

# **TAX REFORM AND AUSTRALIAN TECHNOLOGY INDUSTRIES**

## **SUBMISSION TO THE REVIEW OF BUSINESS TAXATION**

### **TECHNOLOGY TAXATION ALLIANCE**

**AUSTRALIAN INFORMATION INDUSTRY ASSOCIATION**

**AUSTRALIAN ELECTRICAL AND ELECTRONIC MANUFACTURERS'  
ASSOCIATION**

**AUSTRALIAN TELECOMMUNICATIONS INDUSTRY ASSOCIATION**

**ASIA-PACIFIC SMART CARD FORUM**

**AUSTRALIAN INTERACTIVE MULTIMEDIA INDUSTRY ASSOCIATION**

**INTERNET INDUSTRY ASSOCIATION**

*Prepared in Conjunction with*

**PRICEWATERHOUSECOOPERS AUSTRALIA**

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## EXECUTIVE SUMMARY

The Technology Taxation Alliance consists of six major Information Technology and Telecommunication (IT&T) industry associations, representing more than 1,100 member firms, with \$50 billion in revenues, and over 200,000 employees. Fundamental tax reform is essential for Australia's IT&T sectors to reach their full potential globally and domestically for the provision of advanced products, software, systems and services.

Australia is experiencing high levels of economic growth and the IT&T sectors have a vital role to play in maintaining this growth. For example, in the USA, IT&T is credited with being responsible for more than 25% of real economic growth and for lowering inflation by one full percentage point. It also plays a central role in business investment and in employment creation, especially long-term, highly paid jobs.

The IT&T sectors in Australia have also performed impressively, growing three times faster than the economy and increasing their share of GDP to more than 8.2%.

However, the sectors are still not performing to their potential, particularly in the area of trade. While IT&T exports have grown considerably in the last decade, and much more rapidly than imports, the trade deficit continues to grow, reaching more than \$8 billion in 1997/98. The projected trade deficit for 1998/99 is approximately \$10 billion. Under status quo conditions it is projected to grow to \$A22-46 billion by 2005. Domestic demand for IT&T products and services far exceeds domestic capacity.

The reasons for the inadequate capacity of the industry in Australia include:

- investment in global scale IT&T production facilities in Australia is minimal, especially compared with countries such as Ireland, USA, UK, Malaysia, Singapore, Thailand and Taiwan. As a result, Australia is a net importer of most IT&T products; and
- while there are some notable exceptions, the local industry is essentially small scale and domestically focussed; in particular it is hampered by an immature capital market for IT&T investment.

Tax reform is critical to turning this performance around.

The Technology Taxation Alliance and its members believe tax reform is essential if Australian technology industries are to grow, attract investment, generate exports, raise the national level of technical skill and sophistication, and encourage and reward entrepreneurship. Tax reform is also an essential pre-requisite for turning around the trade performance noted above. In particular, a lower corporate tax rate will make Australia a more attractive location for global scale investments in IT&T production facilities.

The power of government policy to create an environment in which innovative technology companies can flourish has been demonstrated in many countries, most notably the United States and Israel where tax policies explicitly encourage innovation and investment. Capital gains tax policy and the tax treatment of venture capital funds have created a major competitive advantage in those countries where government encourages high-risk

investments, and ensures that the returns on those investments are available for reinvestment in the technology sector.

Drawing on the unique characteristics of the technology industries, and with reference to the policies and experiences of other developed nations, the Alliance makes specific recommendations in seven areas of Australian taxation policy. A summary of these recommendations follow:

## **CORPORATE TAX RATE**

The Technology Tax Alliance strongly endorses the adoption of a 30% corporate tax rate. (Section 1.0)

The alliance would support removal of accelerated depreciation subject to the adoption of a number of suggestions with regard to deprecation and effective life.

The Alliance strongly opposes a re-introduction of distribution requirements such as those that applied under Division 7 of the 1936 Act (Section 1.0)

## **CAPITAL GAINS TAX**

- The Alliance recommends a stepped CGT model for ‘active’ long-term business investments held a minimum of 5 years. (Section 2.1)
- Extension of Australian tax-free status to foreign exempt pension funds investing in Australian venture-backed companies. (Section 2.2)
- Provisions for rollover of realised capital gains within limited partnerships and similar venture-backed investment vehicles. (Section 2.3)
- Elimination of CGT liability on share-for-share transactions where shares exchanged have equivalent value. (Section 2.4)

## **WIDELY HELD TRUST FLOW-THROUGH**

The Alliance supports the flow-through of taxation of tax-preferred earnings derived on “venture-backed” investments by collective investment vehicles. (Section 3.0)

## **DEDUCTIONS**

### **Research & Development Tax Concession**

The Alliance recommends the introduction of a 200% rate of R&D deduction. (Section 4.1)

### **Deduction of ‘Blackhole’ Expenditures**

The Alliance favours the write-off of ‘blackhole’ expenditures as outlined on pp 100-102 of *A Platform for Consultation*. (Section 4.2)

### **Expanded Definition of Wasting Assets**

The Alliance recommends an expanded definition of wasting assets to include a wider, more commercial definition of intellectual property. (Section 4.3)

## **INVESTMENT IN OR BY OVERSEAS ENTITIES**

### **Treatment of Overseas Dividends**

Allow franking credits for foreign tax paid in non tax haven countries by Australian entities. (Section 5.1)

### **Resident Dividend Withholding Tax**

The Alliance supports the proposal for a resident dividend withholding tax in place of the deferred company tax proposal outlined in *A New Tax System*. (Section 5.2)

### **Dividend Withholding Tax Rates under Double Tax Agreements**

Australia’s double tax agreements must be renegotiated as a matter of urgency to eliminate foreign and Australian dividend withholding tax on dividends paid into or out of Australia, or reduce dividend withholding tax rates. (Section 5.3)

### **Withholding Tax on Royalties**

Australia’s double tax agreements must be renegotiated as a matter of urgency to eliminate Australian and foreign royalty withholding tax on royalties paid out of and into Australia. (Section 5.5)

## **EMPLOYEE SHARE OPTION PLANS**

The Alliance recommends deferring the taxation on employee share options until a gain is actually realised (ie. when the relevant shares are sold by the employee and funds are available to pay tax). (Section 6.0)

## **CONSOLIDATED GROUP RULES**

The Alliance supports the proposed reform of Consolidated Group rules on the following basis:

- 100% common ownership should be a pre-requisite for consolidation, subject to an appropriate allowance for outside employee share ownership;
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- there should be certain technical modifications to the proposed regime to resolve some anomalies and uncertainties in it.

## INTRODUCTION

The **Technology Taxation Alliance** includes six leading Australian industry associations in the areas of computer hardware, software, services, electrical equipment and communications, electronics manufacture, electronic commerce and the internet:

- Australian Information Industry Association (AIIA)
- Australian Electrical and Electronic Manufacturers' Association (AEEMA),
- Australian Telecommunications Industry Association (ATIA)
- Asia-Pacific Smart Card Forum (APSCF)
- Australian Interactive Multimedia Industry Association (AIMIA)
- Internet Industry Association (IIA)

The Alliance represents an unprecedented instance of related associations joining together to address a critical issue with a common voice. Together, these associations represent more than 1,100 Australian technology firms with:

- \$A 50 billion annual turnover;
- 200,000 Australian employees;
- average 15 % annual growth rate; and
- representing more than 8.2% of Australia's GDP.

The Alliance and its members believe tax reform is vital for the future of the technology industries in Australia, in order to:

- encourage the growth of high technology firms;
- foster an entrepreneurial business culture;
- attract domestic and international investment – including venture capital investment - into technology companies;
- encourage investment in research and development;
- remove unnecessary cost imposts on businesses; and
- ensure appropriate rewards for entrepreneurs and employees in the industry.

## **THE ROLE OF THE INFORMATION INDUSTRY IN ECONOMIC PERFORMANCE**

Governments' most important challenge is to provide an economic climate which facilitates wealth creation and employment for their citizens. The IT&T industry sectors are the key to meeting this challenge. Governments around the world and within Australia have long recognised the importance of the sectors and the need to encourage their growth. This is for a number of reasons:

- IT underpins the competitiveness of all industry sectors and access to the latest technology is critical for international competitiveness;
- The IT&T industry is the fastest growing industry sector globally – in 1997 it was worth approximately \$US1800 billion, about 6% of global GDP, and growing at about 7% per annum (compared to global GDP which is growing at about 5.5%);
- The IT&T industry is the fastest growing sector in international trade – in 1995, trade amounted to \$US600 billion, accounting for 12% of world trade, up from 4% in 1983; and
- The industry is characterised by high valued added and by high value jobs.

