REVIEW OF BUSINESS TAXATION

SUBMISSION BY THE PULP & PAPER MANUFACTURERS FEDERATION OF AUSTRALIA

SUMMARY

The PPMFA strongly supports the proposed 30% corporate income tax rate. However, to assist in attracting investment to highly capital intensive industries such as pulp and paper, the PPMFA considers that a 50% loading should be applied to the economic lives of assets, as a replacement for the current accelerated depreciation regime.

The PPMFA is fundamentally opposed to the introduction of a deferred company tax (DCT), as it represents an additional tax at the company level on account of shareholder distributions. In addition, it would potentially increase the 15% withholding tax on unfranked dividends paid offshore to 36%.

Although the PPMFA supports the concept of company consolidation for tax purposes, it favours a more flexible consolidation regime which is more in line with the consolidation rules applying in New Zealand. There should not be a requirement for a resident Australian holding company.

The PPMFA strongly supports the retention of the immediate tax deductibility of expenditure on the planting and tending of plantations.

The PPMFA supports any proposal to dispense with fringe benefits tax (FBT) and to attribute the taxable value of fringe benefits to the relevant employee. The PPMFA supports the removal of "non-remuneration" benefits, such as on-premises car parking and meal entertainment, from the FBT net. While the PPMFA does support the alignment of the FBT and income tax years, this proposal would be impractical with the new reportable fringe benefit requirements.

The PPMFA supports the removal of indexation and averaging in order to achieve the capping of a capital gains tax (CGT) rate for individuals at 30%, or the adoption of a stepped rate of CGT dependent on the time over which an asset is held.

INTRODUCTION

The Pulp & Paper Manufacturers Federation of Australia (PPMFA) appreciates the opportunity to provide a submission to this Review.

The PPMFA was established in 1981 and represents the interests of the five major companies which collectively produce 97% of the paper and paper products manufactured in Australia. Its member companies are Amcor (Australian Paper), Carter Holt Harvey Tissue Australia, Kimberly-Clark Australia, Fletcher Challenge Paper Australia, and Visy Industries.

The pulp and paper industry has fixed capital investments of $3.9 billion; annual sales of $3.1 billion; directly employs approximately 8,000 people, and has a further impact on the employment of an additional 100,000 people. It is a significant employer in regional Australia.

The pulp and paper industry is the most capital intensive manufacturing industry in Australia. It is an integral part of a highly competitive, globalised industry.

The PPMFA believes the current business tax system is complex, unpredictable, and at times obscure. As a consequence, Australian business bears high compliance costs and is confronted with a level of uncertainty that inhibits project development and job creation.

The PPMFA considers that the creation of an internationally competitive business taxation regime will generate substantial benefits for the Australian community. It welcomes the current review of business taxation, headed by Mr John Ralph, as a first step in this process.

KEY ISSUES

1. REDUCTION IN CORPORATE TAX RATE

The PPMFA strongly supports the proposed 30% corporate income tax rate. We acknowledge that this cannot be achieved in a fiscally responsible way without the removal of certain tax preferences. As discussed in *A Platform for Consultation*, the removal of the current accelerated depreciation regime provides one way to fund a lower corporate tax rate.

The PPMFA argues, however, that the complete removal of accelerated depreciation provisions would disadvantage capital intensive industries to a much greater extent than less capital intensive sectors of the economy. This would have important implications for future investment decisions in capital intensive industries. Consequently we believe that a loading should be applied to the economic lives of assets. This loading could be specifically targeted towards capital intensive industries, and should be at least 50%.

We are concerned about the forthcoming review of the schedule of economic lives for plant to be undertaken by the Commissioner of Taxation. Until such a schedule is produced it is difficult to support without qualification the removal of accelerated rates, with or without the application of a loading to the economic life of plant.

Analysis undertaken by members of the PPMFA concerning future investment decisions indicates that the proposed 30% corporate rate will compensate in a significant way for the loss of current accelerated depreciation rates. However, this assessment is on the basis of a loading being applied to the economic lives of assets, and retention of the current 125% tax concession for R&D expenditure.

