ASX SUBMISSION

REVIEW OF BUSINESS TAXATION

SECOND DISCUSSION PAPER

A PLATFORM FOR CONSULTATION

April 1999

AUSTRALIAN STOCK EXCHANGE

Contacts

Michael Roche National Manager, Strategic Planning & Review and Chief Economist ASX Ltd Ph: (02) 9227 0019	**Jason Anderson** Senior Economist Strategic Planning & Review ASX Ltd Ph: (02) 9227 0953	**Michael Giddings** Group Taxation Manager Legal Services ASX Ltd Ph: (02) 9227 0801

Executive Summary

ASX strongly encourages the government to make the globalisation of Australian business the driving force for reform of business taxation. In trade and industry policy, Australian governments have confronted the difficult issues that arise when actively participating in international markets.

Taxation policy should not be an exception to this overall trend. Cross-border investment flows are vital to reducing the cost of capital in Australia, and the generation of employment in the industries of the future. With these issues taken into account, it might be possible to reduce the company tax rate without sacrificing tax concessions that contribute to investment in important sectors of the Australian economy.

As a result, ASX disagrees strongly with the government's requirement that tax reform recommendations of the Review of Business Taxation be revenue neutral (against the baseline of *A New Tax System*).

If the government imposes a revenue neutral constraint, then ASX believes that the Review of Business Taxation can at least strike a balance between the achievement of growth and equity goals for tax reform, drawing on options contained in the second Review of Business Taxation discussion paper *A Platform for Consultation*. In this submission, ASX sets out arguments for the following proposals:

- Reduction of the company tax rate to 30 per cent. In the context of the Government's revenue neutral constraint, this would have to be funded by the abolition of tax concessions (in particular accelerated depreciation).
- An entity taxation system that taxes companies and trusts in the same manner, while accommodating collective investment vehicles.
- The entity system is implemented through a resident dividend withholding tax, which accommodates the overlap between Australia's tax system and that of other countries, so that the tax burden on foreign investors is not increased as a result of deferred company tax.
- Foreign source income is given some limited tax relief through provisions to create franking credits for foreign dividend withholding tax.
- Reforms to the thin capitalisation rules.
- Adoption of an optional mark-to-market for equities and equity derivatives.

ASX is particularly concerned about the deferred company tax proposal. Modelling analysis by ASX indicates that deferred company tax will raise the tax burden on non-resident investors in large, globalised Australian companies. For a theoretical Australian company, DCT is estimated to raise the weighted average cost of capital by 8 per cent (from 10.8 per cent to 11.6 per cent), and decrease the estimated market value of equity by 16 per cent. DCT is expected to diminish Australia's position as a regional financial centre for equities, and indirectly impact on resident investors.

ASX has carefully considered the options for reform of capital gains tax. Some preliminary analysis of this issue is provided in the submission, and ASX has commissioned detailed analysis of CGT reform. ASX argues that any CGT reforms should:

- significantly reduce the current harsh and uncompetitive rates of capital gains tax, while preserving the progressive structure of the income tax system.
- be neutral as to the duration of an asset holding.
- maintain indexation as a necessary structure for capital gains taxation.

ASX strongly supports moves to reduce personal capital gains tax rates below those for other income, but not at the price of removing indexation. ASX believes that CGT rate reductions can be at least partly funded by behavioural responses, as lower CGT rates both encourages new investment activity and leads investors to sell assets that they would otherwise hold for longer periods of time, thereby increasing the tax base. If the response is sufficiently great, then a rate reduction may well be largely self-funding.

ASX notes that with indexation in place and the reduction of the entity tax rate to 30 per cent, Australia will achieve a highly competitive business CGT regime.

The proposal to provide an exemption from capital gains tax for scrip-for-scrip transactions is strongly supported, and this reform can be funded through the abolition of averaging provisions.

Introductory comments

Globalisation raises the premium on reform to achieve efficient government policies. With mobile capital, companies have considerable scope in their choice of national base, so international differences in business environments will play a greater role in that choice. In trade and industry policy, Australian governments have confronted the difficult issues that arise when actively participating in international markets.

Taxation policy should not be an exception to this overall trend. Cross-border investment flows are vital to reducing the cost of capital in Australia, and facilitating access to overseas income growth for Australian investors.

Trends show that Australia's investment abroad has reaped considerable income growth in the past decade. Investment income from overseas increased by an average of 16 per cent in nominal dollars between 1989-90 and 1997-98.[1] This was much faster than growth in income sourced domestically, which increased at an average annual rate of 6 per cent in nominal terms over the same period.

Investment neutrality is vital in terms of the impact of tax on existing activity. It is vitally important that the headquarters and tax domicile of our major Australian companies remains in Australia. It would be a perverse outcome of tax reform if Australian governments are to make considerable effort to encourage the regional headquarters of foreign companies to locate in Australia, while causing our domestic companies question their continued maintenance of Australia as their headquarters.

Responses by existing firms may not often be dramatic, but beneath the surface the effects are clearly significant. The pressures that led James Hardie Industries to promote a fundamental restructuring of its business reflects the fact that tax systems influence business decisions.

Responses by existing companies are important for a number of reasons. The most important reason is that Australia may diminish its taxation revenue base if companies shift their domicile for tax purposes. As a result, foreign source income may not be repatriated to Australia, and Australian shareholders are penalised by the flow of Australian revenue through the new foreign entity before dividends are paid from this income back to Australia. This outcome would have serious effects on the local services sector, which supplies high value financial and business services to company headquarters.

Investment neutrality is also important for incentives to undertake new investment. A revenue neutral analysis cannot take account of investment that does not proceed and the profits that are not generated because of the excess burdens of taxation on capital. These hidden costs do not show up in revenue estimates, because the economic activity does not proceed.

---

[1] ABS Catalogue 5302.0, Balance of Payments and International Investment Position, Australia.

New investment might be sourced from foreign investors. In terms of future investment, the fact that foreign investors typically attach great weight to how a country's headline corporate tax rate compares with that of other countries is itself a matter which needs to be taken very seriously by Government. With these issues taken into account, it might be possible to reduce the company tax rate without sacrificing tax concessions that contribute to investment in important sectors of the Australian economy.

Other countries have been able to implement company tax rate reductions without forgoing targetted tax concessions. Among OECD countries, corporate tax rates fell in Denmark, France, Germany, Ireland, Japan, Poland, Switzerland and Turkey in 1998. Amongst OECD countries, the average rate among OECD countries dropped by almost three percentage points to 34.8 percent at 1 January 1999[2]. In the UK, the company tax rate is 30 per cent, yet accelerated depreciation is preserved. Lower tax rates, in conjunction with accelerated depreciation, are partly driven by the increasing globalisation of business and rapidly evolving technologies that make internationalisation of investment possible.

Globalisation is not just an issue of foreign investment in Australia. Investment abroad by Australian companies is also important, as the rest of the world will increasingly be the source of our future economic growth. Australia is a small country, and important opportunities for long-term growth will be drawn from overseas. The very rapid growth in foreign source income, as identified above, reflects the successful exploitation of Australia's human and technological skills in overseas markets. The taxation system should accommodate rather than stifle investment abroad, so that the high growth of this income stream continues.

Principles for international investment income neutrality do not imply competition by reducing tax burdens - on the contrary, there should be broad agreement on the tax principles. By the same token, Australia should not unilaterally introduce policies that increase the tax burden - because this too could result in an erosion of tax revenues without any benefit in terms of greater investment.

The terms of reference of this current review are set, however, to increase business taxation revenue by approximately $1.67 bn in 2000-01 (falling to $650 m in 2002-03) [3]. The review may recommend changes to the policy reforms that generate this revenue, but any amendments must still generate the revenue identified in *A New Tax System*. As a result, the business sector will contribute significantly to the funds required for other tax reform, including personal tax rate reductions.

In this environment, reforms of business taxation must be recommended on the basis of minimising distortions to investment decisions. It would be preferable to focus on maximising overall economic welfare, but this could lead to lower business taxation, which is well beyond the rules of this review. This foundation for reform has led to four key recommendations in this submission:

---

[2] KPMG Corporate Tax Survey, January 1999.
[3] See page 127 of *A New Tax System*.

1. Accepting a revenue neutral constraint, that tax concessions (other than the research and development tax concession), and in particular accelerated depreciation, be abolished to fund a reduction of the company tax rate.
2. That entity taxation, involving the taxation of trusts as companies, be accepted as the basic structure for business taxation.
3. That reform not increase (and to the extent possible reduce) the already excessive taxation of cross-border income flows, from Australia to foreign investors, and from overseas to Australian investors.
4. That taxation of financial arrangements adopt an elective mark-to-market taxation for traded financial assets and liabilities, in preference to a compulsory regime.

These recommendations will lead to a broader and fairer base for taxation of business income, while reducing the distortions that are inherent in overlapping domestic taxation systems. ASX encourages the government to be cautious about the timing of reform, particularly in terms of Australia's position in the investment cycle. Some economic commentators are forecasting a capital expenditure recession. It would be most unfortunate to reduce investment incentives if this outcome comes to pass.

Capital gains tax is a separate area for reform that is under consideration. **ASX is concerned that recommendations for some of the capital gains tax reform proposals are not yet sufficiently informed by a comprehensive analysis of possible behavioural responses.** In particular, CGT rate reductions might be expected to create incentives for investment and asset sales that would otherwise be held to avoid CGT. A closer examination of the revenue implications of rate reductions is warranted before significant reform of the CGT provisions, including abolition of indexation, is recommended. Analysis of rate reductions in conjunction with unlocking effects is discussed in Chapter 5.

Structural change to the imputation system

The overview to the discussion paper canvasses the possibility of abolishing imputation and returning to a classical system. ASX has some views on the benefits of structural reform to the imputation system. While the Review of Business Taxation has ruled out the abolition of company tax, which would obviate imputation, ASX believes that this reform warrants further consideration, due to significant drawbacks to operating an imputation system, as discussed below. Abolition of company tax would be consistent with an entity taxation system, but it would mean that all companies are taxed like trusts, rather than the reverse.

The best tax system for a closed economy is an imputation system. Imputation can ensure that income from business is taxed only at the personal level (at the marginal tax rate of the individual). In reality, of course, there are cross-border profit flows - and imputation can have some deleterious effects for cross-border flows.

When there are foreign shareholders receiving profit from Australia, and Australian shareholders receiving profit from investment in other nations,

profits are subject to taxation at multiple points. Company tax at source of profit; border tax; additional company tax in the home country; and personal taxation of the shareholder. This situation is true (to varying degrees) of all nations.

The significance of multiple taxation points is that tax is reduced by having shareholders located in the same country as profits are generated. A company with small values of foreign profits relative to domestic profits will generally wear multiple taxation points. The company will not respond - and the shareholder's country will extract tax revenue from profits that are generated overseas.

However, as the importance of foreign profits increases and the proportion of foreign shareholders increases, there will be a greater preference to become resident overseas for tax purposes, because this would diminish the multiple taxation points. There will be a threshold where a company would move offshore for tax purposes - thereby greatly diminishing the tax revenue of the country of former residence.

Reducing the tax burden on foreign-source income in a revenue neutral manner could be undertaken through a fundamental restructure of Australia's imputation system. Franking credits for company taxes paid overseas could be attached to foreign source income distributed to resident shareholders. Depending on the method of implementation, this policy would significantly reduce the Australian tax take from foreign source income. To pay for this revenue reduction, it would be possible to reduce the amount of franking attached to domestic-source profits distributed to resident shareholders. A form of this approach has been adopted by the United Kingdom, which has overhauled its own imputation system.

There are a range of issues that need to be addressed in the context of this proposal. For example, many Australian entities would have no foreign source income, and investors in these entities would be penalised by the reduction of franking attached to domestic source profits. Furthermore, the implementation of credits for foreign company taxes would need to protect the tax revenue from increases in offshore tax rates, but this is not an intractable problem.

This policy represents a more radical approach to tax reform, as it would clearly tackle issues related to the overlap between Australia's imputation system and tax systems of other countries.

Recommendations

ASX's set of recommendations comply with the revenue neutrality requirement. A tally of revenue impacts in provided in Table 1.

Trade-off between company tax rate reductions and abolition of tax concessions (Submission Chapter 1)

ASX submits that the R&D tax concession not be abolished.

ASX submits that the committee recommend that the company tax rate be lowered to 30 per cent, and that abolition of tax concessions, primarily accelerated depreciation, be used to fund this reform.

If the committee wishes to recommend a form of streaming policy (for foreign source income to non-resident investors), then this could be funded by a having a company tax rate that is marginally higher than 30 per cent.

Entity taxation system (Submission Chapter 2)

ASX strongly submits that the deferred company tax (DCT) not be the recommended option for the entity tax system.