Recent data from the USA show the IT&T industry has made a major contribution to the impressive performance of the US economy through the 1990s. Indeed, the Chairman of the Federal Reserve Board, Allan Greenspan, has explained to Australia's Prime Minister the central role of IT in driving economic growth in the US. While the full economic impact of the industries cannot be precisely evaluated, their impact is undoubtedly significant.

The IT&T industries in the US have been growing at more than double the rate of the overall economy, and are responsible for more than 25% of real economic growth. In five years, 1993-1998, the sectors' share of US GDP has grown from 6.4% to 8.2%. IT&T also plays a central role in business investment, accounting for more than 45% of all business equipment investment in the US. Declining prices for IT&T products have lowered inflation by a full percentage point. On the jobs front, the 7.4 million people employed in the US in the IT&T industries and IT&T related jobs earned on average 64% more than the average earnings for private sector employment

However, the greater economic contribution of the information industry is through application of the technologies across all sectors of the economy. Precise measures of the value of increased productivity and new capability have been difficult to obtain. But recent studies from the US reveal:

- a gross marginal return from information technology usage of 86.5% over 1988-92, compared with 8.5% for capital and 1.2% for labour;

- gross marginal benefits of information technology usage among Fortune 500 companies of more than 60%;
- one unit of computer capital contributes as much to the growth of output as 98 units of other forms of capital; and
- information systems (IS) labour expenditure generates several times as much output as expenditure on non-IS labour.

Performance in Australia is broadly comparable.

With regard to the IT&T industry itself in Australia:

- The industry is growing at three times that of the economy and real GDP in the communications industry trebled between 1990 and 1996, compared with a 15% increase in manufacturing; and
- The sectors share of GDP has risen to more than 8.2%.

#### *Contribution to Trade*

However, the sectors are still not performing to their full potential in Australia, particularly in their contribution to trade.

- *Australian* exports of IT&T products and services have increased substantially, from A\$1.5 billion in 1990 to more than A\$3 billion in 1995; from the broader information industry, exports exceeded A\$4 billion, ranking sixth in exports, well ahead of wool, wheat and meat.
- However, *Australian* share of international trade in IT&T is extremely low, at 0.3%, compared with a 1.2% share of GDP and a 2.4% share of IT&T market.
- The *Australian* trade deficit in IT&T was estimated at A\$7-14 billion in 1995 (depending again on industry definition), and is projected to grow, under status quo conditions, to A\$22-46 billion by 2005.

A trade deficit in IT&T is not of itself necessarily a bad thing, as it reflects the very high levels of technology take-up in Australia. Indeed, domestic demand far exceeds domestic capacity to supply. However, a sustained deficit of this magnitude would have an impact on our overall balance of trade, our exchange rate and the economy generally.

The main reasons for the inadequate domestic capacity are:

- Investment in global scale IT&T production facilities in Australia is minimal, especially compared with countries such as Ireland, USA, UK, Malaysia, Singapore, Thailand and Taiwan. As a result, Australia is a net importer of most IT&T products.
- While there are some notable exceptions, the local industry is essentially small scale and domestically focussed; in particular it is hampered by an immature capital market for IT&T investment.

Despite this, the IT&T industry is an important, rapidly growing, industry on which the whole economy is highly dependent. In the future, its importance will only increase, as the full potential of the information economy is realised.

The Technology Taxation Alliance believes that Australia needs to be both a smart user of information technology and an important developer and supplier of information industry goods and services. The application of information and communications technology will be the key to future productivity growth and job creation. It will underpin the competitiveness of all Australian industries including the export sector.

### ***Tax Reform and the IT&T Industry***

Overall, the Australian tax environment has proved an impediment to investment, capital raising and employee retention for high technology industries, and generally speaking, technology companies face a better environment in other developed countries. Recent taxation changes have not always been beneficial to the IT&T sectors. The reduction in the R&D tax concession to 125% has led to significant falls in R&D. Changes to the depreciation arrangements for software expenditure have added 5-7% to software costs.

Issues of specific concern to technology companies include:

- Australia's corporate tax rate exceeds that of many other developed economies.
- Capital gains tax and the treatment of limited partnerships restrict the availability of equity and other finance for small firms.
- The tax system encourages investment in real estate and other areas that add nothing to national competitiveness, and discourages riskier investments in technology firms.
- The current 125% R&D tax concession provides only a marginal incentive for high technology companies.
- The application of withholding tax to royalty payments penalises trade in intellectual property and dividend withholding tax rates negotiated under Australia's international double tax agreements penalise Australian-owned groups that globalise.
- Employee Stock Option Plans (ESOPs) are a key factor in motivating and retaining talented people, but Australian law imposes barriers rather than offering incentives to the implementation of ESOPs.

The Alliance believes the right tax regime would benefit the technology industries by:

- encouraging capital formation;
- stimulating and rewarding innovation; and
- attracting investment, including overseas venture capital.

In recent years many studies, commissioned by government as well as by the private sector, have addressed these issues and have reflected broad agreement on most. The public discussion of issues encouraged by the Review of Business Taxation, and recent speeches and articles by a number of cabinet ministers, have sent welcome signals to the technology industries that CGT reform, as well as other measures designed to foster capital formation for emerging technology companies, have top priority with this government.

The members of the Technology Taxation Alliance welcome this new direction, will work to encourage constructive dialogue and will lend their support to programs that address these issues in a comprehensive and realistic manner.

## **POLICY AND INNOVATION: INTERNATIONAL BENCHMARKS**

Decades of research and experience tell us that the vast majority of new products and new business models come out of small companies. The sheer number of patents filed by an IBM or Bell Labs is very impressive, but the technologies that create new industries, wealth, jobs and internationally competitive businesses are usually the work of small, creative teams, often with venture funding.

### ***United States***

Nothing illustrates better the effectiveness of government tax and regulatory policy in stimulating an industry than the explosive growth in technology companies and venture capital investment that began in the United States in the late 1970s and continues at record levels in 1999.

The following summary of “Legislative Impact on Venture Capital Investment” is from William Bygrave and Jeffrey Timmons, *Venture Capital at the Crossroads* (Harvard Business School, 1992), the most detailed study of the history and dynamics of venture investment in the US:

- The 1978 Revenue Act reduced the prevailing capital gains tax rate from 49.5% to 28%, thereby creating the first major tax incentive for long-term equity investments since the late 1960s. This resulted in a tenfold increase in capital commitments for venture capital funds during the following year.
- The 1979 ERISA [Employment Retirement Income Security Act] “Prudent Man” Rule governing investment guidelines for pension fund managers was revised and clarified to allow for higher-risk investments, including venture capital arrangements.
- The 1980 Small Business Investment Incentive Act redefined venture capital firms as business development companies, removing the need for them to register as investment advisers with the Securities and Exchange Commission (SEC). Fewer reporting requirements and the elimination of the risk of violating investment adviser regulations gave investors more flexibility.
- The 1980 ERISA “Safe Harbor” Regulation stated clearly that venture-capital fund managers would not be considered fiduciaries of pension fund assets invested in the pools (venture capital partnerships) that they managed. This gave venture capitalists more freedom and removed a serious risk exposure in accepting pension funds as limited partners.
- The 1981 Economic Recovery Tax Act lowered further the capital gains tax rate paid by individuals from 28% to 20%, causing a twofold increase in commitments to venture capital funds in 1981.

Individually and collectively, these five pieces of legislation completely revamped the venture capital industry, both immediately and throughout the next decade to the present, resulting in a tenfold increase in the size of the US venture capital pool.

This summary would have little point if venture capital had been ineffectively managed or directed only to the realisation of speculative gains with no long-term benefit to the US economy. In fact, just the opposite occurred: the newly released pool of venture capital proved to be the catalyst for spectacular growth in companies, employment, commerce and taxation.

The 1997 PricewaterhouseCoopers/National Venture Capital Association sponsored study, *The Economic Impact of Venture Capital*, outlined the ongoing growth of 464 venture-backed US companies:

- More than 80% of companies were focussed on high technology.
- Up to 75% of these firms were dependent on VC during the first 5 years of their existence, and needed to raise an average of \$US 16 million apiece over this period.
- On average, US venture-backed US companies went public at just under 4 years of age.
- Venture-backed companies created jobs at an average growth rate of 34% per year – contrasted with a 4% job decline among Fortune 500 companies.
- The jobs created are high-quality, skilled positions – 61% of these are engineers, scientists and managers, compared with 15% of jobs created in the US economy as a whole.
- Venture-backed companies grew revenues 38% per annum, vs 24% for non-venture backed companies and only 3.5% for Fortune 500 companies

### *Australia*

The 1998 PricewaterhouseCoopers *Economic Impact of Venture Capital Survey* clearly demonstrates the economic impact of venture capital in the Australian economy through the responses of 294 venture-backed small and medium enterprises that had received a total of \$272 million. Among its findings:

- **Venture capital is a major contributor to economic growth:** During the period from 1992/93 to 1996/97, the Australian venture-backed companies surveyed had an average
  - 12.1% annual growth in sales
  - 34.9% annual growth in profits
  - 5.2% annual growth in exports
  - 9.5% annual growth in employment
- **Venture-backed companies in the development/expansion stage have the highest growth levels:**
  - 17% growth in sales
  - 42% growth in profits
  - 29% higher exports
  - 33% greater investment in premises, plant and equipment
  - 66% growth in R&D

14% growth in employment

- all up substantially over corresponding data for 1995/96.