In our view it will be necessary to ensure that the present value of the R&D incentive is maintained if the corporate tax rate is reduced to 30%. The R&D incentive has operated effectively for nearly 14 years, and has contributed to employment creation, greater competitiveness, export enhancement, import replacement and improved production processes.

2. DEFERRED COMPANY TAX (DCT) AND RESIDENT DIVIDEND WITHHOLDING TAX (RDWT)

The PPMFA is fundamentally opposed to the proposed introduction of a deferred company tax (DCT). Such a tax would represent an additional tax at the company level on account of shareholder distributions.

A resident dividend withholding tax (RDWT) would be the preferred option. However, we are concerned about compliance costs and the implications for non-resident shareholders. In respect of non-resident shareholders, as we understand the proposal, a refund would be provided to a non-resident and dividend withholding tax would apply to the refund. There is a concern that this withholding may not be creditable in some foreign jurisdictions. It may be necessary to renegotiate some of Australia's double taxation treaties to achieve this outcome. If a RDWT is to apply, such renegotiation should commence as a matter of priority.

Deferred Company Tax

The proposal that all company distributions will need to be fully franked, along with a system of applying DCT to distributions where insufficient franking credits arise, will have a major negative impact on many companies.

Companies previously paying unfranked or partly franked dividends will either have to pay lower cash dividends or pay the DCT.

There will be a cash-flow impact for a company, if at the time a dividend is paid the company has insufficient franking credits available to fully frank that dividend. This is because the company will be required to pay DCT at the time of distribution.

Under the current proposal, we are concerned that DCT once paid will not be able to be utilised against a later company tax assessment. In this scenario it is considered that the requirement to pay this additional company tax on account of shareholder distributions will be reflected in the tax expense of the company. The impact on the profit of companies, and the perceptions of performance flowing from this, needs serious consideration.

Companies with large numbers of foreign shareholders on their books may find their share price depressed. All dividends paid to non-resident shareholders will bear Australian tax at an effective rate of 36%. At present unfranked dividends paid to a non-resident shareholder bear Australian withholding tax at an effective rate of between 15% and 30%, depending on what country the shareholder resides in. Where a dividend payment is received by a non-resident shareholder, the effect of the change will be to subject unfranked dividends to a 36% DCT payment. To the non-resident this replaces withholding tax with a higher underlying corporate tax payment. Non resident shareholders are therefore potentially worse off if they are exempt in their jurisdiction or, if taxable, they are likely to encounter problems in obtaining foreign tax credits.

Australian companies with significant foreign source income will be disadvantaged compared to those which are focussed purely in the domestic market. If a company repatriates profits from its overseas operations by way of dividends to Australia these will largely be exempt from Australian tax with no credit for foreign taxes paid (for franking or other purposes). However, distribution of these profits to shareholders as a dividend will require payment of DCT by the company. The proposal may encourage Australian companies to re-invest foreign profits overseas and not repatriate profits back to Australia.

The proposed new system would mean that tax concessions (e.g. timing differences, R&D expenditure) have no after tax value to the company because distributed tax-preferred profits will now be subject to tax at the entity level. This proposal may also change the behaviour of companies, especially if the lack of company tax paid is due to timing differences.

Given the application of deferred company tax to the tax preferred profits at the entity level, rather than at the investor level, there will be significant incentive for entities to retain these profits for future investment, rather than to distribute the profits to shareholders and to obtain further invested funds when required.

For the reasons outlined above, the PPMFA does not believe DCT is a suitable method of achieving the Government's objective. Maintenance of the present system, or a system where there is no effect on the profit and loss account of the dividend paying company, is our strong preference.

Resident Dividend Withholding Tax

The PPMFA supports the RDWT option, because it does not have the harsh impact on corporate profits of a DCT. A RDWT would ensure that all distributions through the entity chain are subject to full corporate tax, and that distributions to individuals are taxed at source. This would satisfy the Government's integrity concerns. However, dividend streaming rules, dealing with situations such as where franked dividends were paid to some shareholders and unfranked dividends to others, would remain.