ASX submits that the option for a resident dividend withholding tax be recommended in preference to deferred company tax.

ASX recommends that if the deferred company tax is recommended by the committee, the it should not be introduced until maximum negotiation of tax creditability for DCT with key countries is secured.

ASX submits that the options for avoiding double taxation of tax preferences in the proposed entity system are not satisfactorily developed. Further work to achieve an appropriate solution to this issue is required.

ASX submits that tax-preferred income accruing to CIVs not be taxed within the entity.

ASX submits that the definition of CIVs be broadened to cover wholesale trusts that are directly and predominantly owned by widely-held entities.

ASX submits that the options for taxation of pooled superannuation trusts may not result in neutrality across investment vehicles, given the proposal to allow CIVs to operate as flow-through vehicles. More analysis of the implications for superannuation policy objectives should be undertaken before the committee makes recommendations to implement the options contained in the discussion paper.

Taxation of non-residents (Submission Chapter 3)

ASX strongly supports the option to introduce a Non-Resident Investor Tax Credit (NRITC).

ASX strongly supports the option to extend the current conduit income provisions.

At a minimum, the committee should recommend further analysis of a dividend streaming policy for foreign source income. This analysis should include an examination of its relationship to the principles outlined in *A Strong Foundation*, options for implementation and the revenue implications these options.

ASX recommends that non-resident companies be allowed to attach franking credits (arising from Australian company tax) to distributions. Similarly, foreign trusts that will be subject to entity taxation should also be allowed to attach franking credits to distributions.

Taxation of foreign source income (Submission Chapter 4)

ASX strongly supports the proposed option for franking credits attached to be dividends received from resident entities to flow through non-resident entities to resident investors.

ASX strongly supports the option to allow domestic entities to pass through an imputation credit for foreign DWT to Australian shareholders.

ASX generally supports proposals to amend the thin capitalisation rules.

Taxation of financial arrangements (Submission Chapter 5)

ASX supports the change in policy from compulsory to elective mark-to-market taxation for financial assets/liabilities. It is hoped that the principle for mark-to-market taxation to be elective is reflected throughout the other rules governing the taxation of financial assets/liabilities and is not defeated in practice through difficulties in complying with anti-avoidance/synthetic disposal rules.

ASX submits that of the 3 options discussed for entitling taxpayers to gain access to mark-to-market treatment, the third option in paragraph 6.53, allowing for a combination of the transaction basis and the asset class/entity-wide basis, should be adopted.

ASX opposes the introduction of the proposed synthetic equity rules referred to in Chapter 7.

There is a genuine risk that the difficulty of complying with the synthetic rules will effectively force taxpayers who wish to elect for realisation taxation of equities (such as superannuation funds, collective investment vehicles

and insurance companies) into mark-to-market treatment of their equities and equity derivatives.

ASX submits that if synthetic equity rules are adopted they should, at very least:

- exclude from their operation the use of derivatives which are not directly based on a particular type of share, that is, portfolio hedging should generally be excluded;
- exclude legitimate short term hedging arrangements. In this context, the definition of short term hedging should be based on a 2 year period.

If the proposed synthetic equity measures are to proceed, ASX seeks to be consulted in the process of formulating the rules.

ASX supports the exclusion of ordinary shares and equity derivatives from the timing adjustment proposals developed in Chapter 6 of the discussion paper.

ASX submits that premiums on deep-in-the-money equity derivatives should not be subject to the timing adjustment proposals developed in Chapter 6 of the discussion paper.

ASX submits that the taxation of hedging transactions should be covered by the rules relating to elective mark-to-market/realisation taxation. Investors should be entitled to elect to have both sides of a hedging transaction taxed on a mark-to-market basis or alternatively on a realisation basis.

ASX opposes the introduction of further loss quarantining rules into income tax legislation. In particular, ASX strongly opposes the introduction of specific measures which target quoted equity securities.

ASX submits that the conversion of convertible notes or converting preference shares should not be treated as a disposal event on which tax could be payable. Instead, the conversion should be treated as a capital gains tax rollover event.

Reform of capital gains taxation (Submission Chapter 6)

ASX does not support the abolition of indexation to finance reductions of CGT rates or other tax reform as identified in the discussion paper.

ASX supports the abolition of averaging, but only if the funds raised are used to pay for exemption from CGT for scrip-for-scrip transactions for public and private entities.

ASX submits that recommendations on the reduction of personal capital gains tax rates should not be made until a comprehensive analysis of likely behavioural responses to a CGT rate reduction is available. In particular, potential 'unlocking' effects and incentives for business formation due to CGT rate reductions should be carefully evaluated, because the evidence from overseas suggests that behavioural

responses can be significant. As a result, rate reductions at the individual tax level might have a much lower cost to revenue than is indicated in the discussion paper.

ASX submits that the indexation of capital gains should not be abolished to fund the rate reduction options identified in the discussion paper. The options in the paper raise equity issues or may have distorting impacts on investment decisions.

ASX recommends a rate reduction policy that maintains the progressive structure of income taxation, and reform that is neutral to the duration of asset holdings. ASX's modelling indicates that some of the reform options raise concerns in terms of equity issues or long-term revenue outcomes (see Attachment 2).

ASX has undertaken some modelling of capital gains tax reforms to consider the possibility that rate reductions generate 'unlocking' through increased realisation of capital gains. If an appropriate accounting for behavioural responses is made, then ASX argues that the following options for CGT reform be considered:

- maintenance of indexation.
- a 20 % reduction in marginal tax rates.

Preliminary analysis suggests that these proposals would be close to self-funding if the realisation of capital gains increases by about 15 % in response to the lower tax rates (see Attachment 2).

Table 1: ASX Submission - Revenue Neutral Recommendations

	1999-00	*2000-01*	*2001-02*	*2002-03*	*2003-04*
Cost to revenue of reducing the company tax rate					
As per Part A of Table 39.1[1]	-160	-2700	-2840	-2500	-2920
Gain to revenue from investments at a 30 per cent company tax rate					
As per Part B of Table 39.1	0	180	1770	2390	2730
Growth dividend	0	50	100	150	200
Net revenue from company tax rate and investments trade-off	**-160**	**-2470**	**-970**	**40**	**10**
Alternative entity options					
Provide CIVs with flow-through treatment and not tax tax-preferred income	0	-60	-100	-70	-60
Replace DCT with RWDT	-40	170	-80	-90	-90
Franking credits for foreign DWT for CIVs	0	0	-50	-50	-60
Franking credits for foreign DWT for other entities	0	0	-160	-170	-190
Tighten thin capitalisation provisions[2]	0	50	500	350	400
Total	**-40**	**160**	**110**	**-30**	**0**
Alternative taxation arrangements for CGT					
Remove CGT averaging	0	0	150	150	200
Scrip-for-scrip rollover relief for listed public companies	0	0	-100	-50	-50
Reduction in CGT rate for individuals	0	0	?	?	?

1. ASX understands that the RBT has deleted the estimate for company payment arrangements
2. Implemented as a fixed gearing ratio

[4] See page 127 of *A New Tax System*.

1. Trade-off between company tax rate reductions and abolition of tax concessions

The basic elements of revenue neutral tax reform proposed in the discussion paper are:

- Changes to the corporate tax rate
- Abolition or reduction of tax concessions, such as accelerated depreciation
- Changes to capital gains tax (at the personal level)

ASX argues that revenue neutral reforms should be assessed with principles identified in *A Strong Foundation*. The two key principles are:

1. the principle of investment neutrality; and
2. that tax concessions should only be maintained if there is well-established economic rationale for their existence .

These principles place the onus on supporters of tax concessions to validate their existence with economic rationales and empirical evidence where possible.

1.1 R&D tax concession

ASX believes that there is an established policy rationale for offering concessions to subsidise investment in research and development, due to the public goods that can arise from such investments. Public good benefits associated with R&D are by their nature difficult to quantify, which impedes decisive empirical analysis to determine the appropriate means and level of subsidisation. In principle, however, the R&D incentive is expected to generate public goods to some degree, which distinguishes it from most other tax concessions available in Australia.

In the absence of increases in other R&D incentives such as grants, abolition of the R&D tax concession would have substantive effects on R&D investment in Australia. Taking into account the public goods attributable to additional R&D, the R&D tax concession should be placed at the bottom of the list of tax concessions that might be abolished.

ASX submits that the R&D tax concession not be abolished.

1.2 Accelerated depreciation

An important issue when considering accelerated depreciation is the effect it has on choices of factors of production. By reducing the after-tax cost of depreciable assets, this concession encourages all businesses to choose plant and equipment over labour as a means of production.

Furthermore, by encouraging investment in capital intensive industries, the overall effect of accelerated depreciation is to edge the economy towards production that relies more heavily on physical capital rather human capital, such as mining and manufacturing.

This policy direction appears to be counter to the overall trend in economic activity around the world, where growth is being primarily sourced from the services sector. Australia is no exception to this pattern. Our services sector now represents 80 per cent of economic activity, up from 75 per cent in 1989-90. Employment growth has been sourced primarily from the services sector.

A policy position that is agnostic about the future path of economic activity, and the choice of capital and labour that future industries will draw upon, will place the smallest constraint on resources moving within our economy. ASX believes that abolition of accelerated depreciation will release government revenue that can be used to achieve a more equal distribution of the tax burden across all industries.

Accepting the revenue neutral constraints of this Review, ASX submits that accelerated depreciation be abolished.

1.3 Taxation reductions

In a revenue neutral environment, increased revenue arising from abolition of accelerated depreciation can be used to reduce taxes in a number of ways. The primary choices in the current review appear to be:

- Reduction of the company tax rate.
- Reduction of capital gains tax.

There is a third option that is not analysed in the discussion paper: further reduction of taxes currently raised from foreign source income earned by Australian globalised firms. In Australia, the imputation system in fact penalises resident shareholders of globalised companies. The argument is as follows. Imputation credits are only available for residents. Generally, repatriated foreign profits are not subject to Australian company tax - so they do not create franking credits. Domestic profits (with franking credits attached) are pooled with foreign profits prior to distribution to shareholders. Domestic and foreign shareholders receive both domestic and pooled profits - so domestic shareholders get a portion of unfranked foreign profits and foreign shareholders get some franked domestic profits. In effect, the foreign profits dilute the value of franking credits for resident

shareholders. Dilution increases as foreign profits rise - so the penalty increases as the company becomes more successful overseas.

In this respect, ASX strongly supports the proposal for imputation credits for foreign dividend withholding taxes, which remove some of the excessive tax burden on foreign source income. This proposal recognises two facts: that the greatest bias arising from separate domestic tax systems is for international investment flows, and that Australia is a small country that will need to draw on investment abroad as a source of future growth. In this respect, the recent performance of Australia's largest companies expanding offshore reflects our future. While domestic activity is vitally important, the ability to make use of our finance and human capital overseas is critical to growth. As a result, the fetters of the tax system on foreign source income should be carefully examined.

In section 3.2 of this submission, ASX submits that the committee recommend a dividend streaming policy for foreign source income to non-resident investors. If the committee supports the proposal for a form of dividend streaming, then this could be funded by a having a company tax rate that is marginally higher than 30 per cent. As this option was not analysed in the discussion paper, a firm costing is not provided, which impedes its consideration in terms of revenue neutrality. Nevertheless, dividend streaming would be unlikely to cost more than $600 m, which equates to 1 percentage point of the company tax rate.

Restricting consideration of tax reductions to company taxes and capital gains tax, ASX submits that revenue from abolition of concessions be used solely to fund a lower company tax rate. Due to Australia's imputation system, an important incentive created by accelerated depreciation is lower Australian tax on dividends distributed to non-resident investors. Abolition of accelerated depreciation will in isolation make Australia a less competitive investment location by raising the tax burden for some foreign investors. On the other hand, expenditure of tax revenue on a lower company tax rate will essentially benefit foreign investors, due to the operation of our imputation system. As a result, trading accelerated depreciation for a lower company tax rate would maintain some international neutrality, evaluated in terms of existing returns to foreign investors.

For franked dividends paid to non-residents, some of the revenue foregone by a lower company tax will accrue to foreign governments. Where another country operates a foreign tax credit system and a higher company tax rate than Australia's (new) rate, foregone company on income accruing to non-portfolio investors will be partially taxed at the company level overseas.

It is clear, however, that this situation will not clawback most of the benefits from foreign investors. The lower company tax rate will enable Australian companies to increase their distributions to shareholders, so that investors receive more dividends. This delivers higher after-tax benefits for foreign investors affected by clawback on existing dividends received.