- **Venture capital is important or crucial for companies**, in the opinion of 89% of the respondents, half of whom said they could not have existed or survived without it. More than half the respondents saw the venture capital investor as a ‘real partner’ in the business, bringing connections, advice, strategic insight and other added value to the relationship.

In the words of the survey, ‘These finding suggest that venture backed companies are the *engines of growth* of the Australian economy.’ Sixty percent of the firms in the PricewaterhouseCoopers target group were in the health, medical, technology and biotechnology sectors.

In Europe similar studies by Coopers & Lybrand and PriceWaterhouse Coopers showed equally impressive performance by venture backed firms. The studies covered:

- 12 European countries (1996)
- France (1996)
- UK (1997)
- Israel (1998)

The following table summarises the levels of venture capital activity in four economies during 1998 (1997 for the UK). Whether considered on a per capita basis, or as a percentage of GDP, or in relation to the number of companies or the total financial sector, Australia’s venture capital performance lags behinds that of the other developed economies. As a percentage of GDP, Australia’s performance was less than half that of the USA and considerably below that of Israel and the UK.

	<i>United States</i>	<i>UK (1997 data)</i>	<i>Israel</i>	<i>Australia</i>
<i>Number of investees companies</i>	2,856	1,200	252	217
<i>Amount invested</i>	\$US 14.2 billion	£4.2 billion (\$US 6.7 billion)	\$US 557 million	\$A 473 million (\$US 298 million)
<i>Number of active Venture Capital Funds (estimated)</i>	540	120	45	50
<i>Percentage in high tech investments</i>	79%	NA	93%	43%

- ***Tax Impact on Taxation Revenues***

Although reductions in capital gains tax and other taxes may seem to threaten tax revenues, the Alliance believes its proposals can be accommodated within the concept of revenue neutrality. Indeed, the Alliance believes there will be a significant growth dividend especially from the proposed changes to CGT. There is in fact a well-documented inverse relationship between CGT rates and CGT revenues. A wealth of historic data and macroeconomic studies demonstrate that CGT reduction for companies and individuals results in higher tax collections; the conclusions of a US Congressional study are outlined below in Sections 2.9, **Macroeconomic Impact of CGT Reform**, and 2.10, **Impact of CGT Reform on Tax Revenues**.

In addition, the evidence from the Surveys of the performance of venture-backed companies in North America, Europe and even Australia, mentioned earlier in this submission, demonstrates clearly the growth which will be unleashed if the reforms proposed by this submission are adopted. This would lead to increases in government revenue from PAYE income tax and corporate tax as well as CGT.

The Technology Taxation Alliance believes as a result the Government need have no concern about achieving its revenue goals.

Finally, we should note the additional benefits of a robust, innovative technology sector:

- cross-fertilisation with universities and research centres;
- technology transfer with multinationals;
- enabling technologies that improve the performance and international competitiveness of other Australian enterprises;
- “Born Global” focus on exports and international markets;
- exposure to overseas markets and competition; and
- expansion of global networks.

In summary, the creation, funding and development of small venture-backed companies – particularly technology companies – is vital to the present and future growth of the Australian economy. To foster this growth, Australian tax policy must:

- reduce CGT;
  - remove regulatory barriers – particularly barriers to international trade and investment;
  - encourage innovation and entrepreneurship; and
  - create a climate in which technology firms can remain in Australia rather than being forced to migrate to the US or elsewhere.
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The following sections make specific recommendations for accomplishing these objectives.

## **ISSUES AND RECOMMENDATIONS**

### **1.0 AUSTRALIAN CORPORATE TAX RATES**

- 1.1** Australia's corporate tax rate of 36% is among the highest in the developed world and above the OECD average (about 34.8%) and the Asia/Pacific average (about 32%). It acts as a disincentive to the development of local business; discourages inward investment from other countries; and is a factor in driving successful Australian businesses offshore. All these considerations are important to the growth of Australian technology companies, especially emerging companies.
- 1.2** The global trend is to lower corporate tax rates; of the industrialised nations in the OECD, eight lowered rates during 1998 and only Argentina and Mexico raised them. During 1995-99, the average corporate tax rate among OECD countries dropped by almost three percentage points. This trend reflects the recognition that lower corporate tax rates are a competitive tool in attracting and retaining internationally mobile business and capital.
- 1.3** Anecdotal evidence, including interviews with multinational technology companies headquartered in Silicon Valley, indicates that the local corporate tax rate is the first – and often the last – number that the American CFO looks at when evaluating sites for overseas expansion.

“If the tax rate is uncompetitive compared with Singapore (26%) or Hong Kong (16.5%), it doesn't matter how many other concessions or lifestyle considerations Australia can offer” (Bill Hillyard, Managing Director, Hewlett Packard Australia 1989-94, interviewed in Palo Alto, CA, 1996, by Roger Allen and Bob Hunt).

### **1.4 Tradeoffs and Revenue Neutrality**

*A Platform for Consultation* sets out a number of measures – some costed, some not – which would generate considerable tax revenues and offset the cost to revenue of a 30% corporate rate. The most significant of these is the 'effective life' model for asset depreciation, which would not impose any hardship on the technology companies represented by the Alliance.

The Alliance would support the abolition of the accelerated depreciation tax incentive in exchange for the proposed cut in the corporate tax rate subject to the adoption of the following recommendations. It is felt that these recommendations are important to ensure that Australian capital intensive businesses can continue to compete in the international marketplace.

- The adoption of an effective life regime as the basis for write-off of physical assets must be fully cognitive of the increasing impact of technological obsolescence.

- A change in the rate of depreciation after depreciation has commenced be allowed where there is virtual certainty that the effective life of the asset has dramatically shortened.
- Changes to the capital allowance regime and the corporate tax rate should be done contemporaneously or within a relatively short period of time (say 2 years).
- The adoption of a “pooling model” under which low cost items are pooled and depreciated as a single unit will achieve an appropriate balance between economic equity and efficiency. It is suggested that all items that cost less than \$1,000, acquired by a business within the income year, could be pooled and depreciated over 4 years.
- We fully support the option to replace the current legal concept of ownership with a concept that recognises a requisite economic interest in the asset.

Another important contributor to tax revenue will be the estimated \$200 million annual growth dividend resulting from foreign multinationals electing to have Australian profits taxed in this country rather than shifted to lower-tax jurisdictions. The additional tax revenues to be anticipated from CGT reform are discussed in Sections 2.9 and 2.10, below. In light of the potential savings as well as the additional revenues to be expected from taxation reform, the Alliance sees no reason for tradeoffs in other areas; in particular, there is no rational argument for the sacrifice of the R&D tax concession (see Section 4) and many strong arguments why the level of R&D support should be raised.

A comment is made in *A Platform for Consultation* at page 70 that “a reduction in the company tax rate to 30 per cent would increase the incentive to alienate personal income through interposed entities, at a cost to revenue.” Commentators have suggested that the Government may contemplate the re-introduction of distribution requirements, such as those that existed in Division 7 of Part III of the Income Tax Assessment Act 1936 as a way of dealing with this cost to revenue. The Alliance would strongly oppose such a move. Many technology companies are private companies for tax purposes and would be adversely affected by a revival of Division 7.

One of the major sources of funding for technology companies is to re-invest their retained profits. It is often difficult for these companies to borrow or obtain equity investors. The revenue should be concerned here solely with ensuring that retained profits are not diverted by business controllers in some way to personal use. The revenue should not attempt to dictate private company investment policy by dictating that any proportion of profits must be distributed in any given year. The existing law, together with proposals contained in *A Platform for Consultation*, adequately protects the revenue in this regard.

In particular,

- the provisions contained in Division 7A of the ITAA 1936 already operate to deem loans and transfers of property from private companies to shareholders or associates to be unfranked dividends unless very strict requirements are met;
- *Platform* proposes the extension of these rules to trusts;
- *Platform* and ANTS also propose the taxation of all non-cash benefits provided by entities to their shareholders or beneficiaries under the FBT system;
- The “profits first” rule, combined with the comprehensive definition of “distribution” proposed by *Platform*, will also ensure that distributions from entities to another entity are properly identified.

## 1.5 Recommendation

The Alliance recommends the reduction of the current 36% company tax rate to 30%.

