Australia to position itself as an attractive global investment destination, its business tax system must be simple to understand and comply with, competitive and effective in attracting new investment whilst maintaining the revenue base and economic efficiency.

### 3. Recommendations of previous reviews

It is important to consider the recommendations of recent extensive consultations and reviews of corporate interest deductibility by the Henry Tax Review (2009) and the Board of Taxation's *Review of the Arm's Length Debt Test* (2014) and *Review of the Debt and Equity Tax Rules* (2015).

**The Henry Review** reviewed the range of alternative options for taxing company income. These included the current source-based tax on the full nominal return to equity, a comprehensive business income tax model that taxes the full return to capital (debt and equity) albeit at a possibly lower marginal rate, and the business-level expenditure tax model (which can be imposed on either a source or destination basis).

The Review concluded that, while removing interest deductibility may facilitate a reduction in the company income tax rate, it would also reduce the effectiveness of the corporate tax base as a backstop to the personal income tax system. It also concluded that this option would also increase the cost of debt financed investment, and cause significant transitional issues for highly leveraged businesses.<sup>2</sup>

As a result, it recommended that the company income tax model should be retained in its present form. The Review also concluded that the thin capitalisation and transfer pricing rules should continue to be used as mechanisms to ensure that what is judged to be the appropriate level of tax is collected from investments in Australia.

**The Board of Taxation's *Review of the Arm's Length Debt Test* (2014)** highlighted the importance of keeping the arm's length debt test (ALDT) within the thin capitalisation framework, noting that:

*"However, although not many taxpayers rely on the ALDT, they are generally of the kind that contributes significant economic activity within the services, resources and infrastructure industries. Based on submissions to the review, without the ALDT, many major projects that are highly leveraged particularly in the early stages would be at risk. Naturally, any potential disincentives caused by the Australian tax system are a concern to taxpayers and the Government"* (pp. 5-6).

**The Board of Taxation's *Review of the Debt and Equity Tax Rules* (2015)** examined Australia's debt and equity tax rules in comparison with global markets and made the following observations:

*"The Board is of the view that it is important for Australia that the tax system allows businesses to compete on a neutral basis, does not unduly hinder business decisions, and enhances Australia's status as an attractive place for business and investment.*

*The Board also understands that Australia has one of the most robust tax regimes amongst OECD member countries. Specific rules have been introduced to protect Australia's ability to exercise its jurisdiction to tax. The rules have been further strengthened by recent reforms to transfer pricing and the general anti-avoidance rule in Part IVA.*

*The Board is of the view that the Australian debt and equity tax rules are fundamentally different to tax rules in other jurisdictions. Despite the differences, the Board considers that the Australian debt and equity tax rules do not,*

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<sup>2</sup> *Australia's Future Tax System: Final Report to the Treasurer*, ("The Henry Review"), Part 2, Volume 1, pp.164, 180.

*in and of themselves, create international arbitrage opportunities such that the domestic rules should be amended to address these potential mismatches.”*

Removing interest deductibility would make Australia an exception in global markets, require a wide-ranging review of capital structures and a significant shift in investment structuring, and from an international context may also raise opportunities for tax arbitrage.

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In summary, AVCAL’s view is that interest deductibility should remain a core element of Australia’s corporate income tax system, given the significant role that the principles plays in facilitating business activity and economic growth.

It should also be noted that there is no evidence that limiting interest deductions can effectively “pay for” corporate tax reductions to generate net long-term growth.

Neither is there any evidence that the availability of interest deductions has led to the excessive use of leverage in the business sector. In fact, there are many safeguards in the current prudential regulatory framework – such as bank capital adequacy rules and APRA requirements, and the corporate tax system – such as the thin capitalisation rules, debt equity rules, transfer pricing rules and anti-avoidance laws, to appropriately stamp out any practices which seek to artificially use excessive leverage and protect the integrity of Australia’s business income tax base.

If you would like to discuss any aspect of this submission further, please do not hesitate to contact me or Dr Kar Mei Tang.

Yours sincerely,

**Yasser El-Ansary**  
Chief Executive  
AVCAL