Furthermore, dividends distributed to foreign investors in Australian companies are not generally characterised by clawback through overseas taxation. Portfolio investors, such as investment funds and individuals, do

not typically have access to foreign tax credit systems, while tax-exempt investors, such as US pension funds, have no use for tax credits at all. Such investors will receive full benefit of the lower Australian company tax rate. Finally, important segments of Australia's offshore investors have company tax rates below Australia's 36 per cent rate (Table 2)

Table 2: Company tax rates

Country	Company tax rate
Hong Kong	16
Singapore	26
Malaysia	28
Thailand	30
United Kingdom	30
New Zealand	33
France	33.3
USA	35
Japan	34.5 [5]

Source: http//www.tax.kpmg.net/library/country-tax-facts

With the proposal to tie the tax rate for capital gains accruing to non-residents to the entity tax rate, a lower company tax rate will also reduce taxation of capital gains tax for non-residents.

By contrast, reduction of capital gains tax rates will primarily benefit resident investors with holdings of capital assets. This would mean that funding a reduction of capital gains tax purely from abolition of accelerated depreciation would marginally shift our business tax burden from resident to non-resident investors.

ASX believes that it is preferable not to increase Australia's tax burden on non-residents, given the multiple taxation points that currently affect foreign investors in Australia. In a revenue neutral environment, ASX recommends that the overall reform package is neutral for residents and non-residents. In this context, reductions of tax levied on residents, such as a lower capital gains tax, should be raised through revenue paid by residents.

Accepting a revenue neutral constraint, ASX submits that the committee recommend that the company tax rate be lowered to 30 per cent, and that abolition of tax concessions, primarily accelerated depreciation, be used to fund this reform.

If the committee supports a proposal for streaming of foreign source income to non-resident investors, then a marginally higher company tax rate could be considered. Depending on the nature of the streaming policy, a slightly higher company tax rate of 31 per cent might be sufficient to fund this proposal.

---

[5] Rate for largest income earning companies.

[7] "More and Sooner," Wall Street Journal, June 23, 1998.

[8] Raymond J. Keating (Small Business Survival Committee), "Please, Steal from the GOP, Mr. President," Washington Times, January 23, 1997.

2. Entity taxation system

The three options for entity taxation are:

1. Deferred company tax
2. Resident dividend withholding tax
3. Taxation of incorporate dividends

ASX prefers the option for a resident dividend withholding tax to a deferred company tax. The deferred company tax proposal has several negative features, which are discussed in section 2.1.

As described in Chapter 15 of the discussion paper, the DCT and RDWT proposals are a combination of two distinct policy moves. The first policy is a requirement for full franking of distributions by Australian entities. The second policy is a provision for a switch between company tax and dividend withholding tax, so as to increase the creditability of Australian taxes for non-resident investors.

While these two policies interact, it is possible to separate out their effects. The switching proposal can be implemented to have the effect of raising or reducing tax revenue. In the entity proposals, it is implemented to support the increased tax revenue from full franking proposals. As such, the issue of whether the switch is acceptable by foreign tax authorities is critical. ASX recommends that the entity proposals not be introduced until resolution of this issue is reached with key countries.

If the switch is generally accepted, then there would be some amelioration of the impact of full franking on non-residents. A corollary argument is that the switch policy should be pursued in the absence of entity taxation, as it would achieve maximum creditability for Australian taxes paid by non-resident investors.

2.1 Deferred company tax

The deferred company tax proposal would have important implications for all shareholders in Australian companies, but its negative impacts are concentrated on non-residents. Deferred company tax would accelerate and increase the degree of washout of tax concessions. Deferred company tax will be levied on distributed profits not currently subject to normal company tax. Because tax concessions can generate untaxed distributed profits, full franking will create “washout” prior to receipt of the dividend by a shareholder. This outcome will be particularly deleterious to shareholders and trust beneficiaries that are non-resident for tax purposes.
Increasing the tax burden on overseas investors creates a barrier to globalisation of Australian companies, and discourages investment in

Australia. The vast majority of non-resident shareholders have their holdings in listed companies, which are Australia's largest businesses. This policy would therefore have a concentrated impact on large Australian companies, due to the heavy concentration of foreign ownership in these entities.

At its worst, the deferred company tax could lead some Australian companies to shift their headquarters and domicile offshore for tax purposes. Some companies have already made public statements indicating that this response is being evaluated. As a result, ASX is very concerned that the deferred company tax will do significant damage to Australia's position as a regional financial centre.

Creditability of deferred company tax ?

A key issue is whether DCT will be creditable overseas. ASX is not confident that necessary international arrangements can be put in place in the near term to facilitate the proposed full franking regime, without unduly impinging on the investment and related income flows into and out of Australia. Past experience is that international Double Taxation Agreements can take years to negotiate. Invariably, renegotiation of Double Tax Agreements to accommodate full franking would involve Australia granting concessions to participant countries in other areas of taxation. ASX is not aware of any concessions that might be available for negotiation with other countries.

In fact, a deferred company tax might prompt other countries to implement a similar policy in response. If an Australian resident invests in a US listed public company and the US company earned income not subject to US federal tax, dividends would be remitted to Australia subject to only the US withholding tax (15%) currently permitted by the Australia/US treaty. The US government might be entitled to ask why it should not impose a deferred corporate tax on such dividends, in reply to Australia's full franking system. This would lead to a higher tax burden on foreign source income created by the overseas investment of Australian globalised companies. As a result, deferred company tax could lead to the advent of a "fortress Australia" mentality with only Australian companies with local assets and local shareholders remaining in Australia.

Even if DCT is treated as a company tax by other countries, creditability of DCT will almost certainly not extend to all investors, because there are restrictions on credits in existing regimes. For example, the United States does not provide foreign tax credits to portfolio investors (where a shareholding is less than 10 per cent of the total equity). Moreover, tax-exempt entities that are non-resident for tax purposes -have no facility for tax credits, so the tax cannot be avoided.

Non-resident portfolio investors are a very important shareholder base, as this group includes global fund managers. At an aggregate level, investment income flows from Australia to portfolio investors were almost half of all

income flows to non-residents in 1997-98[12]. For example, one of the world's biggest global fund managers, the Capital Group Companies, owns 5.05 per cent of BHP [13]. Capital Group Companies is a US-based fund that typically takes long-term, direct equity positions in companies. Such portfolio investors will have no claim to tax credits for DCT, so their tax burden will rise.

The fact that portfolio investors are better off under the DCT proposal, as noted in Chapter 30, arises because of the switch policy (as described above), which should be pursued in any event. If the switch proposal is not accepted overseas (or given expected delays, until it is accepted), DCT will raise the tax burden on portfolio investors. Irrespective of outcomes on the switch policy, tax-exempt non-resident investors will be worse off.

Modelling of the impact of DCT on Australian companies

ASX commissioned modelling analysis of the deferred company tax proposal by Arthur Andersen. Attachment 1 to this submission outlines the key modelling results. ASX welcomes scrutiny and discussion of the modelling analysis.

The modeling analysis in Attachment 1 assesses the impact of deferred company tax on two companies. One company, Company A, is a large Australian global company with subsidiaries overseas and a significant foreign shareholder base. Detailed consolidated financial data for seven years are provided in Attachment 1, Annex 1. Key financial assumptions for this company are as follows:

- Company A earns 60 percent of its income outside Australia.

- The shareholding profile is set at 60 percent Australian residents (30 percent top-rate individuals and 30 percent superannuation funds) and 40 percent non-resident (half of whom reside in countries which allow foreign tax credits for Australian dividend withholding tax).

- The company is assumed not to have any carried forward tax losses available.

- The opening tax book value of the company's depreciable assets is equal to 60 percent of their value in the company's financial accounts. The average depreciation rates for financial accounting and tax accounting, respectively are 15% and 25%. Abolition of accelerated depreciation would result in the tax depreciation rate falling to 15% for assets acquired in or after 2001.

- The company maintains a constant ratio of debt to total market value of 26 percent (corresponding to a debt to market-value-of-equity ratio of 35.2 percent).

---

[12] ABS Catalogue 5302.0, Balance of Payments and International Investment Position, Australia.

[13] 'US Fund Shows Up on BHP Register', Sydney Morning Herald, 1 April 1999.

- Cash dividends paid in each year are held constant at their base case level under all scenarios, as is debt.

The second company, Company B, is primarily Australian-based. It is modelled to illustrate a large start-up company that draws heavily on tax concessions, such as accelerated depreciation, for domestic growth. The financial structure of Company B is similar to that for Company A, other than:

- 80 percent of income is sourced from Australia, and 90 percent of shareholders Australian.

- Company B has sufficient tax losses arising from accelerated depreciation carried forward for it not to need to pay Australian tax for around 3 years. This means that it is unable to fully frank dividends in early years, so it may be subject to double taxation of distributed income.

Results for Company A

The modelling work shows that the deferred company tax proposal would have a significant negative impact on the cost of capital for Australian companies with large proportions of non-resident shareholders. Results for Company A are provided in Table 3. Effective tax rates are the net present value of Australian taxes and overseas company taxes as a ratio to dividends received. The company tax rate is assumed to be 36 per cent. Tax value calculations take into account the fact that franking credits are available for resident shareholders. As a consequence, effective tax rates for resident shareholders are lower than for non-resident shareholders. Note that in Table 3, the effective tax rate for Australian taxpayers with DCT in place is 36 per cent, which is the same as the company tax rate. This outcome is simply a coincidence, as the taxes for Company A are primarily driven by overseas taxation of foreign source income. For comparison, note that the effective tax rate for Company B under existing tax provisions is about half that for Company A, because Company B only derives 20 per cent of its income from overseas.

Table 3: Modelling results for impact of deferred company tax on effective tax rates, market value of initial equity and cost of capital

Effective Tax Rates	*Current*	*DCT*[1]	*% difference*[2]
Aus taxpayers	33.4%	36.0%	7.8%
Aus super funds	33.4%	36.0%	7.8%
Non-residents, credit countries	48.5%	63.0%	29.9%
Non-residents, exemption countries	48.5%	65.4%	34.7%
Average:	39.4%	47.3%	19.9%
Market value of initial equity ($m)	3,752		-16.3%

		3,139	
Cost of equity capital	13.3%	14.6%	10.0%
Weighted average cost of capital (WACC)	10.8%	11.6%	8.0%

1. Foreign Dividend Account dividends exempt from DCT.
2. A positive number indicates an increase from the current value.

The results are based on the assumption that deferred company tax will not be creditable overseas, because it is yet to be established that this will be the case. As a result, the effective tax rates for non-residents increase very significantly, due to the extra tax burden on currently unfranked dividends. The effective tax rates for residents also rise, because DCT brings forward tax from the future to today, so the net present value of company taxes increases. The increase in effective tax rates increases the cost of capital for the company, and the market value of the company is reduced by about 16 per cent.

The modelling analysis shows that the penalty of DCT falls predominantly on non-resident shareholders. As a result, ASX is very concerned that the deferred company tax will do significant damage to Australia's position as a regional financial centre. Moreover, due to the impact of the tax increase on the cost of capital, the proposal will have negative spillover effects on Australian shareholders. DCT will increase the cost of financing domestic and offshore investment from equity.

Results for Company B

The key feature of Company B is that it has a significant stock of accumulated tax losses, which could arise if it has invested heavily and received benefit from tax concessions. In this event, if the company pays dividends, it will have insufficient tax liability to fully frank those dividends, and it will need to pay DCT.

This action would bring forward a future tax liability, which contributes to the increases in effective tax rates (as the NPV of the taxes rises). The other assumption is that there is no effective means of reducing the double tax burden associated with DCT, in the absence of a policy solution. The results from this analysis underscore the importance of finding an appropriate solution to the potential double taxation of tax concessions, as ASX does not believe that the options described in the discussion paper will fully ameliorate this problem.

Table 4: Impact of deferred company tax on Company B

Effective Tax Rates	*Current*	*DCT*[1]	*% difference*[2]
Aus taxpayers	16.1%	17.2%	7.0%
Aus super funds	16.1%	17.2%	7.0%
Non-residents, credit countries	38.4%	49.0%	27.5%
Non-residents, exemption countries	39.7%	50.5%	27.3%
Average:	18.4%	20.5%	11.3%
Market value of initial equity ($m)	5,151	4,522	-12.2%
Cost of equity capital	13.0%	13.8%	6.7%
Weighted average cost of capital (WACC)	10.9%	11.5%	5.7%

1. Foreign Dividend Account dividends exempt from DCT.
2. A positive number indicates an increase from the current value.

Impact of deferred company tax on reported after-tax profits

A further reason why DCT should not be recommended is its negative impact on reported after-tax profits of affected companies. The discussion paper notes that this change would need to be comprehended by markets and shareholders, because the imputation system means that DCT would shift significant tax liability from resident shareholders to the corporate (a timing difference). In the absence of a full assessment of the implications of this effect, it is possible that market analysts would mark down the performance of such companies.