The Alliance sees the move to a 30% corporate rate as critical to Australia’s economic health. We believe a 30% corporate tax rate can be achieved without a large number of tradeoffs. Specifically, substantial revenue neutrality does not require giving up two other key policies of great importance to Australia’s technology industries: CGT reform and the retention of an effective R&D tax concession.

The Alliance supports the abolition of accelerated depreciation subject to the provisos spelled out in Section 1.4.

The Alliance strongly opposes any re-introduction of distribution requirements for private companies.

## 2.0 CAPITAL GAINS TAX

- 2.1 Australia's relatively high rate of capital gains tax compared with other developed economies, together with the absence of special status for long term investments ('patient capital'), for high-risk investments, or for specific industries, is regularly cited by the financial sector and the technology industries as the single greatest impediment to the development of an effective Australian venture capital industry.
- 2.2 A key requirement for Australian or US based venture capitals funds is the ability to **roll over** investment vehicles without creating any tax liability until a liquidity event puts into the investors' hands the cash with which to satisfy that liability. Examples would be the exercise of share options; the exchange of common for preferred shares (or vice versa); and share-for-share acquisitions without creating a taxable event.
- 2.3 A factor in the success of the venture capital industry in the US, especially since the late 1970s, has been the growing presence of pension funds and other tax-exempt entities as suppliers of the funds managed by venture capitalists. When foreign exempt entities invest directly or indirectly in Australian firms, their returns are taxable under current law. It is important for the growth of the technology industries that such overseas investors have the same tax-free status when they invest in Australia as in their own markets.
- 2.4 A number of different models are outlined in *A Platform for Consultation*; among them:
- across-the-board CGT reduction for individuals, e.g. capped at 30%;
  - favourable CGT treatment for long-term investment; and
  - special treatment for targeted industries, e.g. technology industries.

**2.4.1 Across-the-board CGT reduction for individuals.** Either by creating a distinct CGT rate (e.g., 30%), or by capping the maximum rate for all income at a level lower than the present top rates, or by reducing rates for all taxpayers by a uniform percentage (e.g., 20%). In the view of the Alliance members, no policy that centres on a CGT rate around 30% will provide enough incentive to investment, particularly high-risk investment in technology companies. Other factors being equal, including the treatment of capital losses, we believe a stepped model would prove more effective.

**2.4.2 Favourable CGT treatment for long-term investment.** Both the US and the UK have introduced stepped CGT rates for individuals, and the UK for companies, with very low effective tax rates for gains on the sale of long-term assets.

- The US defines *short-term* as less than 12 months, *short-mid term* as 12-18 months, *mid-term* as 18-60 months, and *long-term* as greater than 60 months. The maximum individual CGT rates applied are 39.6%, 28%, 20% and 18% respectively, while companies are taxed at a uniform 35% on gains.

- The UK steps down the percentage of chargeable capital gain by 7.5% each year an asset has been held, to a minimum of 25% of the gain at Year 10 and after. Thus, for a high-rate taxpayer in the 40% bracket, the effective rate on a less-than-one year asset is 40% and on a 10-year asset, 10% (40% of 25%). Corporate tax rate from April 1999 is 30%, with a special rate of 20% for small companies with under £300,000 taxable profits, and from April 2000 a 10% rate for companies with under £10,000 taxable profits.

The Technology Taxation Alliance agrees with the principles behind both the UK and US taxation regimes and believes adoption of a similar model would attract long-term investors and make a substantial amount of capital available for the Australian technology sector.

One such model would be a series of five equal step-downs in the rate of tax applicable to the gain, in accordance with the following table. This would have the effect of reducing the tax paid to 25% of the applicable rate for the maximum holding period of 5 years. At a top marginal rate of 47%, the rate of tax payable for investment held for more than five years would be 11.75%.

<i>Investment Holding Period</i>	<i>Rate reduction</i>
< 1 year	Normal margin rate – no reduction
1-2 years	15% of applicable marginal rate
2-3 years	30% of applicable marginal rate
3-4 years	45% of applicable marginal rate
4-5 years	60% of applicable marginal rate
5 years	75% of applicable marginal rate

The Technology Tax Alliance also believes that appropriate tracing provisions should be incorporated into the enabling legislation to ensure that the investment holding period for these purposes is not artificially curtailed by the kinds of corporate restructures set out in this submission with regard to scrip-for-scrip rollover relief.

#### ***2.4.3 Targeted CGT relief for critical industries.***

The Alliance has given considerable thought to whether it should argue for preferential CGT treatment for the IT&T sectors. The important role that the sectors play in economic growth and the part venture capital plays in fuelling that growth are powerful arguments in favour of special treatment.

On the other hand, the Alliance also recognises the need to reward entrepreneurship and risk-taking across the economy. The inevitable concerns about definitions, complexity and the potential for abuse also require consideration.

On balance, the Alliance has decided to propose across the board changes for all active business investments.

If the Government wanted to provide special treatment for IT&T or the technology industries more generally, one possibility would be to ensure that, whatever CGT relief was applied across the board, these sectors receive the benefit of:

- a reasonably fast phase down of CGT rates for short-mid term investments (see 2.4.2) to give investors sufficient flexibility; and
- widespread scrip for scrip relief (see 2.8).

The management of the Innovation Investment Funds and Pooled Development Funds programs within AusIndustry should provide a sound basis for the administration of any special provisions.

## **2.5 Foreign Pension Funds and other tax-free investment vehicles**

The Alliance supports the position of the Australian Venture Capital Association Ltd (AVCAL) in its submission to the Review of Business Taxation (22 December 1998):

- Australia needs a larger and deeper venture capital market if the objectives of economic growth, job creation and higher living standards for Australians can be realised; and
- The major international suppliers of venture capital, namely offshore pension funds, will not enter the Australian market under present taxation regulations; and
- The tax law should be amended to allow listed countries . . . foreign pension funds to invest either directly or indirectly into the Australian venture capital industry without the imposition of any tax on dividends, interest or gains made by those foreign pension funds. . . .
- Australian venture capital trusts should not be taxed as companies, a position not inconsistent with the pursuit of “investment neutrality”.

As the AVCAL submission points out, ‘the exemption of non-resident pension funds from Australian taxation on venture capital investments would not be at cost to the Australian Revenue,’ since

- no such investment is presently occurring;
- capital losses would not be deductible;
- such funds supplement rather than displace Australian funds; and
- the ultimate effect would be to grow Australian businesses and therefore tax revenues.

The Alliance also supports the extension of tax exempt status to complying superannuation entities (ie. complying superannuation funds, approved deposit funds,

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pooled superannuation trusts) and pooled development funds that are resident in Australia for their investments in Australian “venture-backed” companies, either directly or through collective investment vehicles specifically constituted to allow resident complying superannuation entities, pooled development funds and exempt foreign pension funds to invest in Australian venture-backed companies.

It would be necessary to license “venture-backed” companies (see 2.7 on page 18) on the basis of the following qualifications:

- small-to-medium enterprise;
- utilising or developing new technology;
- not an established player in the market which it plans to enter or where it operates; and
- not the holder of other assets such as real estate or portfolio interests in shares.

The reason for giving an exemption to resident complying superannuation entities and pooled development funds is that at present they are taxed at a 15% rate on their investment income and gains and, unlike overseas pension funds, they are not major participants in the venture capital market. A stepped-rate CGT, if it becomes available for individuals making “patient” investments, will cause complying superannuation entities and pooled development funds to become uncompetitive as vehicles for such investments, unless they are given an exemption for their income and gains from venture-backed companies.

## **2.6 Tax Treatment of Limited Partnerships**

Under Australian tax law, limited partnerships are treated like corporations and all distributions/dividends to limited partners are taxable to the individuals. This means that limited partnerships – which in the US are the standard mechanism through which Venture Capital funds invest – are unable to defer tax on interim distributions/exchanges of shares until a liquidity event. Since overseas investors will want to use a limited partnership as the investment vehicle of choice, the absence of flow-through treatment has been a major disincentive to overseas investment in Australia.

The Alliance agrees with the AVCAL position outlined in its submission to Senator Gibson of 11 March 1998, suggesting:

‘ . . . an amendment to the limited partnership provisions so as to deem those provisions not to apply to a limited partnership investing in an Australian venture capital trust. A mechanism is suggested to ensure that the trust is one approved by the Government.’

## **2.7 Certification of Venture Funds**

The ‘mechanism’ mentioned by AVCAL is certification by the Industry Research and Development Board. There must be a streamlined mechanism for registering a

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company or investor as a “venture backed” entity along lines similar to that utilised under the PDF scheme.

## 2.8 Share-for-Share Transactions

*A Platform for Consultation* (pp. 295-298) outlines the disincentive to corporate mergers imposed by the current treatment of share-for-share transactions as taxable events. This issue is addressed in great detail in the submission of the Securities Institute of Australia, *The Revenue Impact of Capital Gains Tax Rollover Relief for Share-Swap Mergers and Demergers* (prepared by Access Economics). In the words of the SIA report,

‘There are clear potential economic inefficiencies in the current CGT treatment of share-swap mergers to the extent that potential CGT liabilities prevent mergers from proceeding. In addition, the current CGT treatment can lead to a CGT liability even though the transactions may not involve cash with which the tax could be paid. . . .