Taxation of unfranked inter-entity distributions

This option achieves similar outcomes to the first two options in relation to inter-entity distributions. However, unfranked dividends paid to individual shareholders are not taxed at source, but are taxed in the recipient's hands. This could give rise to integrity concerns, as potential exists for unfranked dividends not to be declared as income. Dividend streaming rules would remain with this option, but there would be reduced compliance costs, as there would be no need to pay DCT, or deduct RDWT on unfranked dividends.

Inter-company dividends

The multiple taxation of dividends flowing between companies is currently addressed through a rebate system. This system works because companies within a corporate group are treated as separate legal entities. This distinction would be lost under the consolidation proposals. Where a consolidated group is in an overall tax loss position, dividends received from outside the group would have to be offset against those losses, resulting in the losses being wasted. If this is not addressed, a number of corporate groups will incur significant financial losses.

We understand two possible solutions have been proposed: a dividend deduction or a modified exemption system. The PPMFA recommends that these solutions be given serious consideration by the Government.

Conclusion

The PPMFA's strong preference is for retention of the current system. If one of the full franking options is to be adopted, the PPMFA's preferred option is a resident dividend withholding tax, although some modification for the treatment of inter-company dividends and the impact on tax losses would be required.

3. GROUP TAX CONSOLIDATION

In general, the PPMFA supports the concept of company consolidation for tax purposes. However, the proposed consolidation rules are radical and inflexible, and in our view are detrimental to the corporate sector. We favour a more flexible consolidation regime which is more in line with the consolidation rules applying in New Zealand.

The need for a resident Australian holding company

The consolidated entity regime would not be available to a group of Australian companies unless there was a single Australian holding entity. Many foreign groups may therefore need to restructure.

This is a departure from the existing grouping eligibility criteria in relation to revenue and CGT losses and roll-overs which are part of the current partial consolidation regime, and which the new consolidation regime is designed to absorb and expand.

The need to have a common Australian parent before consolidation is available is contrary to each of the aims of the review process of equity, efficiency and simplicity. It could result in fragmented and smaller consolidated groups, the wasting of tax attributes that could otherwise be utilised in a larger group context as is the case at present, and would also require the same ultimately wholly-owned group to prepare more than one consolidated return.

Indeed, introducing a requirement that there exist a common Australian parent company before consolidation is available would unnecessarily limit the availability of the regime, particularly to foreign multinationals doing business in Australia. Many such groups organise their different business units as separate operating groups, rather than all under the same umbrella Australian holding company. Given that another of the aims of the Ralph Committee is to foster Australia's international competitiveness by ensuring that the business tax system does not influence business decisions unnecessarily, to impose such a requirement would discriminate against such international investment.

Compliance costs

Although the consolidation rules are touted as being elective, in essence they are compulsory. No corporate group could operate efficiently from a tax perspective without entering into the proposed consolidation rules. This will in itself cause large compliance costs as corporate groups are forced to restructure to enable them to meet the one holding company requirement.

The repeal of the current grouping provisions is premised on the basis that:

i. Consolidation would replace grouping.

ii. The current grouping provisions have problems of integrity and compliance costs.

In relation to (i) we do not believe the proposed consolidation rules adequately replace the grouping provisions. The consolidation rules are far more restrictive because of their all or nothing nature, and the one holding company requirement. It is a top down consolidation which, as previously noted, will preclude some international groups from entering into the regime.

The proposal to repeal the current grouping provisions is premised on the fact that loopholes in the rules are being exploited by corporate groups, in particular the cascading of losses. This concern should not be the driving force behind repealing the entire grouping provision. Any loopholes in the grouping rules should be plugged with amending legislation to prevent loss cascading and other perceived gaps in the legislation.

Existing losses would be foregone under the proposals to the extent they would not be brought into the consolidated group. This would firstly have a negative earnings and balance sheet impact for many companies as the recognition of benefits would have to be reversed. Secondly, we do not accept that the long standing practice of allowing tax loss grouping and tax loss carry forward can be simply removed or severely restricted.