ASX is concerned that significant, costly analysis would be required to filter out the pure timing effects of DCT from the real impacts on non-residents. This problem will be exacerbated if the DCT is introduced without agreement on the facility for switching (as described above). Given the long delays in determining international positions on such policies, uncertainty about the

final impact on non-residents will further complicate the market assessment of DCT impacts. Moreover DCT will have impacts that differ according to the composition of non-resident shareholders - so foreign analysts would be required to make different assessment of impacts for each segment of the market (for pensions funds, for pooled investment funds, for corporate investors etc).

As Australia only represents less than 2 per cent of the global market for equities, it seems highly unlikely that analysts in key overseas markets could justify the cost of conducting the necessary filtering analysis on a company-by-company basis. If this is the case, then the negative impact on the reported after-tax profit of affected companies could be much more than a simple timing effect. There will be real market consequences, as the performance of key Australian companies is marked down by market analysts.

It seems likely that affected companies would anticipate this outcome, and reduce dividend payouts and increase retained earnings. This situation would be very damaging for investors that prefer dividend flows as an income source. Moreover, this outcome would diminish the rate of return from domestic sharemarket investment relative to foreign equity investment.

In relation to temporary tax preferences, the company could delay payment of concessional income until the future company tax liability is generated. This would diminish the net present value of the concession. Increased retained earnings could lead the company to fund investment from equity rather than debt. This switch would increase tax liabilities, thereby facilitating payment of franked dividends.

ASX strongly submits that the deferred company tax is not the recommended option for the entity tax system.

2.2 Resident Dividend Withholding Tax (RDWT)

RDWT would remove several of the negative effects of DCT. In particular, unfranked distributions paid to non-residents would pay DWT rather than the company tax rate, and the after-tax reported profits would not be affected.

Selection of the RDWT option has implications for recommendations on other policy issues. Treatment of the profits remitted by branches of foreign companies is considered with reference to the entity regime.

Taxation of the branches of foreign companies as entities would have ramifications for the government's offshore banking unit policy, including the implementation of improvements to this policy, which are contained in Tax Laws Amendment Bill No. 4, which is currently passing through Parliament.

The discussion paper notes that if the RDWT is implemented, then there is a weaker case for taxing branches as entities. The revenue raised from taxing branches as entities would be considerably smaller under the RDWT policy than the DCT, yet there would still be legislative and administrative complexity arising implementing OBU policy for branches subject to the entities regime.

If the committee recommends that a RDWT be adopted to implement the entities regime, ASX submits that branches of foreign companies not be included in the entities regime.

ASX recommends that the option for a resident dividend withholding tax be recommended in preference to deferred company tax.

2.3 Options to avoid the double taxation of distributed tax-preferred income

An adequate solution to the potential double taxation of tax-preferred income is a necessary corollary of a full franking proposal.

Table 15.2 of the discussion paper illustrates the tax impact of temporary tax preferences. A problem with this table is that the company distribution policy that is modelled for current tax law is not optimal. The company should reduce its distribution in Year 1, and increase it in Year 2, so that maximum value from franking credits is obtained.

As such, the options should provide a solution to the double taxation of permanent tax preferences. However, a simple split between temporary and permanent tax preferences is not possible.

ASX submits that Options 1 and 4 are not solutions to the basic problem of double taxation, as they are tailored to specific behaviour by the entity.

The discussion paper notes that Option 2 is designed for the DCT proposal. Given that ASX does not recommend the DCT proposal, Option 2 is also considered inappropriate.

This leaves Option 3 (Allows prepayment of tax on temporary tax preferences). This approach is supported on the basis that it provides companies with the flexibility to manage distributions that are currently unfranked. There is, however, a structural problem with this option. It is proposed that this arrangement not be allowed for permanent tax preferences. A difficulty with this principle is that distinguishing a permanent tax preference from a temporary preference can be difficult. In particular, the investment profile for the entity will determine the duration of preference value - but this is likely to be very difficult to determine ex ante.

ASX submits that the options for avoiding double taxation of tax preferences are not satisfactorily developed. Further work to achieve an appropriate solution to this issue is required.

2.4 Preventing double tax through the entity chain under the full franking system

ASX submits that Option 1 (Gross-up and credit) is the recommended means of preventing double tax through the entity chain. This option is strongly preferred to an exemption approach (Option 2), because this approach would mean that deductions attributable to the dividend received will not be available.

2.5 Collective investment vehicles

ASX strongly supports the proposal to exclude collective investment vehicles from the entities regimes, so that they are taxed on a flow-through basis. This approach will avoid cash flow problems and administration costs of taxing some widely held entities as companies. Moreover, a facility for CIVs will help ensure appropriate treatment of foreign source income and distributions to non-residents.

Definition of CIVs

ASX recommends that the definition of CIVs be as wide as possible. The discussion paper argues that:

> Discretionary trusts and trading trusts, or closely held entities, would not qualify and would be taxed as entities as A New Tax System proposes.

ASX argues that the definition of CIVs depends in part on whether tax-preferred income distributed by a CIV is taxed or not. If the tax-preferred income is taxed, then as the discussion paper notes:

> This treatment would put CIVs, and business structures incorporating a CIV, on a similar competitive footing to other entities.

Hence, distortions associated with the pass-through of tax preferences are removed, and the impact of being defined as a CIV or not is limited to the issue of whether distributions of taxable income retain their character (for example, as capital gains or foreign source income).

It is not apparent in the discussion paper that a purpose of the entity system is to change the character of income distributed by an entity from that received. This would mean that if CIV tax-preferred income is to be taxed, then the definition of CIVs should be as wide as possible. If tax-preferred income is not taxed, then the definition of CIVs should be somewhat narrower.

2.6 Should tax-preferred income accruing to CIVs be taxed ?

ASX supports the investment neutrality principle proposed in *A Strong Foundation*. Depending on the definition of a CIV, it seems likely that most widely-held trusts will be CIVs, and such trusts cannot retain profits and must distribute all taxable income.

This situation means that many CIVs will not have the ability to retain tax-preferred income as a source of funds for future investment. This feature distinguishes such CIVs from companies. The fact that CIVs will have income flow-through characteristics suggests that their entity structure is more closely aligned to that of a partnership than a company structure.

An alignment between CIVs and partnerships suggests that the treatment of preference income should be similar for investment undertaken through a CIV and a partnership. This interpretation would suggest that the tax-preferred income should also be allowed to flow-through a CIV, to be consistent with the neutrality principle.

ASX submits that tax-preferred income accruing to CIVs not be taxed within the entity.

2.7 Definition of CIVs

If tax-preferred income is to be passed through a CIV untaxed, then a narrower definition of CIVs is likely to be necessary.

The discussion paper raises the option of a widely-held test for determining a CIV. Widely-held entities would include:

- listed entities
- trusts with more than 50 investors or
- trusts that are publicly offered, and where the top 20 unit holders own less than 75 per cent of the value of units.

A likely problem with this definition of CIVs is that is would exclude some wholesale trusts. Many wholesale trusts are primarily held by superannuation funds, and the weight of their investment would mean that the wholesale trust does not meet the third criteria for determining a widely-held entity.

This outcome would defeat the intention of the CIV facility, to the extent that the holders of the wholesale trust are predominantly comprised of widely-held entities.

ASX submits that the definition of CIVs be broadened to cover wholesale trusts that are directly and predominantly owned by widely-held entities.

2.8 Pooled superannuation trusts

The discussion paper argues that the current arrangements for pooled superannuation trusts would be inconsistent with the redesigned imputation system to apply to other entities under the new entity tax regime. In particular, the need for neutrality between PSTs and unit trusts under the new entity system is identified as a rationale for incorporating PSTs into the entity system.

It is not clear, however, that unit trusts will be treated as entities for tax purposes. The proposal for collective investment vehicles means that many unit trusts would be classified as CIVs, which are an investment vehicles that lie between entities and individuals. If CIVs include a significant set of vehicles for superannuation funds, then it is arguable that PSTs should be treated as a CIV rather than an entity for tax purposes.

Furthermore, taxing PSTs as entities is expected to have ramifications for investor incentives for superannuation and savings. It is not apparent that the recommendations pertaining to PSTs have been analysed in the context of the government's policy objectives for superannuation.

ASX submits that the options for taxation of pooled superannuation trusts may not result in neutrality across investment vehicles, given the proposal to allow CIVs to operate as flow-through vehicles. More analysis of the implications for superannuation policy objectives should be undertaken before the committee makes recommendations to implement the options contained in the discussion paper.

3. Investment in Australia by non-residents

3.1 Option for a Non-Resident Investor Tax Credit (NRITC)

Australia currently exempts franked dividends paid to non-residents from dividend withholding tax (DWT). This policy reduces the tax burden on foreign investors. A drawback of this policy is that most countries provide a credit for DWT paid (at the company level), but there are typically significant restrictions on creditability of company taxes.

The option to impose DWT on all dividends distributed to non-residents and refund some entity tax is a worthwhile policy to achieve greater creditability for Australian taxes. If Australia's tax mix was transferred from company taxes to the DWT, then tax revenue can be maintained and the overall tax burden on dividends paid to non-residents is reduced. If this policy is accepted by other countries, then it should be implemented.

ASX strongly supports the option to introduce a Non-Resident Investor Tax Credit (NRITC).

3.2 Treatment of conduit income for entities (other than CIVs)

In terms of problems raised by the DCT/RDWT proposals, there is a clear need to extend the current FDA arrangements by using a foreign income account. This option will diminish the potential for taxation of (currently exempt) foreign source income that is passed through to non-resident investors.

ASX strongly supports the option to extend the current conduit income provisions to accommodate a RDWT.

It is disappointing that an option for streaming of foreign source income to non-resident investors is not discussed in the discussion paper. In Australia, the imputation system penalises resident shareholders of globalised companies. The argument is as follows. Imputation credits are only available for residents. Generally, repatriated foreign profits are not subject to Australian company tax - so they do not create franking credits. Domestic profits (with franking credits attached) are pooled with foreign profits prior to distribution to shareholders. Domestic and foreign shareholders receive both domestic and pooled profits - so domestic shareholders get a portion of unfranked foreign profits and foreign shareholders get some franked domestic profits. In effect, the foreign profits

dilute the value of franking credits for resident shareholders. Dilution increases as foreign profits rise - so the penalty increases as the company becomes more successful overseas.

Streaming would reduce the dilution of franking credits by enabling Australian globalised companies to pass foreign source profits to non-resident investors. This approach would ensure that dividends paid to resident investors are sourced first from franked domestic source dividends, which maximises the value of franking for those investors. This approach would diminish the penalty for residents investors of investing in globalising Australian companies.

At a minimum, the committee should recommend further analysis of a dividend streaming policy for foreign source income. This analysis should include an examination of its relationship to the principles outlined in *A Strong Foundation*, options for implementation and the revenue implications these options.

3.3 Proposal to allow franking credits to be available to residents investing in Australia via non-resident entities.

ASX strongly supports the proposed option for franking credits attached to dividends received from resident entities to flow through non-resident entities to resident investors.

There is a remaining issue as to why non-resident companies that pay Australian company tax are not able to directly issue franking credits to their resident investors. The purpose of the entity taxation system is to remove differences between the taxation treatment of different legal entities. It is then reasonable to ask why the system should not encompass companies that are non-resident for tax purposes.

ASX recommends that non-resident companies be allowed to attach franking credits (arising from Australian company tax) to distributions. Similarly, foreign trusts that will be subject to entity taxation should also be allowed to attach franking credits to distributions.

4.Taxation of foreign source income

ASX supports policies that reduce the multiple levels of taxation that burden cross-border income flows, and thereby bias investment decisions. ASX acknowledges that neutrality for international investment is not wholly within the control of the Australian government. As a small country, however, it is likely that Australia will draw significant growth through the overseas operations of our domestic companies. This situation makes it imperative that the taxation of foreign source income from such companies is carefully examined.

There is an important bias in the choices of overseas investment by Australians. Offshore income from an individual's shareholding in a foreign company, managed through a domestic or foreign trust, is taxed more favourably to income from a individual's shareholding in an Australian company operating overseas. Tax credits for foreign underlying and withholding taxes are attached to income from the shareholding in a foreign company - but a similar credit does not pass through to the shareholder in the Australian company. This situation biases investment away from the Australian company. The entity system proposal will largely remove this bias by preventing the pass through of credits via a trust. Investment through a CIV will, however, preserve the existing bias, as CIV will be able to pass-through credits to investors.

4.1 Allow an imputation credit for withholding tax paid on foreign dividends

ASX argues that the multiple taxation of foreign source income can discourage the repatriation of offshore profits by Australian companies. The significance of multiple taxation points is that tax is reduced by having shareholders located in the same country as profits are generated. A company with small values of foreign profits relative to domestic profits will generally wear multiple taxation points. The company will not respond - and the shareholder's country will extract tax revenue from profits that are generated overseas.