‘As with share-swap mergers, the current CGT treatment of company demergers can lead to clear economic inefficiencies, and again, there could be a CGT liability even though the transactions are unlikely to involve cash with which the tax could be paid. In this case there would also be no change in the beneficial ownership of underlying assets’ (Executive Summary, p.iii).

The report recommends the elimination of CGT liability for both mergers and demergers of Australian public companies. These recommendations are supported by a series of models based on Australian historical data and US data on the likely elasticity of share-swap mergers to rollover relief for CGT.

The SIA models show an initial cumulative *cost* to taxation revenue of \$136.6 million for tax years 2001/02 through 2003/04, followed by a net cumulative *gain* to tax revenues of \$398.5 million through tax year 2009/10, giving a *Net Present Value* of \$160.6 million for this policy change (p. iv).

The Alliance believes the most favourable impact to the technology industries would result from extending the elimination of ‘share-for-share’ CGT liability beyond Australian public companies to cover mergers and demergers involving one public and one private company, more than one public or private company, and two or more private companies where the shares exchanged are of the same value and where at least one entity is a venture-backed enterprise or where no tax avoidance is involved.

The key policy consideration here in ensuring that the CGT treatment of corporate restructures does not operate to discourage persons who provide enterprises concerned with their intellectual capital or who are the driving forces behind those enterprises from staying with the businesses they have started or they run until they wish to exit for commercial reasons. At this point, they should pay CGT at the appropriate rate on their gains. Exit decisions should **not** be tax driven.

- Typically a small (usual private for tax purposes) company may need to merge with one or more other (private) companies to obtain synergies in skills and

technology before obtaining outside equity investment (though an industry partner, a venture capitalist or a business angel). At this stage, it is likely that the investment entity will remain a private company, with the original “brains” behind each outfit staying involved at an executive level. Hence the need for rollovers in relation to the transfer of assets of or shares in a number of private companies to just one private company.

- Outside investors often prefer to invest in a new “clean” entity. Hence, there is a need for a rollover for the transfer of the assets of or shares in one private company to another private company when an investment is to become “venture-backed” for the first time.
- If venture capital is involved, the venture capitalist will want an exit strategy, which will usually involve a float (IPO) or a trade sale. In the case of a float, the original founders of the company may well stay with the company after the float, selling out at a much later stage. Hence the need for a rollover for transfer of assets of or shares in one or more private companies to a new public (for tax purposes) company.
- Circumstances also can arise where a public entity may be taken private by a consortium involving some of the public entity’s original shareholders and a new entity established. Hence, there is a need for a rollover where assets of or shares in a public company are transferred to a private company.

In the above excursus, we have referred solely to rollovers between companies of various kinds. The new entity system of taxation seeks to treat the income and capital gains of various types of limited liability entities in a revenue neutral way. It follows that the above rollovers should apply equally to trusts and limited partnerships if the entity taxation system is adopted, for reasons of consistency and revenue neutrality.

Similarly, it follows that all kinds of entities as well as individuals should be able to avail themselves of these rollovers.

The Alliance recognises that the Government and the RBT may have some concerns regarding the potential this range of rollovers may provide for tax avoidance. However, it should be possible to limit the opportunities in this regard by ensuring that –

- the rollover is only available in relation to “active assets” as currently defined in Part IIIA, Division 17A, of the ITAA 1936 or to shares in companies whose assets comprise mostly active assets; and
  - ensuring that the general anti-avoidance provisions in Part IVA of the ITAA 1936 apply to these rollovers; and
  - ensuring that the rollovers are not available to the extent to which the taxpayer claiming them receives cash or cash equivalents as consideration for or in connection with the transfer of the shares or the assets.
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While these proposals would benefit emerging enterprises in the IT & T sector, the Alliance does not propose limiting this proposal to just those enterprises. Any founder, investor or promoter of a new business which becomes successful should be treated in the same way. Today, it just happens that the IT & T sector has the most to gain, because of that sector's need for capital to fuel growth. Tomorrow it will be another sector. In both cases, though, the country and the Australian revenue benefit because new ventures can be run through to their appropriate commercial conclusions untrammelled by the artificial constraints of the tax system.

Finally, we would stress that these proposals do not involve an exemption from CGT liability, but rather the deferral of CGT liability until the gain is converted to cash. This is entirely consistent with the foundation of the current CGT and income tax system which will remain largely based on the crystallisation of gains and income after ANTS is enacted, despite the philosophical commitment of RBT to a "comprehensive taxation system". Failing to allow these rollovers has the effect of taxing unrealised gains because of corporate restructures and funding arrangements, a system which is inherently discriminatory. Not even the reform of the taxation of financial instruments has gone that far ("mark to market" being offered as an option only).

## **2.9 Macroeconomic Impact of CGT Reform**

Numerous studies have attempted to quantify the benefits of CGT reform in a range of developed countries. *The Economic Effects of Capital Gains Taxation* (Joint Economic Committee of the US Congress, June 1997), outlines the testimony of Dr Allan Sinai of Primark Decision Economics modelling the effects of introducing a 50% CGT exclusion for individuals and reducing the corporate CGT rate from 35% to 25%. Dr Sinai projected the following effects, averaged for the period 1997-2002:

- \$US 51 billion (0.1%) annual rise in GDP
- \$US 17.6 billion annual rise in business spending
- \$US 44.1 billion annual increase in national savings
- 356,000 new jobs annually and an annual 0.2% fall in unemployment
- Annual 2.1% rise in household net worth
- Annual 6.8% drop in the cost of capital
- Additional \$US 17.2 billion in Federal tax receipts

A recent DRI/McGraw-Hill study examined these issues and concluded, "The evidence suggest to almost all economists that a capital gains cut is good for the economy and roughly neutral for tax collections."

## 2.10 Impact of CGT Reform on Tax Revenues

*The Economic Effects of Capital Gains Taxation* includes time-series data from the US Internal Revenue Service plotting CGT revenues (in constant, inflation-adjusted dollars) compared with CGT rates for the years 1965 through 1994. These dramatically illustrate the inverse relationship between changes in the CGT rate and tax receipts:

- When the maximum CGT rate rose from 25% to 35% in 1969, CGT revenues dropped from \$US 25 billion to \$US 12 billion.
- When the maximum CGT rate was lowered to 28% in 1978, CGT revenues rose and remained above \$US 20 billion despite the recession.
- When the CGT rate was lowered again to 20% in 1981, CGT revenues began to climb, peaking above \$US 70 billion in 1986.
- After the CGT rate moved back to 28% in 1986, CGT revenue fell dramatically to a low of \$36 billion in 1994, despite a higher rate, a bigger economy and a stronger stock market.

Although the inverse relation between CGT rates and CGT revenues may seem counterintuitive, it is explained by several factors:

- The *unlocking effect*, which expands the tax base because realisations increase in response to the lower tax rate.
- The *dynamic effect*, which measures the increase in tax revenue, generated from the impact of lower tax rates on economic growth.
- The *asset price effect*, in which lower CGT rates increase the value of existing assets and hence the tax paid on the higher value of these assets when realised.

A study by the National Bureau of Economic Research indicates that, when the unlocking effect *alone* is taken into account, the revenue-maximising CGT rate falls somewhere between 9% and 21%.

## 2.11 Recommendations

The Alliance recommends a stepped CGT model with an ultimate effective rate of 11.25% at the top marginal rate for “active” business investments held a minimum of 5 years, which we believe is the model best suited to rewarding the founders of high-technology ventures.

The Alliance also recommends:

- extension of Australian tax-free status to foreign exempt pension funds , complying superannuation and entities and pooled development funds investing in Australian “venture-backed” companies;

- provisions for rollover of realised capital gains within limited partnerships and similar venture-backed investment vehicles (cf AVCAL position);
- elimination of CGT liability on share-for-share transactions in mergers and demergers where shares exchanged have equivalent value, in four categories of transaction: public to public; private to public; and private-private where at least one entity is a venture-backed enterprise, or where no tax avoidance is involved, and public to private.

The Alliance supports the abolition of CGT indexing and averaging for the reasons advanced in Chapter 12 of *A Platform for Consultation*.

The Alliance is of the view that the introduction of a \$1,000 tax free CGT threshold has less value as a structural reform than the other CGT reforms which we have proposed.

### **3.0 WIDELY HELD TRUST FLOW-THROUGH**

**3.1** The Treasurer’s announcement that cash management trusts and other vehicles will be subject to ‘flow-through’ taxation means that income earned and distributed by such trusts will not be taxed in the hands of the trustee, but rather in the hands of individual investors at their marginal tax rates. The application of this treatment to other investment vehicles including widely held unit trusts that distribute all or nearly all their income annually will be a major stimulus to investment in the technology sector.