Contrary to the Committee’s comments that compliance costs will be reduced, it is our view that there will be no significant change in compliance costs. As already noted some groups will be forced to restructure to get into the consolidation regime. Once within the regime it will be necessary to maintain records to enable the accurate reconstruction of cost base when an entity exits the consolidation.

Dividend rebates and tax losses

As mentioned above, the multiple taxation of dividends flowing between companies is addressed through the rebate system. Under the current system, when a company in a group receives dividends and the group has tax losses from its underlying business operations in other companies, the flow of the dividends can be controlled to ensure that the benefit of the rebate (or loss) is not wasted. Controlling dividend flows to avoid such wastage has been a feature of basic corporate tax planning for a long time. The techniques used to control dividend flows do not involve avoidance of tax – they do no more than avoid destroying shareholder wealth by wasting legitimate tax losses incurred by a group.

Entry/exit rules

To facilitate exit at entity level from a consolidated group, the discussion paper proposes that the cost bases of assets (including goodwill) could be adjusted on entry by allocating the difference between equity and asset cost bases across all of the assets based on their comparative market values. On exit, the cost base of equity would be calculated by reference to the cost bases of assets in the departing entity.

Alternatively, equity cost base on exit could be established on the basis of the price paid for the equity (by the group at the time of entry into the group) plus the net change in the aggregate cost base of the assets of the entity while held by the consolidated group. Any capital gain or loss on exit would be the difference between the sum of the assets cost bases on entry and exit.

Given that the complex tracking of asset movements will still be required, coupled with the other tracing rules on exit, it is questionable whether a consolidation regime would alleviate much of the administrative complexity for corporate groups. It could even make it more complex.

Joint and several liability

It would seem from the proposals that, on exiting the group, the deconsolidated entity takes with it none of the group’s beneficial tax attributes such as accumulated tax losses and franking credits.

The argument could therefore be made that because the deconsolidating entity would forego the tax attributes it generates while a member of the consolidated group when it exits, it should also be entitled to forego any associated liability, at least from a tax perspective.

The resolution of this issue is important, particularly as it is likely to impact on the value placed on acquiring other entities that are members of consolidated groups.

Conclusion

The PPMFA would support a consolidation regime which has the following features:

- Elective.

- Does not require a resident Australian holding company.

- Preserves existing carry forward losses and franking credits.

- Allows for more than one consolidated group within a wholly owned group of companies.

- The consolidation rules should not replace the current grouping rules, but should operate alongside or within the current grouping rules.

- Any perceived deficiencies within the grouping provisions should be fixed with amending legislation.

4. PLANTATIONS (TRADING STOCK)

Currently expenditure on planting and raising crops for sale or use in a business is immediately deductible for tax purposes. However, crops do not constitute trading stock for tax purposes until harvested. Accordingly, there is no requirement to bring their value to tax until they are either harvested or sold with the land. For annual crops this treatment does not raise significant problems. However for long-life crops, the Ralph Committee considers that current treatment provides a significant tax deferral benefit that is not available to other investments.

The reform option proposed is to move the tax treatment closer to accounting treatment, and defer deductions on planting and raising crops until the value of the crop is realised.

The PPMFA strongly supports the retention of immediate deductibility for the following reasons:

- Removing the immediate deductibility will result in a substantial one-off increase in the after tax cost of annual plantation investment now, and over the longer term will be a substantial impediment to increasing the area of new plantings.

- The Accounting Standard AAS 35 provides the ability to expense as incurred plantation development and maintenance costs for statutory reporting purposes.

- Tree plantations are a long-term investment.

- Investors have to wait a long time (20-30 years) for their first returns.

- Plantations already face a substantial impediment to investment because of the lack of efficient secondary markets. This situation is exacerbated by the inability to gain immediate deductibility for the purchase of standing trees.

- Plantations are often low yielding assets with slow asset turnover.

- New plantations create substantial downstream processing opportunities and jobs in value-added downstream processing in regional Australia (1 direct job + 3 indirect jobs for every 1,000m^3 harvested).

- A supportive taxation regime is required if the Federal and State Governments' 2020 Vision for a tripling of plantation development is to be realised.