However, as the importance of foreign profits increases and the proportion of foreign shareholders increases, there will be a greater preference to become resident overseas for tax purposes, because this would diminish the multiple taxation points. There will be a threshold where a company would move offshore for tax purposes - thereby greatly diminishing the tax revenue of the country of former residence.

Some of Australia's key foreign markets, such as the United States, operate classical tax systems, where company profits are taxed at the company level and if distributed they are taxed a second time at the individual level. By comparison, US profits of an Australian company are taxed at the company level, and repatriated profits are subject to US withholding tax, exempted

from Australian company tax, but then subject to Australian personal tax when distributed to the Australian shareholder.

If the Australian company domiciled in the US for tax purposes, and switched its shareholder base from Australia to the US, it would not be subject to the withholding tax. Apart from differences in the Australian and US personal tax rates, the extra burden of the withholding tax makes an important difference to remaining domiciled in Australia for tax purposes.

Australian government efforts to reduce the cost of the border tax would represent an important step to alleviating the bias on investment decisions of Australian globalised companies. It will also diminish the bias between indirect investment in foreign companies (via a CIV) and direct investment in Australian companies, as described earlier.

For these reasons, ASX strongly supports the option to allow domestic entities to pass through an imputation credit for foreign DWT to Australian shareholders.

While the extension of this proposal to underlying taxes should be considered by the government, this further step would raise significant revenue concerns. It would mean that increases in foreign underlying taxes would reduce the tax revenue from foreign source income. In contrast, the imputation credit for foreign DWT proposal should not have this problem. The revenue cost will be generally limited by the operation of tax treaties, which restrict DWT to 15 per cent. This is a very positive feature of the proposal, because it limits the potential for increasing the credit rate over time.

Finally, the revenue cost of the proposal depends on the response of Australian globalised companies. If companies respond by increasing their profit repatriation, then Australian investors will receive more taxable foreign source income. This would mean that the government will raise more personal tax from individual investors. The overall cost of the proposal would be accordingly reduced.

ASX strongly supports the option to allow domestic entities to pass through an imputation credit for foreign DWT to Australian shareholders.

4.2 Thin capitalisation rules

ASX supports the position on changes to the thin capitalisation rules that are contained in the Business Coalition on Tax Reform's submission. The proposed reforms will appropriately reduce potential tax avoidance under the existing rules.

ASX generally supports proposals to amend the thin capitalisation rules.

5. Reform of capital gains tax

5.1 Estimation of revenue costs of CGT rate reductions

The International comparisons information paper notes that most countries allow preferential taxation treatment of capital gains, particularly where the gain is realised by an individual taxpayer. Most countries have capital gains tax rates that are below the rate for wage income. Australia taxes capital gains at the same rate as ordinary income, but we have indexation of capital gains, which is available in only a few other countries.

The impact of CGT reform on the economy and tax revenues can be difficult to predict. The discussion paper states, however, that '… it is noteworthy that the USA and the UK have reduced their effective rates and have experienced increased investment and business development'. Furthermore, the impact of a lock-in effect on tax revenues is also accepted. 'The realisations basis of the CGT means that there is a lock-in effect for investors. This effect increases with the size of the unrealised capital gains associated with the asset and the rate of tax that would be payable.'

Both factors would suggest that there are important feedback effects for the economy and revenue arising from a reduction in the rate of capital gains tax. The discussion paper does not attempt to distil lessons from outcomes from capital gains tax reform in other countries, particularly the US. The revenue costs for CGT reform, as described in Chapter 39, do not attempt to take such feedbacks into account.

The government should draw on a comprehensive information base for analysis of options for capital gains tax reform. ASX urges the Committee that its recommendations on that reform of the capital gains tax system, as described in the discussion paper, be deferred until an adequate analysis of potential dynamic effects from reform is available as a basis for making a policy decision. Based on assessments of overseas experiences, it seems probable that the revenue cost of CGT rate reductions would be significantly lower than the values identified in table 39.2 in PFC. Further analysis of behavioural responses to capital gains tax is provided in Attachment 1.

ASX argues that there could be significant unlocking effects from CGT rate reductions. In Chart 5 of Attachment 2, a scenario is modelled for the following CGT rate cuts:

- from 47 per cent to 40 per cent
- from 30 per cent to 25 per cent
- from 17 per cent to 12 per cent

Chart 5 models effective tax rate outcomes assuming that there is a 15 per cent increase in the CGT taxable base due to unlocking of taxable assets in response to these rate cuts. **Notably, this modelling assumes that indexation remains, as unlocking of capital assets pays for the rate**

cuts. The modelling shows that with unlocking taken into account, a rate cut could be implemented at a much lower cost to revenue than is assumed in the discussion paper.

Chart 5 shows that the revenue cost attributable to taxpayers currently at 47 and 30 per cent tax rates is very small, while taxpayers in the lowest income bracket (who contribute a minor part of the taxable base) benefit marginally better. For all taxpayers, the reduction in effective tax rate is always less than 1 per cent for assets held for less than 15 years.

ASX submits that recommendations on the reform of capital gains tax should not be made until a comprehensive analysis of likely behavioural responses to a CGT rate reduction is available. In particular, potential 'unlocking' effects and incentives for business formation due to CGT rate reductions should be carefully evaluated, because the evidence from overseas suggests that behavioural responses can be significant. Rate reductions at the individual tax level might have a much lower cost to revenue than is indicated in the discussion paper.

5.2 Means of implementing rate cuts for CGT

There are four basic ways of implementing a cut to CGT described in the discussion paper.

1. Exemption of $1,000 of CGT from taxation.
2. Lowering of the maximum CGT to 30 per cent.
3. Reduction of CGT rates each by 20 per cent.
4. Rate reduction over time (tapering).

ASX suggests that the revenue cost of options 2 to 4 are less than that indicated in the discussion paper, due to 'unlocking' effects and incentives for business formation as discussed in Attachment 2.

An assessment of the rate reduction options should take a view on equity issues and potential distortions to investment decisions. Attachment 3 to this submission outlines some preliminary modelling of the reform options identified in the discussion paper. Modelling suggests that there are important equity issues associated with the rate reduction options identified in the discussion paper.

According to the logic of 'unlocking' effects (as discussed in Attachment 2), lowering the maximum CGT rate to 30 per cent will achieve the greatest revenue return. As the wealthy are the most likely to be holding assets, a rate cut from 47% to 30% will create a large incentive to unlock assets. There are, however, important equity issues associated with a 30% maximum rate, as none of the spillover benefits of a rate cut will accrue to taxpayers on a marginal rate below 30%.

In terms of a rate reduction that is greater for longer-held assets, ASX believes that there is a confusion between the duration of investment and the duration of holding of that investment by any single individual. Duration of the holding should not be the focus of policy, because there is no correlation between the duration of holdings and asset life. For example, equity stocks finance investment in assets for the life of a company, although trading means that ownership may transfer between individuals.

While there may be rationales for policy to encourage long-term *investments* (in specific forms of capital), there is no logical reason why long-term *holdings* of financial capital by an individual will yield greater investment than a series of consecutive short-term holdings by separate individuals. Indeed, tax incentives based on holding periods may actually impede long-term investment by causing stock prices to diverge from their fundamental values, which will reduce liquidity in asset markets.

Rate reductions implemented through tapering confuse the duration of asset holdings with the duration of investment, and this approach has the potential to significantly distort investment behaviour. Moreover, the long-term revenue implications of the tapered rate options in the discussion paper might be of concern (see Attachment 2).

ASX recommends a rate reduction policy that maintains the progressive structure of income taxation, and reform that is neutral to the duration of asset holdings.

ASX recommends that the option for a proportional reduction in tax rates is the preferred means of implementing a rate cut.

5.3 Indexation

The tax law currently distinguishes between an asset's real increase in value and the increase due solely to inflation. For assets that have been held for a long time, a considerable part of their nominal value can simply reflect inflation. In the absence of indexation, taxes on the inflationary component can exceed any real increase in an asset's value, meaning the tax rate on real gains can be 100 percent or more. As a result, indexation removes an important distortion from incentives to invest in capital assets.

When inflation is at low levels, the importance of indexation is diminished. In the current economic environment, where inflation appears to have stabilised below three per cent, it might be tempting to abolish indexation. There is no certainty, however, that inflation will not rise again. In any event, it is important that the structure of the tax system be the most efficient for investment activities, and indexation is a necessary component of this system.

ASX does not support the abolition of indexation for the purposes of calculating asset values for tax purposes. Indexation avoids distortions to the taxation of capital assets, and it should be maintained as part of CGT

provisions. It should be noted that the revenue cost of rate reduction options identified in Table 39.2 are estimates assuming that indexation is removed. With indexation in place, the revenue cost of reducing CGT rates will be lower than the estimates in Table 39.2, because the tax base would be smaller.

ASX does not support the abolition of indexation to finance reductions of CGT rates or other tax reform as identified in the discussion paper.

As a consequence, ASX submits that the indexation of capital gains should not be abolished to fund the rate reduction options identified in the discussion paper.

5.4 Relief for scrip-for-scrip transactions

It is vital that the comprehensive income taxation principle distinguishes income flows from exchanges of capital by businesses. Where there is a reconstitution of capital that does not generate income, the comprehensive income taxation principle implies that this transaction should not be taxed.

In this respect, the proposal to extend capital gains tax rollover provisions to scrip-for-scrip transactions is a step in the right direction. There is also potentially positive outcomes in recommendations for reform of share buybacks and liquidations. In particular, the Review must address the double taxation that occurs when a company buys back shares for cash.

The CGT implications of splitting a company into several entities is another dimension of this issue. As this action is simply a reverse of a scrip-for-scrip transaction, it is arguable that CGT rollover provisions also be extended to corporate de-mergers. **This policy would lend symmetry to the CGT treatment of corporate restructuring.**

If the principle underlying the exemption is correct, then the exemption should be available for all businesses. Public and private entities should be able to merge or demerge without incurring a CGT liability.

The discussion paper argues, however, that there may be tax avoidance problems if an exemption is extended to private companies. If the government decides not to extend the policy to most private entities, then it is preferable to implement the policy for a limited range of entities than not at all.

In this event, ASX suggests that a means of drawing the line for inclusion in the exemption would be listed entities and collective investment vehicles.

In some cases, a merger occurs between a listed entity and an unlisted entity, such as a listed company and a private company. ASX believes that the exemption should extend to such mergers because the risk of tax avoidance should be limited by the involvement of the listed company.

The policy should not discriminate between domestic and foreign companies.

ASX supports the proposal to exempt scrip-for-scrip transactions of listed company equity from capital gains tax. If the principle underlying the exemption is correct, however, then the exemption should be available for all businesses. Public and private entities should be able to merge or demerge without incurring a CGT liability.

5.5 Averaging

ASX acknowledges the grounds for abolition of averaging of capital gains for tax purposes that are described the discussion paper. The existing averaging provisions can allow some taxpayers to avoid tax through exploitation of the tax-free threshold.

On the other hand, there is arguably a sound rationale for having averaging provisions. Averaging recognises the fact that a capital gains are lumpy, so that a realisation can push an individual's assessable income into a higher marginal tax bracket than would be the case for their ordinary income. Optimal progressive taxation policy should perhaps be based on the income flow over an individual's lifetime.

Inevitably there is a trade-off between protecting the revenue from exploitation and the policy objective of averaging. One means of partly preserving the policy goal of averaging while abolishing the provisions is to use the associated revenue raised to contribute to the funding of a general reduction of capital gains tax rates.

ASX supports the proposal to abolish capital gains tax averaging, and submits that the revenue from this reform be used to fund an exemption of scrip-for-scrip transactions for public and private entities.

6. Taxation of financial arrangements

6.1 General Response to Elective Mark-to-Market Taxation

In the ASX submission on the 1996 *Issues Paper*, it was submitted that equity and equity derivatives should not be included as "financial arrangements". The main reasons put forward in support of this submission were, in essence:

- greater variability in yield on equity than other financial arrangements;
- the absence of a fixed term for equity; and
- greater volatility in value.

The concerns raised by ASX about inclusion of equity and equity derivatives as financial assets/liabilities have to a significant extent been addressed in the *A Platform for Consultation* by replacement of the proposal for compulsory mark-to-market taxation of traded financial assets/liabilities with an elective regime.

For the reasons set out in the submission on the *Issues Paper* ASX supports this change in policy from compulsory to elective mark-to-market taxation for financial assets/liabilities.

It is hoped that the principle for mark-to-market taxation to be elective is reflected throughout the other rules governing the taxation of financial assets/liabilities and is not defeated in practice through difficulties in complying with anti-avoidance/synthetic disposal rules.