#### **3.2 Recommendation**

The Alliance supports the flow-through of taxation of tax-preferred earnings derived on venture-backed investments by collective investment vehicles. The Alliance supports the inclusion of pooled superannuation trusts in the definition of collective investment vehicles.

## 4.0 DEDUCTIONS

### 4.1 Research & Development Tax Concession

The government's position in providing a higher level of deductibility for inherently risky and uncertain R&D activity is fully justified by market failure and the fact that this intervention increases the levels of business enterprise R&D.

This market failure has long been recognised by governments. Nevertheless, even the property rights given to technology developers by patents and copyright are inadequate, as some "technology assets" such as "know how", technical expertise and experience in problem solving and the development of skills cannot be protected, and the business enterprise that has funded the development of these "technology assets" may lose much of the benefit if employees leave or if others copy what the business enterprise regards as a "proprietary technology" that is legally unprotected. Even where a patent protects a particular technology, the patents owned by the originator may be insufficiently broad to prevent copying by competitors who develop parallel technology. Large corporations may deliberately and systematically infringe a patent held by a smaller corporation in the knowledge that the smaller corporation may lack the means to fight the infringement, typically in the US courts, which is an expensive and protracted process. Informed economic opinion therefore recognises that in addition to patents and copyright, government incentives for business enterprise R&D are necessary to correct for market failure. This view that there is market failure in respect of business enterprise R&D is given support by a number of empirical studies confirming that social returns to the community from industrial R&D expenditure exceed the returns to the private investor.

A study by Martin Neil Baily and Robert Z Lawrence ("Tax Policies for Innovation and Competitiveness" commissioned by the US Council on Research and Technology) examined the effectiveness of the US R&D tax credit.

Baily and Lawrence themselves commented as follows:

"The case of government aid to stimulate R&D is qualitatively different from that used by those seeking tax support for particular industries and firms. Proponents of such provisions often point to the benefits they will provide for job creation or investment in a particular industry, but their arguments often assume that labour and capital have no alternative uses. Over the long run, however, most of the people drawn into the activity are drawn away from another; most of the capital invested in one activity will be drawn away from capital invested in others. To justify reallocating resources towards a particular activity, its social benefits should exceed those obtained elsewhere in the economy. We should assume that a given quantity of resources is being fully utilised by the private market and then demonstrate that government intervention could increase the efficiency with which those resources are being used.

"Government support for industrial R&D meets this more severe and appropriate test. If we moved resources from some other profitable activity into expanded R&D spending, society as a whole would be better off. While for most activities in the

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economy, the returns for labour and capital reflect the value of their social benefits; in the case of R&D, the social returns exceed those, which accrue to the performer.

Baily and Lawrence cited the following empirical evidence comparing the social to the private return from industrial R&D. In general the studies looked at particular innovations.

<i>Author of study</i>	<i>Return to private investor</i>	<i>Social return</i>
<i>Mansfield 1997</i>	25%	56%
<i>Nathan 1978</i>	About 35%	70%
<i>Foster 1978</i>	24%	99%
<i>Scherer</i>	-	70% to 104%
<i>Terlecky J, 1974</i>	30%	80%
<i>Minasian 1965</i>	-	54%
<i>Fellner 1970</i>	-	31 to 55%

**4.2** Other countries recognise the importance of substantial R&D tax concessions as part of the total package designed to attract international investment; for example, major concessions are offered to foreign companies by Ireland, Malaysia and Singapore (tax deductibility of up to 200% is offered); Japan, Portugal, Canada, and the United States offer R&D tax credits, in some cases targeted at R&D conducted in co-operation with multinationals; the Netherlands provides a 40% tax concession on R&D salaries for small to medium businesses; other countries including China, France, Germany and Switzerland offer R&D concessions for enterprises in targeted states and districts. Underlying all these programs is the recognition that there is market failure in relation to business enterprise R&D, and that R&D concessions raise the level of business enterprise R&D. In addition corporate R&D:

- maintains international competitiveness;
- generates exports;
- attracts multinational partners and leads to technology transfer from leading centres of innovation;
- creates high-paying jobs;
- helps redirect the secondary and tertiary curriculum towards more marketable skills;
- attracts domestic and international venture capital; and

- creates wealth and enduring competitive advantage for the nation.

**4.3** Australia's gross expenditure on R&D, at 1.61% of GDP, appears superficially to be in line with the OECD average of 1.94% of GDP. However, Australian investment is overweighted on the side of public expenditure, 0.84% of GDP vs 0.71% for the OECD average; by contrast, industrial spending, at only 0.74% of GDP, is far below the OECD average of 1.19%. When less than half of a nation's R&D is conducted by commercial entities, the high-value-added, innovative products and technologies that generate wealth, exports and employment are in danger of drying up, leaving old, low-technology industries with shrinking employment vulnerable to competition from low-wage producing nations.

**4.4** A 1998 Business Council of Australia study (reported in *BRW*, 13 July 1998, p. 20) reveals a dramatic fall in R&D activity since the 1996 reduction in the R&D tax deduction from 150% to 125%, cutting the benefit to companies in half. According to *BRW*, the report estimates that R&D fell 3% during 1996-97, 5% during 1997-98, and should fall even further during 1998-99. Cumulatively, \$1.5 billion has been lost on 'potential business expenditure on research and development' – a disturbing contrast to the preceding decade, when Australian R&D expenditure had grown by 16% per year. The BCA concludes that the effect of the reduction in government assistance "may reduce GDP over the long term by a figure somewhere between \$300 million and \$700 per annum" (*ibid*, p. 21). In the words of Sir Gustav Nossal, 'The downturn in R&D spending revealed in the BCA survey is a tragedy for this country and it is directly attributable to the tax changes' (*ibid*, p. 22).

Interviews with PricewaterhouseCoopers clients in the technology sector confirm that many companies who could benefit from the currently available deduction are not taking it. The current 125% rate is not high enough to attract attention at Board level, especially in smaller technology companies where the administrative cost (registering with the IR&D Board, maintaining the required records and filling out the forms needed to claim the deduction) / tax benefit ratio is generally slight. Besides research that has been deferred temporarily or indefinitely by smaller companies, larger firms are motivated by overseas tax regimes to move R&D offshore.

**4.5** Several studies, including one conducted for the OECD (*Fiscal Measures to Promote R&D and Innovation*, Committee for Scientific and Technological Policy, 1996), indicate the superiority of a tax concession-based over a grants-based policy as a stimulus to R&D and the emerging technology sector. Specifically;

- Programs such as the R&D tax concession are far cheaper and easier to administer than grants schemes;
- Concession-based incentives have no cost to government (apart from the paperwork involved in registration) until a company is profitable;
- They are effective for companies of all sizes and different stages of development;
- They provide a company with certainty in its planning and expenditure, whereas grant schemes involve many months of uncertainty waiting for approval;

- They do not require government to conduct comparative assessments of technologies or to ‘pick winners’; and
- Studies indicate the long-term tax gains from the profits flowing from R&D activity outweigh short-term tax shortfalls by 2:1.

**4.6** The definition of R&D activities contained in Sections 73B(1) and 73B(2B) of the Income Tax Assessment Act 1936 is overly narrow and has become more focussed on fundamental scientific research than on commercial development (included in the usual definition of R&D in the United States and other countries). This definition requires more legislative support and certainty – in particular, the requirement for ‘high levels of technical risk’ is too vague and incapable of fair administrative application. The original concepts of reasonable levels of technical uncertainty should be introduced in concert with binding rulings on what is and is not eligible R&D in particular industries, such as software.

#### **4.7 Recommendation**

The Alliance recommends that the R&D tax concession be preserved and that the effective rate be raised to **200%** to deliver the demonstrated benefits of increased R&D investment and overseas investment attraction.

The Alliance recommends that the definition of ‘Research and Development’ in the enabling legislation be amended to cover the commercially oriented R&D conducted by the vast majority of Australian technology companies.

#### **4.8 Deduction of ‘Blackhole’ Expenditures**

So-called blackhole expenditures, as outlined on p 100-102 of *A Platform for Consultation*, are those that do not currently qualify either for deduction or write-off. These include several areas of expenditure important to technology companies:

- company pre-incorporation costs, including legal and consulting fees;
- successful or unsuccessful feasibility studies;
- cost of export market development;
- prospectus and underwriting costs; and
- corporate takeover defence costs.

Making these and other blackhole expenses deductible either immediately or over a period of time would benefit technology companies of all sizes and stages of development.

#### **4.9 Recommendation**

The Alliance favours the write-off of ‘blackhole’ expenditures along the lines of Table 1.1 on page 101 of *A Platform for Consultation*.