- Removing the immediate deductibility will substantially reduce the IRRs on already low yielding assets and cause a cessation of new planting.

De-minimus rule - $10,000 (Wasting Assets)

The proposed capping at $10,000 of aggregate $300 write-offs is unhelpful. Given the objective of improving the efficiency of the tax system, having to capitalise minor amounts under $300, rather than expensing them, is clearly objectionable.

Blackhole expenditure

The PPMFA supports the review of blackhole expenditures, i.e. those that are currently non-deductible or can't be included in the cost base of an asset. Where the benefit of the expenditure is immediate it should be deductible. Where it is indeterminate, there should be amortisation over a period not exceeding 10 years.

5. FRINGE BENEFITS TAX (FBT)

The PPMFA supports any proposal to dispense with FBT and attribute the taxable value of fringe benefits to the relevant employee. The PPMFA strongly supports the removal of "non-remuneration" benefits, such as on-premises car parking and meal entertainment, from the FBT net.

We appreciate that there is some cost to revenue in the above proposals and that there may be a case to review the concessional treatment of motor vehicles.

If the Government decides that the employer is to continue to pay FBT, then the PPMFA considers it is essential that action is taken to lessen the administrative burden for employers in complying with the FBT laws. The FBT Reporting Bill could also be revisited to address provisions that impose complex and costly compliance requirements for little benefit.

Taxing fringe benefits on employees

The proposal shifts the taxation burden from the employer to employees, but the administrative burden remains with the employers. The employer would still be required to calculate the value of benefits and report this on employees' group certificates. The discussion paper does not deal with the manner in which the proposal would fit in with the PAYE provisions. Therefore, the compliance difficulties currently being experienced by employers in relation to the government's proposal to require fringe benefits to be allocated between employees and reported on group certificates have not been addressed.

Cars

The result of implementing either of the alternative valuation methods in the discussion paper would be that the attractiveness of salary packaging a car will decrease significantly for higher paid employees. While there is a strong case in principle for the valuation of car fringe benefits to be brought closer to commercial values, the PPMFA stresses the need to keep the valuation rules simple.

Entertainment and car parking

The PPMFA supports a return to non-deductibility of entertainment with no FBT. The rules relating to FBT and entertainment are an example of how out of control the administrative requirements have become. The reversion of entertainment to non-deductible/non-FBT'able would reduce the horrendous compliance costs associated with the very complex application of the law adopted by the ATO.

The PPMFA supports the proposal to exclude on-premises car parking benefits from FBT. We agree that the cost of such parking is a deductible business expense and should remain so. Removing car parking provided on premises would also significantly reduce compliance costs.

Alignment of the FBT and income tax years

The PPMFA agrees that alignment of the dates would be useful. However, this would be impractical given the new reportable fringe benefits requirements under which fringe benefits need to be disclosed on employees' group certificates which must be provided within 14 days of year end. If alignment were to occur, the lodgement date for the FBT return would need to be extended. A lodgement date of 28 days after the end of the FBT year (as is currently the case) would not be practical as tax and accounting personnel responsible for preparation of FBT returns would be otherwise occupied with year end financial accounting and reporting obligations.

Therefore, the PPMFA considers the alignment proposal in its current form to be unworkable.

6. CAPITAL GAINS TAX (CGT)

The PPMFA supports the aims outlined in the discussion paper, including the need to strike a balance between the collection of an appropriate contribution to revenue, and the importance of encouraging investment, attracting capital and creating a more vibrant capital market.

We support the removal of indexation and averaging in order to achieve the capping of a CGT rate for individuals at 30%, or the adoption of a stepped rate of CGT dependent on the time over which an asset is held.

The PPMFA does not support the introduction of a $1,000 per annum CGT tax threshold.

We consider the script for script rollover relief for the merger of two separate entities to be a long overdue reform in the CGT area. However, it should not be restricted to listed public company shares.

7. ANTI-AVOIDANCE RULES

The PPMFA considers that the Government should detail any proposed anti-avoidance measures in response to John Ralph's letter to the Treasurer of 22 February 1999 to enable informed public comment.