6.2 Eligibility to Make Mark-to-Market Election

ASX submits that all types of taxpayers should be entitled to adopt mark-to-market taxation of equity and equity derivatives. We do not perceive difficulties in extending eligibility beyond market makers.

ASX favours the third option canvassed in paragraph 6.55 of the *A Platform for Consultation*. Changes to the current system should be flexible enough to recognise that investors can hold shares as long term, possibly strategic, investments or for short term, possibly speculative, gains. In the context of reforms to the taxation of financial arrangements, recognition of this would be to allow the election to be taxed on a realisation basis for the long term holdings and on a mark-to-market basis for other holdings.

Concerns about adverse selection could be met by insisting that the classification of equity to be taxed on mark-to-market or on realisation would need to be on a "once and for all" basis upon acquisition.

Where investors elect to be taxed on a realisation basis, and their equity is trading stock under the rules in Division 70 of the 1997 Tax Act, then the rules set out in that Division should in general terms continue to apply.

Likewise, if the investor is not a trader in equities/equity derivatives, then the capital gains tax rules should apply.

ASX submits that the third option in paragraph 6.53 of the RFC Paper, allowing for a combination of the transaction basis and the asset class/entity-wide basis, should be adopted.

6.3 Inclusion of Equity Derivatives in Mark-to-Market/Realisation Regime

The taxation of equity derivatives under current legislation is considered by many investors to be uncertain. If the inclusion of equity derivatives as financial assets/liabilities, leads to the application of clear and certain rules then ASX believes investment in these markets would benefit.

Equity derivatives involve 2 sided contracts under which the investor paying premium acquires an asset (the option to require something to be done if the option is exercised, usually to buy or sell shares at a certain price) and the investor receiving premium assumes a liability (the obligation to do something if the option is exercised, usually to buy or sell shares at a certain price). The financial arrangement rules dealing with mark-to-market taxation need to provide suitable arrangements to bring to account:

- changes in the value of equity derivatives which are assets; and
- changes in the amount of obligations arising from equity derivatives which are liabilities.

ASX would like to be involved in any consultation process in the development of suitable rules for the taxation of equity derivatives.

6.4 Timing Adjustment

ASX supports the exclusion of ordinary shares and equity derivatives from the timing adjustment proposals developed in Chapter 6 of the *A Platform for Consultation*. The exclusion is consistent with the identification of the fundamental differences between equity and other financial arrangements referred to above and specifically the variability of yield on equity (and the lack of yield on some equity derivatives) compared to other types of financial arrangements.

It has been suggested that the timing adjustment rules could extend to deep-in-the-money equity options such that an imputed rate of interest (perhaps based on a risk free rate of return) would be applied to the premium paid/received upon creation of the options.

It would seem that such a system would not be necessary for short dated deep-in-the-money options such as exchange traded "low exercise price options" (LEPOs) because the term of such options is typically only 2 to 3 months.

There is however a number of longer dated deep-in-the-money equity warrants which are exchange traded. These include:

- Premium Income Equity (PIE) warrants;
- Low Exercise Price warrants;
- BLOC warrants;
- Capped Call warrants.

Details regarding the terms and operation of these warrants can be provided to the Review Committee if necessary.

PIE warrants provide a periodic cash yield to holders in the form of dividends. These dividends are already included in assessable income of holders and therefore there is no need for accruals taxation or a timing adjustment. Low Exercise Price, BLOC and Capped Call warrants do not produce an ongoing yield for holders.

Paragraphs 6.2 lists as the first factor in determining whether the timing adjustment should apply the degree of certainty in estimating future "returns" on an instrument. Paragraph 6.12 of the *A Platform for Consultation* states that returns which are not predictable should not be subject to a timing adjustment.

For the deep-in-the-money warrants which produce dividends there are 2 types of "returns", the dividends and any gain realised on disposal or expiry. The dividends are already taxed on receipt and therefore do not need to be subject to the timing adjustment. The predictability gains upon disposal/expiry of these deep-in-the-money warrants is linked to a large extent to the volatility in value throughout their life. The level of volatility of deep-in-the-money warrants is broadly the same as the volatility of the underlying equity. Invariably, the level of return on these warrants cannot be predicted with certainty.

It is therefore submitted that premiums on deep-in-the-money equity derivatives should not be subject to the timing adjustment proposals developed in Chapter 6. Consistent with this approach the taxation of LEPOs, and premiums, should be on an elective mark-to-market/realisation basis.

6.5 Hedging

The *A Platform for Consultation* rightly recognises the administrative and compliance difficulties associated with the special hedge taxation rules proposed in Chapter 10 of the *Issues Paper*. In the ASX submission on the *Issues Paper* it was noted that specific hedging strategies for equities and equity securities are often difficult to designate and to track. It is understood that several corporate taxpayers making submissions on the *Issues Paper* opposed compulsory hedge taxation rules on these grounds. ASX agrees that the imposition of such hedge taxation rules should be avoided.

The *A Platform for Consultation*, at paragraph 6.59, refers to the possibility of allowing taxpayers to have both sides of a transaction involving hedging

taxed on a mark-to-market basis. The Paper does not however contemplate having both sides of a transaction involving hedging taxed on a realisation basis.

ASX submits that the taxation of hedging transactions should be covered by the rules relating to elective mark-to-market/realisation taxation. Investors should be entitled to elect to have both sides of a hedging transaction taxed on a mark-to-market basis or alternatively on a realisation basis.

6.6 Quarantining of Losses

Measures dealing with the quarantining of losses are discussed in Chapters 6 and 12 of the *A Platform for Consultation*. Paragraph 12.4 correctly identifies the negative perception held by many taxpayers that the quarantining of capital losses against capital gains is unduly harsh.

All forms of loss quarantining assume, in essence, a tax avoidance purpose motivating the disposal of an asset at a loss. Effectively, a distortion is created against investing in the class of asset which is quarantined.

Chapter 7 contains specific proposals designed to counteract the improper acceleration of losses in the form of the wash sale and straddle rules.

ASX's general view is that there is not a genuine need for loss quarantining rules as the reasons motivating the disposal of an asset will be economic rather than taxation. If rules denying the availability of tax losses are to be imposed they should be confined to specific avoidance strategies such as wash sales and straddle transactions.

Chapter 6 puts forward the option of quarantining losses on financial assets and liabilities. Paragraph 12.29 puts forward the option of quarantining losses on shares and units. If the only financial assets held by a particular taxpayer are shares or units then the options would have the same effect.

ASX opposes the introduction of further loss quarantining rules into income tax legislation. In particular, ASX strongly opposes the introduction of specific measures which target quoted equity securities.

6.7 Synthetic Arrangements

ASX has grave concerns about the application of deemed disposal rules for "synthetic equity arrangements" developed in Chapter 7 of *A Platform for Consultation*. The core of these concerns is the potentially negative impact on the ASX markets, particularly the impact on Australian resident individuals who are investors in or members of collective investment vehicles, superannuation funds and insurance companies. ASX is also concerned about the potentially adverse impact the synthetic equity

measures could have on Australia's aspirations as a regional financial centre.

Paragraph 7.41 correctly notes that synthetic equity rules introduce complexity to a taxation system. The is a genuine concern that the principle impact of the rules will be to create uncertainty amongst many investors which will ultimately lead to them to not take out derivative positions and to avoid ASX's exchange trade option and other derivatives markets.

ASX opposes the introduction of the proposed synthetic disposal rules referred to in Chapter 7 of the *A Platform for Consultation*.

Insufficient Threat to Government Revenue

From the outset we note that each of the examples developed in Appendix A to Chapter 7 deal with the use of synthetic arrangements or products which produce franking credit benefits. These examples do not support the need for synthetic disposal rules to be introduced because none of the franking credit benefits have been available since the franking credit trading measures were announced in the 1997 Budget. The risk to Government revenue posed by the availability of non-franking credit taxation benefits under synthetic arrangements is far less than that available under franking credit trading.

It is submitted that the extra level of complexity which would be added by the proposed synthetic disposal rules (and uncertainty which will be created for equity securities investors) outweighs the benefits to Government of raising relatively small amounts of additional revenue.

It should also be noted that an investor who accounts for tax on equity investments under the capital gains tax provisions will often have limited use for capital losses which the straddle and wash sale rules are aimed at preventing. Furthermore, if (contrary to ASX's submission) proposals for quarantining of losses arising from disposal of financial assets are implemented the utility of such losses would be limited in the same manner as capital losses.

Complexities

The complexities of the synthetic disposal proposals in the context of a self assessment system should not be underestimated. There is a real possibility that if rules relating to the removal of risk on equity securities are constructed in a similar manner to the franking credit trading rules investors who have elected to be taxed on a realisation basis, and who have implemented hedging strategies to manage risk, will want to avoid the complexity of the new rules and effectively assume their portfolios have been disposed of at the end of each tax year by marking them to market. The costs of designing and operating systems which monitor compliance with synthetic equity rules would in many cases be prohibitive.

Alternatively, as noted above, such investors might avoid the use of derivatives altogether so that they do not have to consider application of the synthetic disposal rules. This would be contrary to best practice portfolio management.

The categories of investors who would potentially face this situation include superannuation funds, investment funds and insurance companies. Moreover, it is the individual members of such entities who would suffer in the form of reduced returns and potential mismatches resulting from gains on equities being taxed before disposal.

Contrary to Elective Mark-to-Market Taxation

The application of synthetic disposal rules should be considered in the context of the proposals for mark-to-market taxation of equities to be elective rather than compulsory. The effect of a synthetic disposal rule would be to deem a disposal for tax purposes of an asset prior to actual or legal disposal. This is a similar effect to mark-to-market taxation, that is, there is a deemed disposal for tax purposes at the end of each year an asset is held. Therefore, synthetic rules are unlikely to adversely affect investors who have their equity marked-to-market.

The position is different for investors electing to be taxed on a realisation basis. If they want to exercise their right of election, and want to implement legitimate risk management/hedging strategies, they could be faced with considerable compliance and administrative difficulties. There is a genuine risk that the difficulty of complying with the synthetic rules will effectively force such taxpayers into mark-to-market tax treatment of their equities. This is contrary to the change of Government policy on making mark-to-market taxation of equity securities elective.

Inconsistent With Commercially Prudent Hedging

The application of synthetic disposal rules is particularly harsh in the context of derivatives which are not based on single stocks. The *A Platform for Consultation* recognises in paragraph 7.42 the potential for these rules to interfere with the markets' processes of managing and shifting risk. Examples of such derivatives are warrants or options based on an index or based on a basket of securities. Where an investor takes a position in a derivative which is not based on a specific stock and it also holds a portfolio of different equity securities it would in practice be very difficult to assess the extent to which risk in the specific securities has been removed or reduced.

ASX submits that derivatives which are not directly based on single shares should be excluded from the operation of the proposed synthetic disposal rules.

Exclusion for Short Term Hedging

The *A Platform for Consultation* properly concedes in paragraph 7.32 that commercially motivated hedging should not be unnecessarily affected by the proposed rules.

ASX submits that if the proposed synthetic disposal rules are introduced there should at very least be an exclusion for legitimate short term hedging arrangements. In this context, the definition of short term hedging should be based on a 2 year period.

Need for Further Consultation

The potential impact of the proposed synthetic equity measures on investors in ASX's is likely to be quite substantial. Great care needs to be taken in formulating the rules to ensure that the they are capable of being understood and applied by investors and do not act as a general deterrent to prudent hedging.

ASX recognises the difficulties in developing a suitable test for classifying hybrid instruments as debt or equity. On balance, ASX favours a single determinative factor test which focuses on a debtor/creditor (or shareholder/company) relationship.

If the proposed synthetic equity measures are to proceed, ASX seeks to be consulted in the process of formulating the rules.

6.8 Debt/Equity Hybrids

The *A Platform for Consultation* rightly recognises that Australia's taxation system (comprising the taxation legislation as well as the system of interpreting and applying at a judicial and administrative level) is essentially based on "black letter law", that is, it concentrates on legal form rather than economic substance. In the context of debt/equity hybrids, the *A Platform for Consultation* refers to the objective of determining debt or equity treatment for hybrids according to economic substance. ASX agrees in principle with this objective and believes that if a reasonable and straightforward test for identifying economic substance can be constructed then it should be adopted in the classification of hybrids.

Problems arise however in constructing such a test because a "facts and circumstances test" and a "single determinative factor test" will invariably focus on the terms of an instrument (that is, its legal form) unless a cash flow valuation approach or financial measures (such as delta), as referred to in paragraph 7.22, are used.

However, adoption of a mathematical valuation approach has been questioned because it would only be practical if necessary mathematical calculations/cash flow projections/delta measurements were undertaken upon issue of a product. The guidance provided by an upfront calculation

could become less accurate over time with natural time decay of the product or if assumptions on which the original calculation were made vary.