#### **4.10 Depreciation of Assets**

Current definitions of ‘wasting assets’ for tax purposes focus on tangible assets such as plant and equipment, mining equipment and operations, property improvements, telephone and electrical connections, etc. Intellectual property is recognised as a depreciable asset only when legally protected by patents or copyright. In technology industries, unprotected intangible assets such as management skill, ‘know how,’ technical expertise, experience in problem solving, proprietary methodologies for analysing and addressing customer needs, preparing proposals, and delivery of services are all of great value. Clearly, this value declines over time, making these intangibles wasting assets, but without any provision for depreciation.

The Alliance believes that technical and management skills and methodologies are valid wasting assets, and that depreciation rules should be applied to them, together with an appropriate useful life; with the appropriate useful economic life to the owner, whatever that may be, in each case, rather than a set period equating to the term of monopoly protection under intellectual property law. In the view of the Alliance, these changes are essential to ensure that intangible wasting assets receive the same treatment as plant.

#### **4.11 Recommendation**

The Alliance recommends an expanded definition of wasting assets to include a wider, more commercial definition of intellectual property and the depreciation of such assets over an appropriate useful life. One proposed definition is:

‘Intellectual Property’ means all copyright, patents, registered and unregistered trade marks, Eligible Circuit Layouts (within the meaning of the Circuit Layouts Act 1989), registered designs, Confidential Information and know-how and all other intellectual property as defined in the Convention of July 1967 establishing the World Intellectual Property Organization.

Article 2 (viii) of that Convention states:

" ‘intellectual property’ shall include the rights relating to:

- literary, artistic and scientific works;
- performances of performing artists, phonograms, and broadcasts;
- inventions in all fields of human endeavor;
- scientific discoveries;
- industrial designs;

- trademarks, service marks, and commercial names and designations; and
- protection against unfair competition.

and all other rights resulting from intellectual activity in the industrial, scientific, literary or artistic fields.”

Failure to adopt an expanded definition of IP will result in the preservation of a category of business expense for which no tax write-off is available, contrary to the philosophy of *A Platform for Consultation* in relation to black hole expenses.

## **5.0 INVESTMENT IN OR BY OVERSEAS ENTITIES**

### **5.1 Foreign Dividend Withholding Tax**

The issue of franking credits for foreign dividend withholding tax is raised in the Overview of *A Platform for Consultation* (p. 25):

‘The balance [between investment neutrality and the protection of the domestic tax base] is particularly relevant for credits for withholding taxes imposed on distributions to Australian individuals. At present, individuals are entitled to credits for withholding taxes imposed on distributions they receive. However, no credits are provided for individuals for foreign taxes paid by the domestic companies making distributions of foreign income.

‘This creates a non-neutrality as between people investing abroad directly and those investing through a local entity, which may lead to investors changing their before-tax behaviour as investment via offshore entities becomes more accessible.’

**5.2** One form of ‘before-tax behaviour’ encouraged by the lack of franking credits for foreign tax is the migration of multinational Australian companies to those countries where most of their global revenue originates. James Hardie is the most recent and visible example, but this is an important issue for dozens of Australian technology companies with overseas operations, particularly in the United States. It is precisely those internationally successful firms that government industry policy tries to encourage and whose migration or sale would have the greatest negative impact on the creation of skilled jobs and the growth of the technology sector.

### **5.3 Deferred Company Tax**

The proposal outlined in *A New Tax System* to impose a deferred company tax on all dividends paid out of untaxed profits would have created an inequitable tax burden for overseas companies with profits in Australia, and would have been inconsistent with the spirit – and possibly the letter – of Australia’s international tax treaties. The suggestion in *A Platform for Discussion* (p. 354) of a resident dividend withholding tax would be much more favourable to non-resident international companies and would leave the existing treatment of non-residents effectively unchanged. PricewaterhouseCoopers has prepared a submission on behalf of more than 40 major corporates including full data in support of this position.

### **5.4 Dividend Withholding Tax Rates under Double Tax Agreements**

An impediment for Australian-based multinationals is the dividend withholding tax rates, typically 15%, negotiated under our double tax agreements with other countries. As a result subsidiaries of Australian-based multinationals in overseas jurisdictions with which Australia has a double tax agreement usually pay 15% tax to the foreign government when repatriating dividends to Australia. Added to the underlying tax (typically 30% to 35%) imposed by the foreign jurisdiction on the profits out of which the dividend is paid, this is a large penalty on Australian companies seeking to

globalise. Often, however, Australia imposes no withholding tax when the Australian subsidiary of a foreign multinational pays a dividend to its overseas parent – this will be the case where the dividend is fully franked. Australia’s double tax agreements therefore provide a one-sided benefit for overseas countries, while disadvantaging Australian-based multinationals.

This contrasts with the double tax agreements negotiated by many other developed countries. The Netherlands has negotiated a dividend withholding tax rate of 5% with many of its major trading partners, for example, the US. The US has negotiated a withholding tax rate of 5% for dividends paid in respect of substantial shareholdings in a company. France also has negotiated a similar rate in many of its double tax agreements.

### **5.5 Withholding Tax on Royalties**

Under the current tax regime, most royalties paid to a non resident are subject to withholding tax. Rates are generally 10% to 15% (in accordance with the various double tax agreements). If technology transfer and increased technology uptake are legitimate objectives for tax policy, then it can be argued that a system which provides a greater return to the technology provider will encourage that provider to make the technology available to Australian entities – specifically when the provider is an overseas technology company with no permanent establishment in Australia, providing technology that will be utilised by Australian companies for commercial purposes, for which the provider will be largely compensated in the form of royalties.

Earlier studies have pointed to withholding tax on royalties as having a negative impact on attracting technology (e.g. *The Global Information Economy: The Way Ahead*, DIST Information Industries Taskforce, 1997], which referred to withholding tax on royalties as ‘a tariff on technology,’ and called for its removal).

### **5.6 Recommendations**

Allowing franking credits for foreign tax paid in countries by Australian entities so that these franking credits would pass through to shareholders would relieve the significant tax burden for Australian multinationals managing overseas operations from Australia. The cost to the government of \$210 million in forgone revenue for 2001/2002 (as estimated in *A Platform for Consultation*, p. 802) (if a franking credit were allowed for foreign dividend withholding tax) could be partly funded by the denial of interest deductions to Australian multinationals for offshore investments in highly geared control cases, estimated at \$150 million for 2001/2002 (*ibid.*).

The Alliance recommends that the deferred company tax proposed in *A New Tax System* be replaced with a resident dividend withholding tax, as more attractive and more equitable to international companies investing in Australia.

Australia’s double tax agreements must be renegotiated as a matter of urgency to eliminate foreign and Australian dividend withholding tax on dividends paid into or out of Australia, or reduce dividend withholding tax rates.

Australia’s double tax agreements must be renegotiated as a matter of urgency to

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eliminate Australian and foreign royalty withholding tax on royalties paid out of and into Australia.

Australian withholding tax on royalties is an impediment to the flow of technology into Australia, and foreign royalty withholding tax is a cost for Australian technology owners when they receive royalties from overseas. Many developed countries have entered into double tax agreements that eliminate this form of withholding tax. For example, Germany, the UK and the US do not impose withholding tax on royalties flowing to the other two countries. The Netherlands imposes no royalty withholding tax at all on royalties flowing to any non-resident.

## 6.0 EMPLOYEE SHARE OPTION PLANS (ESOPs)

6.1 Employee Share Option Plans (ESOPs) have long been a key factor in the success of technology based companies in the United States, particularly in the IT&T and biotech industries. They enable growing companies to compensate employees with share options in addition to – and sometime in lieu of part of – their salaries. These options can be exercised from one to five years in the future at a price that is usually substantially lower than the share price at the exercise date. US tax law provides preferential treatment for qualifying Incentive Stock Option ('ISO') schemes:

- The employee has no tax liability, on exercise of the option, on the difference between the option price and the current market value of the shares; and
- On the eventual sale of the shares, the employee is subject to a maximum tax of 20% on long-term capital gains, versus ordinary income tax of up to 39.6%, provided the sale occurs more than one year after the exercise date and two years after the date at which the option was granted.

6.2 A 1997 survey of small (under \$US 50 million in turnover) US firms indicated that **74 percent** of firms granted share options to all employees. In high-technology companies, employee share option plans are all but mandatory. They can be the principal form of compensation and an essential tool in recruiting, motivating and retaining valued employees by letting them share in the company's success. The US-based National Center for Employee Ownership estimates that employees own, or have options to own, shares worth almost **\$US 800 billion**, or about 9% of all the shares in the United States.

6.3 Australian law discourages employee ownership by taxing the employee on the difference between share value and option price either at the grant date or at the exercise date (if terms of the scheme place restrictions on the employee's ability to dispose of the shares); employees are also taxed on this paper profit at the marginal rate for ordinary income rather than at a special capital gains rate. As a consequence, ESOP plans are unattractive to employees and are rarely introduced in Australian technology companies.