If the calculations were made on a dynamic, ongoing basis there would need to be changes to the tax treatment throughout the life of the product and the treatment for issuers and holders could vary between debt and equity which, on grounds of simplicity and certainty, would be unacceptable.

Considering these difficulties, it is perhaps best for ASX to express from the outset what we perceive are features of an acceptable system for classifying hybrids. These are:

- issuers of hybrid securities which are quoted for trade on ASX's equities or derivatives markets should be able to state with certainty in offering circulars and other information accompanying the issue of the securities what the taxation implications are for potential investors in both the primary market and the secondary market. Investors should not be discouraged from investing in hybrid securities because of uncertainty over taxation treatment. Uncertainty in this area leads to a lack of diversification of the types of securities which are issued and impedes the development of a sophisticated, mature and globally competitive equities market.

  The most effective way to meet this objective for quoted securities is for an efficient system of providing product rulings to be made available by the Australian Taxation Office;

- a blanket approach is preferable to a bifurcation approach. That is, hybrid securities should be classified as all debt or as all equity with consequential taxation treatment of the return on the security for holders;

- once a hybrid security is classified as debt or equity there should be symmetrical treatment for both the issuer and for holders of the securities.
- if a debt/equity test for hybrids is introduced, specific anti-avoidance rules such as those contained in sections 46C and 46D and Division 3A of the Tax Act, 1936 should be removed.

On balance, ASX's preference is for a single determinative factor test which focuses on a debtor/creditor (or shareholder/company) relationship. The test would need to identify the key characteristic which distinguishes debt from equity. If there was no clear distinction as a result of applying the basic test then a default mechanism whereby the instrument automatically defaults to debt (or equity) should apply.

ASX is still developing its views on an appropriate test for hybrids and will provide them to the Committee in a separate submission as soon as possible.

Paragraph 6.83 suggests that the conversion of a convertible note or converting preference share could be treated as a taxing event under redesigned tax rules. It is argued that to postpone the disposal event until the shares are realised would be to defer the recognition of economic income. ASX does not agree with this analysis. Any economic gain which might arise on conversion is not realised in the sense that no funds become available which could be used to discharge a taxation liability. In essence,

the conversion should be treated as the exchange of one form of asset (that is, debt with an embedded option) for another form of asset (that is, a share). The economic owner does not change. In these circumstances the conversion should be treated as a capital gains tax rollover event.

Attachment 1: Modelling analysis of deferred company tax

ASX commissioned Arthur Andersen to undertake analysis of the impact of deferred company tax on model Australian companies. Modelling was performed using a tax impact model, which draws on detailed financial structure and assumptions. An important feature of this model is that it takes foreign source income and non-resident investors into account. This feature is necessary for analysis of deferred company tax, because DCT is essentially a withholding tax for resident investors, but it is a kind of company tax for non-residents.

The financial information for this section draws on publicly available information for a prominent Australian company.

Section 2 presents the financial data for the scenario, which is used to generate the results in Section 1.

- Company A: a globalised Australian company.
- Company B: an Australian company that has a domestic focus.

Company A

Company earning 60 percent of its income outside Australia, and with 40 percent foreign shareholders. Consolidated financial data for seven years under each scenario run is attached as Annex 1. Key elements of the company's financial structure:

- The shareholding profile is set at 60 percent Australian residents (30 percent top-rate individuals and 30 percent superannuation funds) and 40 percent non-resident (half of whom reside in countries which allow foreign tax credits for Australian dividend withholding tax).

- The company is assumed not to have any carried forward tax losses available.

- The opening tax book value of the company's depreciable assets is equal to 60 percent of their value in the company's financial accounts. The average depreciation rates for financial accounting and tax accounting, respectively are 15% and 25%. Abolition of accelerated depreciation would result in the tax depreciation rate falling to 15% for assets acquired in or after 2001.

- The company maintains a constant ratio of debt to total market value of 26 percent (corresponding to a debt to market-value-of-equity ratio of 35.2 percent).

- Cash dividends paid in each year are held constant at their base case level under all scenarios, as is debt.

- This company is earning sufficient listed jurisdiction income for it not to be any better off it were able to stream FDA dividends to non-residents only.

Modeling Results

(a) Base Case

Effective Tax Rates

	Current
Aus taxpayers	33.4%
Aus super funds	33.4%
Non-residents, credit countries	48.5%
Non-residents, exemption countries	48.5%
Average:	39.4%
Average tax rate (ignoring shareholder benefits):	48.5%
Market value of initial equity	3,752
Cost of equity capital	13.3%
Weighted average cost of capital (WACC)	10.8%

(b) Deferred company tax (carry-forward of top-up tax), FDA dividends exempt

Effective Tax Rates

	Current	*Base Case*	*% difference*
Aus taxpayers	36.0%	33.4%	7.8%
Aus super funds	36.0%	33.4%	7.8%
Non-residents, credit countries	63.0%	48.5%	29.9%
Non-residents, exemption countries	65.4%	48.5%	34.7%
Average:	47.3%	39.4%	19.9%
Average tax rate (ignoring shareholder benefits):	63.4%		
Market value of initial equity	3,139	3,752	-16.3%
Cost of equity capital	14.6%	13.3%	10.0%
Weighted average cost of capital (WACC)	11.6%	10.8%	8.0%

(c) DCT, carry-forward of top-up tax, FDA dividends exempt (no streaming).

Effective Tax Rates

	Current	*Base Case*	*% difference*
Aus taxpayers	34.7%	33.4%	3.8%
Aus super funds	34.7%	33.4%	3.8%
Non-residents, credit countries	47.7%	48.5%	-1.6%
Non-residents, exemption countries	47.8%	48.5%	-1.6%
Average:	39.9%	39.4%	1.1%
Average tax rate (ignoring shareholder benefits):	55.1%		

Equity Values and the Weighted Average Cost of Capital

	Current	*Base Case*	*% difference*
Market value of initial equity	3,764	3,752	0.3%
Debt:Market Value ratio	26.0%	26.0%	
Cost of equity capital	13.2%	13.3%	-0.6%
Weighted average cost of capital (WACC)	10.7%	10.8%	-0.6%

NB Higher market value (relative to base case) under this option reflects the greater ability to *effectively* stream FDA dividends: offset of carried forward DCT against the parent's income tax liability reduces its current year tax payable, in turn reducing the extent to which it is able to frank dividends out of company tax rather than DCT, relative to the base case. Consequently, the firm is able to pay a higher proportion of FDA dividends, reducing its overall Australian tax liability. (Note switch between Aus and foreign shareholders.)

Company B

Same set of scenarios[14] for a company with the same profile as Company A, other than:

- 80 percent of income sourced from Aus, 90 percent of shareholders Australian.
- Company has sufficient tax losses carried forward for it not to need to pay Aus tax for around 3 years. (Otherwise, DCT has no impact, since company is always paying sufficient tax to fully frank.)

Modelling results

[14] Additional scenario added for streaming of FDA divs – see scenario (da).

(a) Base Case

Effective Tax Rates

	Current
Aus taxpayers	16.1%
Aus super funds	16.1%
Non-residents, credit countries	38.4%
Non-residents, exemption countries	39.7%
Average:	18.4%
Average tax rate (ignoring shareholder benefits):	38.1%
Market value of initial equity	5,151
Cost of equity capital	13.0%
Weighted average cost of capital (WACC)	10.9%

(b) Deferred company tax (carry-forward of top-up tax), FDA dividends not exempt

Effective Tax Rates

	Current	*Base Case*	*% difference*
Aus taxpayers	17.2%	16.1%	7.0%
Aus super funds	17.2%	16.1%	7.0%
Non-residents, credit countries	49.0%	38.4%	27.5%
Non-residents, exemption countries	50.5%	39.7%	27.3%
Average:	20.5%	18.4%	11.3%
Average tax rate (ignoring shareholder benefits):	48.5%		
Market value of initial equity	4,522	5,151	-12.2%
Cost of equity capital	13.8%	13.0%	6.7%
Weighted average cost of capital (WACC)	11.5%	10.9%	5.7%

NB lower market value here relative to (b) is correct according to logic of model, but could be avoided – clearly, company could take actions which would result in it being no worse off than under DCT without carry-forward.

Annex 1

Company A, Consolidated Accounts

(a) Current Rules

Consolidated Income statement	***1999***	***2000***	***2001***	***2002***	***2003***	***2004***
Sales	4,009	4,109	4,335	4,576	4,833	5,106
Interest income	5	5	5	6	6	6
Operating expenses						
Cost of sales etc	(3,187)	(3,267)	(3,447)	(3,638)	(3,842)	(4,060)
Depreciation	(410)	(417)	(437)	(457)	(479)	(502)
Amortisation of intangibles	(26)	(28)	(32)	(36)	(40)	(44)
Interest expense	(84)	(91)	(99)	(107)	(116)	(125)
Tax planning expense	-	-	-	-	-	-
Earnings before tax	306	310	326	344	362	382
Company tax	(153)	(153)	(154)	(155)	(156)	(158)
Other (non-creditable) taxes	-	-	-	-	-	-
Profit after company tax	153	157	173	189	206	224
Less top-up tax (DCT)	-	-	-	-	-	-
Profit after top-up tax	153	157	173	189	206	224
Dividends	(107)	(110)	(121)	(132)	(144)	(156)
Retained Earnings	46	47	52	57	62	67
payout ratio	70.0%	70.0%	70.0%	70.0%	70.0%	70.0%
franking ratio	27.4%	27.5%	26.1%	24.8%	23.5%	22.3%
Consolidated Balance sheet						
Current Assets						
Other current assets	882	904	954	1,007	1,063	1,123
Prepaid tax (voluntary tax)	-	-	-	-	-	-
Surplus cash and investments	75	54	32	5	(27)	(64)
Total current assets and investments	957	958	986	1,011	1,036	1,059
Fixed Assets (Historical Cost)						
Opening value	2,733	2,781	2,912	3,049	3,193	3,344
Plus new investment	431	519	544	570	597	625
Less depreciation	(410)	(417)	(437)	(457)	(479)	(502)
Closing value	2,754	2,883	3,019	3,161	3,311	3,467
Intangible Assets						
Opening value	327	356	398	444	496	554
Plus new investment	52	66	74	83	92	103
Less depreciation	(26)	(28)	(32)	(36)	(40)	(44)
Closing value	352	394	440	491	549	612
Total assets	4,063	4,235	4,444	4,664	4,895	5,139
Total current liabilities	882	904	954	1,007	1,063	1,123
Long-term debt	1,404	1,497	1,594	1,697	1,805	1,920
Shareholders funds						
Issued capital	1,731	1,731	1,731	1,731	1,731	1,731
Retained earnings	46	72	102	132	162	193

Asset revaluation reserves	-	31	63	97	133	171
Total shareholders funds	1,777	1,834	1,896	1,960	2,027	2,096
Total liabilities and equity	4,063	4,235	4,444	4,664	4,895	5,139

(b) Deferred company tax with carry-forward, FDA dividends not exempt from DCT

Consolidated Income statement						
	1999	***2000***	***2001***	***2002***	***2003***	***2004***
Sales	4,009	4,083	4,279	4,479	4,682	4,887
Interest income	5	5	5	6	6	6
Operating expenses						
Cost of sales etc	(3,187)	(3,246)	(3,402)	(3,560)	(3,722)	(3,885)
Depreciation	(410)	(414)	(431)	(447)	(464)	(480)
Amortisation of intangibles	(26)	(28)	(31)	(35)	(39)	(43)
Interest expense	(84)	(91)	(99)	(107)	(115)	(123)
Tax planning expense	-	-	-	-	-	-
Earnings before tax	306	308	321	335	348	362
Company tax	(153)	(153)	(154)	(155)	(156)	(158)
Other (non-creditable) taxes	-	-	-	-	-	-
Profit after company tax	153	155	167	180	192	204
Less top-up tax (DCT)	(20)	(20)	(25)	(31)	(37)	(43)
Profit after top-up tax	133	135	142	149	155	161
Dividends	(107)	(110)	(121)	(132)	(144)	(156)
Retained Earnings	26	24	21	17	11	5
payout ratio	70.0%	71.1%	72.2%	73.5%	75.0%	76.6%
franking ratio	36.0%	36.0%	36.0%	36.0%	36.0%	36.0%
Consolidated Balance sheet						
Current Assets						
Other current assets	882	898	941	985	1,030	1,075
Prepaid tax (voluntary tax)	20	40	65	96	133	175
Surplus cash and investments	75	54	34	12	(11)	(33)
Total current assets and investments	977	993	1,041	1,094	1,152	1,217
Fixed Assets (Historical Cost)						
Opening value	2,733	2,763	2,873	2,983	3,092	3,198
Plus new investment	413	496	511	526	539	550
Less depreciation	(410)	(414)	(431)	(447)	(464)	(480)
Closing value	2,736	2,845	2,954	3,061	3,167	3,269
Intangible Assets						
Opening value	327	354	393	435	482	532
Plus new investment	49	64	70	76	84	91
Less depreciation	(26)	(28)	(31)	(35)	(39)	(43)
Closing value	350	389	431	477	527	581
Total assets	4,063	4,227	4,426	4,632	4,846	5,067
Total current liabilities	882	898	941	985	1,030	1,075
Long-term debt	1,404	1,497	1,594	1,697	1,805	1,920
Shareholders funds						
Issued capital	1,731	1,731	1,731	1,731	1,731	1,731
Retained earnings	46	70	97	123	149	174
Asset revaluation reserves	-	31	63	96	131	167

Total shareholders funds	1,777	1,832	1,890	1,950	2,010	2,072
Total liabilities and equity	4,063	4,227	4,426	4,632	4,846	5,067

(c) DCT, carry-forward of top-up tax, FDA dividends exempt (no streaming).