6.4 If employee shares are issued at a discount to the market price and there are restrictions on their disposal, the existing rules defer taxing the discount until such time as those restrictions lapse. This rule encourages restrictions to be placed on employee shares to defer tax. This can create problems for employers and employees. The employer may have an industrial relations problem, if the employee has been unable to dispose of the shares, because of the restrictions, and the value of the shares falls below the issue price payable by the employee. On the other hand, if the shares appreciate, when the restrictions lapse, the employee usually has to sell the shares to pay the tax. As a result Australian employees tend not to hold shares for a long time in their employer company, unless there are restrictions on their sale. What is needed are tax rules that create an environment where employers can use employee shares as a means for improving industrial relations and promoting cultural change within a company, so that employees identify with the company's future economic welfare. The existing rules discourage employers from doing this and are motivated by short term revenue raising objectives.

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## **6.5 Recommendation**

The Alliance recommends the introduction of ESOP rules providing for employee tax liability only when a gain is actually realised on the difference between the exercise price (including the fee, if any paid to acquire an option) and the sale price of the shares, to be calculated at long-term CGT rates subject to a minimum holding period. Where shares are issued to an employee at a discount to market value, even where there are no restrictions on disposal, there should be tax only on the disposal of the shares.

## 7.0 CONSOLIDATED GROUP RULES

**7.1** Current rules permitting the transfer of losses among 100% wholly-owned companies with a consolidated regime have created tax loopholes for companies and have required anti-avoidance efforts on the part of the ATO. *A Platform for Consultation* recommends that entities be required to make a one-time binding election to consolidate that would result in pooling of profits, losses and credits within the group until one or more units are divested or the group is sold.

The existing mishmash of rules for tax consolidation are too rigid and do not allow flexibility of structuring for technology companies. In addition the same business test may create problems for a technology company that has a volatile share register and carry-forward losses, if it wishes to introduce innovations. A rigid application of the same business test, which is becoming increasingly common on the part of the Australian Taxation Office, may be a brake on economic progress at the micro level.

### 7.2 Recommendation

The Alliance supports the proposed reform of Consolidated Group rules, but on the following basis:

- The Alliance supports the 100% common ownership prerequisite to consolidation for tax purposes only on the basis that shares issued to non-controller employees in group members are ignored, provided they do not exceed a specified percentage (in the Alliance’s view, 10%). This submission highlights elsewhere the importance of employee share ownership in IT & T enterprises (see section 6 above). The particular nature of our industry sector, tending as it does to focus on deferred rather than immediate returns, means that it is necessary for key executive in group subsidiaries to have an equity stake in those companies in certain circumstances. This is particularly true of start-ups and early stage companies subsequently taken over by larger players, as offering executives shares or options in the holding company is too indirect an incentive.
  - The Alliance opposes the “all-in” requirement under which a group cannot consolidate unless all entities eligible to group join in the consolidation. This creates a number of problems and “selective grouping” under which some eligible entities may remain outside the group should be allowed. The main concern arises where one member of the group wishes to undertake significant arms’ length commercial borrowings and the lenders are concerned at the credit risk arising from the “joint and several” nature of the borrowing group member’s obligation to the ATO with regard to the group’s tax liability.
  - Foreign owned groups should be able to consolidate without a requirement for a single resident holding company subject to the enactment of suitable alternative requirements, to protect the revenue, that would be the economical equivalent of a holding company. . The consolidation rules only permit consolidation of non-resident investments in Australia if there is a single entry point. However, for a variety of historical and organisational reasons, quite a number of foreign-owned groups hold their investments in Australia through more than one “entry point”.
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This will be true in the IT & T sector as it is elsewhere. In the interests of preserving and fostering foreign investment, the Alliance believes that the proposed consolidation rules must take account of this.

- The existing inter-company dividend rebate rules should be replaced by a dividend deduction for the recipient company, as in the US, or an equivalent rule. The problem here is the effect of dividends on carry-forward losses. They have the effect of using them up even though the dividends themselves are not taxable, because of the intercorporate dividend rebate. The planning techniques currently used to deal with this inequitable treatment under the existing loss grouping rules are not applicable to the new regime, so the Alliance firmly believes the issue must be addressed.
- The “same business test” will become unworkable in the context of tax consolidation and the existing rules for the carry-forward of losses should be replaced for all entities (other than individuals) by a new set of rules that will deny a tax deduction for carry-forward losses only where on the basis of objective criteria it can be determined that loss trafficking has occurred. For example, if a company group acquires a company with carry forward losses, it would be possible to preserve those losses if the company acquired passed the “same business” test, even though it will fail the beneficial ownership test. However, given the multiplicity of businesses likely to be carried on by a consolidated group, the group (as opposed to the loss company) would never pass the test, so the losses could no longer be carried forward. The Alliance believes that company groups should be able to avail themselves of the benefits of the same business test on a basis similar to other business taxpayers.

## ***Appendix: Technology Taxation Alliance Member Profiles***

### **Australian Information Industry Association (AIIA)**

The AIIA is the national organisation representing the information technology and telecommunications (IT&T) industry of Australia. AIIA represents over 340 incorporated companies based in Australia, ranging from small to large, local to international. AIIA's members are software and services companies; telecommunications carriers; multimedia developers; online services providers; and companies involved in developing, producing and distributing IT&T hardware. AIIA's membership encompasses more than 80% of the total turnover of the IT&T industry in Australia. AIIA lobbies the government on behalf of the Association's members on a range of issues, including industry development, information economy, standards and regulation and government purchasing.

### **Australian Interactive Multimedia Industry Association (AIMIA)**

AIMIA was established in 1992 as the industry association for individuals, companies and organisations interested in digital content and interactive multimedia. The organisation now has 400 individual and corporate members across Australia including small to large multimedia developers and service providers, educational institutions, students as well as start-ups and companies in general media, business, law and consumer markets. AIMIA aims to foster the growth of the digital media industry through providing information and services to members, through lobbying governments and through alliances with other industry bodies. To this end AIMIA and the IIA signed an MOU in 1998 in which they agreed to work together on policy and practical matter

### **Australian Electrical & Electronic Manufacturers' Association (AEEMA)**

The Australian Electrical and Electronic Manufacturers' Association (AEEMA) is the national industry association representing the Australian electrical, electronic and associated industries.

AEEMA represents local and international companies involved in the design, development and production of high technology electrical and electronic products and systems in Australia. The Association's membership comprises 95% of the industry by turnover and includes companies of all sizes, from all areas of the value chain committed to the development of world class industries in Australia.

AEEMA's objective is to strengthen the competitive position of the Australian electrical and electronic industries in both domestic and international markets.

AEEMA operates through nationally based divisions, which are serviced by a Canberra-based Secretariat.

## **Australian Telecommunications Industry Association (ATIA)**

The Australian Telecommunications Industry Association (ATIA) is the peak industry association representing local and international companies involved in the design, development and production of telecommunications products and systems and associated products in Australia. The ATIA provides its membership with representation on policy, commercial and technical issues. Membership of the ATIA comprises companies of all sizes, committed to the development of a world class telecommunications industry in Australia.

The objectives of the ATIA are to: provide a specific focus on those issues crucial to the growth of the Australian telecommunications industry; represent the interests of the telecommunications industry on policy, commercial and technical issues; raise the political and community awareness of the policies needed for the continuing development of the industries; and promote the achievement of the industry and its contribution to the economic wealth of Australia.

The ATIA is a division of the Australian Electrical and Electronic Manufacturers' Association (AEEMA).

## **Asia Pacific Smart Card Forum (APSCF)**

The Asia Pacific Smart Card Forum (APSCF) is the national industry forum promoting the development of a technologically advanced and viable smart card industry in Australia and positioning Australia internationally as a leading supplier of smart card technology and applications.

The APSCF specifically focuses on: undertaking actions to maximise market opportunities; enhancing communication and collaboration within the Australian industry; promoting close co-operation and collaboration with other representative bodies internationally; promoting consultation with the community; enhancing export success through the promotion of Australian smart card capacities in international markets; representing the Australian smart card industry with key policy makers including politicians, departmental officials and community representatives; promoting industry development; and co-ordinating the views of the Australian smart card industry on technical and commercial standards related matters.

## **Internet Industry Association (IIA)**

Founded in the early 1990s, the Internet Industry Association is Australia's peak body representing Internet service providers and also represents some web developers. It has around 150 member companies, who together account for the routing of around three-quarters of Internet traffic in Australia. With a head office in Canberra, the IIA is a vigorous participant in the policy debate in relation to Government's role in and regulation

of the Internet, including digital copyright, privacy, e-commerce enablement, the management of the .au domain space, datacasting and content regulation.