Consolidated Income statement	***1999***	***2000***	***2001***	***2002***	***2003***	***2004***
Sales	4,009	4,094	4,301	4,518	4,742	4,975
Interest income	5	5	5	6	6	6
Operating expenses						
Cost of sales etc	(3,187)	(3,254)	(3,420)	(3,592)	(3,770)	(3,955)
Depreciation	(410)	(416)	(433)	(451)	(470)	(488)
Amortisation of intangibles	(26)	(28)	(32)	(35)	(39)	(43)
Interest expense	(84)	(91)	(99)	(107)	(115)	(124)
Tax planning expense	-	-	-	-	-	-
Earnings before tax	306	309	323	338	354	370
Company tax	(153)	(153)	(154)	(155)	(156)	(158)
Other (non-creditable) taxes	-	-	-	-	-	-
Profit after company tax	153	156	170	184	198	212
Less top-up tax (DCT)	(12)	(12)	(15)	(18)	(22)	(26)
Profit after top-up tax	141	144	154	165	176	186
Dividends	(107)	(110)	(121)	(132)	(144)	(156)
Retained Earnings	34	34	34	33	32	30
payout ratio	70.0%	70.7%	71.3%	72.1%	72.9%	73.7%
franking ratio	32.8%	32.8%	32.4%	32.0%	31.5%	31.1%
Consolidated Balance sheet						
Current Assets						
Other current assets	882	901	946	994	1,043	1,094
Prepaid tax (voluntary tax)	12	24	39	58	79	102
Surplus cash and investments	75	54	33	9	(17)	(43)
Total current assets and investments	969	979	1,019	1,061	1,106	1,154
Fixed Assets (Historical Cost)						
Opening value	2,733	2,770	2,889	3,010	3,132	3,257
Plus new investment	420	505	524	543	562	580
Less depreciation	(410)	(416)	(433)	(451)	(470)	(488)
Closing value	2,743	2,860	2,980	3,101	3,224	3,348
Intangible Assets						
Opening value	327	355	395	439	488	541
Plus new investment	50	65	71	79	87	96
Less depreciation	(26)	(28)	(32)	(35)	(39)	(43)
Closing value	351	391	435	483	536	593
Total assets	4,063	4,230	4,433	4,645	4,865	5,096
Total current liabilities	882	901	946	994	1,043	1,094
Long-term debt	1,404	1,497	1,594	1,697	1,805	1,920
Shareholders funds						
Issued capital	1,731	1,731	1,731	1,731	1,731	1,731
Retained earnings	46	71	99	127	154	182
Asset revaluation reserves	-	31	63	97	132	169
Total shareholders funds	1,777	1,833	1,893	1,954	2,017	2,082
Total liabilities and equity	4,063	4,230	4,433	4,645	4,865	5,096

Attachment 2: Capital Gains Tax Issues

Implications of excessive capital gains tax for economic efficiency

Capital transactions enhance the efficiency of the economy by allocating capital assets to their highest valued uses. CGT discourages capital transactions because the current owner can keep the asset without tax liability, but if the asset is sold, the CGT must be paid.

When higher tax rates shrink the tax base so much that they raise little or no additional revenue, this means that they are eliminating a large volume of mutually advantageous trades. Furthermore, if this is the case, then the capital gains tax must be greater than its optimal rate for the economy as a whole. The optimal rate is the rate at which the marginal benefits derived from the revenue generated by a little higher rate are just equal to the marginal cost in the form of loss of productive economic activity diminished by the rate increase.

Why might the revenue-maximising tax rate for capital assets be below that for ordinary income ?

A lower capital gains tax will release capital resources that investors continue to hold to delay or avoid a tax liability, and thereby reduce an impediment to the purchase and sale of capital assets. As a result, it will improve the efficiency of capital markets and benefit the entire economy.

In itself, this is not a sufficient argument for reduction of capital gains tax. The same argument can be applied to wage income taxes or withholding taxes on non-residents.

A necessary corollary argument is that taxes on capital gains are so high that the rate exceeds its revenue maximising level for this income class. In principle, tax rates could be so high that lowering them could expand the tax base sufficiently to increase the revenue derived from tax.

Evidence of revenue effects of changes to CGT rates in the United States provides some support for the proposition that taxes for income accruing as capital gains are less than those for ordinary income. The US capital gains tax rate has been moved up and down since the late 1970s, providing a substantial amount of evidence that capital gains realisations are very sensitive both in the short run and the long run to changes in the capital gains tax rate. In terms of the long-run effect of CGT on revenue; while there was substantial income growth during the 1980s, capital gains realisations were lower in the early 1990s than during the early 1980s when the capital gains rate was 20 %. The US Congressional Budget Office noted that "There

is strong evidence that realizations of capital gains decline when tax rates on gains are increased."[15]

More recently, the US CGT rate was dropped from 28 per cent to 20 per cent in 1996. This cut in the capital gains tax rates has resulted in government revenue increases even beyond the forecasts of its proponents. The US Congress' Joint Committee on Taxation's original estimates (made in January 1997) projected capital gains revenues rising modestly to $59.6 billion in 1998. In June 1998, the committee revised those revenues up to $72.5 billion this year, and acknowledged that it underestimated capital gains revenue by about $58 billion over the first five years following the rate cut.[16]

This analysis suggests that the revenue maximising rate of tax for capital gains is below that for ordinary income. In fact, it makes sense for this to be the case. Whereas the option for most income is either to earn it or not, in the case of capital gains, taxpayers have another alternative: they can allow their gains to continue accumulating untaxed, rather than realise them and pay the tax.

Realisations and tax avoidance

Some analysts argue that increased realisations partly reflect tax avoidance. If capital gains are taxed at lower rates than ordinary income, then it might be possible for people to take advantage of this "loophole" and pay no taxes. Evidence from the United States suggests that avoidance is quite difficult to achieve in practice. In 1987, when the top tax rate on ordinary income was 70 percent and the capital gains tax rate was 28 percent, the value of realised capital gains were equivalent to about 3 percent of GDP [17]. Despite the drop in the rate, revenues attributable to capital gains were at about the same proportion of GDP when the rates were 50 percent and 20 percent respectively. This outcome suggests that opportunities to convert ordinary income into capital gains are quite limited.

Potential for revenue feedbacks in Australia

One way of assessing the potential for revenue feedbacks from a rate reduction in Australia is to compare the value of capital gains tax paid in Australia and the US. With controls for differences in the size of economies, if the value of tax raised in Australia appears to be less than in the US (which has lower CGT rates for individuals), then this would provide indicative support for potential unlocking of capital gains in Australia as a result of a rate reduction.

---

[15] United States Congressional Budget Office, "How Capital Gains Tax Rates Affect Revenues: The Historical Evidence," 1988

[16] "More and Sooner," Wall Street Journal, June 23, 1998.

[17] Cato Institute, Policy Analysis No. 242, 'The ABCs of the capital gains tax'.

Australia's marginal capital gains tax rates are currently higher than those in the US. Australia taxes capital gains in the same manner as wage income, at the marginal tax of the taxpayer. In the US, capital gains are taxed below the marginal tax rate for wage income. Table A2.1 shows the current income tax rates for Australia, and the proposed scales identified in the government's tax legislation currently before Parliament.

Table A2.1: Tax rates for capital gains in Australia and the United States

Australia				United States		
Current income tax scales		Proposed income tax scales (ANTS)		US income tax scales	Short-term[1] capital gains	Medium-term[2] capital gains
$AUS	%	$AUS	%	$US	%	%
0 - 5,400	0	0 - 6,000	0	0 - 25350	15	10
5,401 - 20,700	20	6,001 - 20,000	17	25351-61400	28	20
20,701 - 38,000	34	20,001 - 50,000	30	61401-128100	31	20
38,001 - 50,000	43	50,001 - 75,000	40	128101-278450	36	20
50,000+	47	75,001+	47	278451	39.6	20
Company rate	36	Company rate[3]	30	Company rate	35	35

1. Asset held less than 12 months.
2. Asset held between 18 months and five years.
3. On the assumption that the trade-off with tax concessions is implemented.

Source: ANTS and *A Platform for Consultation*

If the income tax scales proposed in the current bills are introduced, then capital gains taxation for Australian lower income earners will be roughly on par with rates for gains from medium-term asset holdings by lower income earners in the US (taking Australian indexation into account).

If the company tax rate is lowered to 30 per cent, then capital gains accruing to entities in Australia will be taxed at a significantly lower rate than gains accruing to US companies (particularly when indexation is taken account). This outcome would mean that Australia greatly improves its competitiveness for business capital gains by implementing a 30 per cent company tax rate.

On the other hand, Australian CGT rates for higher income earners will still be relatively high if the government's income tax reforms are implemented. As higher income earners are likely to be the holders of 'locked-in' assets, there might be significant potential for unlocking through reductions of CGT rates for higher-income earners. It is important to note that this argument does not rule out the possibility of rate reductions for lower-income earners.

In 1996-97, the Australian government collected a total of A$2,134 m as tax on capital gains. This was equivalent to 0.4 per cent of GDP. In 1996-97, the US government collected approximately US$56 bn in CGT [18]. This was equivalent to approximately 0.7 per cent of GDP. If it is assumed that the relative sizes of capital asset bases (scaled to GDP) are not greatly dissimilar in both countries, then it appears that the US government is collecting proportionately almost twice as much revenue from capital gains than Australia, despite the much lower marginal tax rates in the US at that time.

In addition to unlocking effects, there are three key differences between the US and Australia systems, however, which might contribute to this difference:

[18] Cato Institute, Policy Analysis No. 242, 'The ABCs of the capital gains tax'.

1. Australia has only had capital gains tax provisions since 1985, whereas the US has had CGT since 1957.
2. Australia indexes capital gains cost base against inflation, but the US does not.
3. Australia exempts assets purchased prior to September 1985.

The first point would suggest that the revenue flow from CGT will grow significantly as the taxable base continues to mature and expand.

The second difference is also important. The tax base is broader without indexation, so the impact of changes in tax rates on revenue raised is greater. This would suggest two things:

- that the US government would raise more revenue (if the marginal tax rates were the same).
- that the proportional response of US asset holders to a reduction of the CGT rate would be greater than for Australian investors.

While abolition of indexation would generate more tax revenue in Australia, the increase would perhaps not be sufficient to significantly push up CGT revenues. Based on 1996-97 data, to double the value of CGT would have required an increase of CGT tax revenues of about $2.5 bn - yet the estimated revenue gained from abolition of indexation in 2001-02 is only $450m. Indexation is arguably not the primary explanation for the relatively low CGT revenues in Australia.

The third point is perhaps the most important point for consideration of the relatively low level of capital gains tax raised in Australia when compared to the US. The exemption for assets purchased prior to September 1985 is expected to represent a significant incentive for 'locking in' to holders of such assets, because the marginal effect of tax on the sale of the asset will be very large. **This point does suggest that a rate reduction in Australia will yield large revenue feedbacks as holders of relevant assets are provided a greater incentive to sell.**

Impact on venture capital

When considering the economic efficiency costs of transaction taxes, of which the capital gains tax is a specific form, a general result is that they penalise less liquid markets. In particular, it would be expected that venture capital is affected by the rate of capital gains taxation on personal income, as new ventures rely heavily on investment by business owners.

Trends in the United States show that higher capital gains taxes have been associated with a drying up of investment capital for small and growing businesses, and lower capital gains taxes have produced substantial increases in business start-ups and financings.

After being reduced in the late 1970s and early 1980s, the capital gains tax rate was increased by 40 percent -- from 20 percent to 28 percent in 1986. As a result

- New business incorporations rose at a 6.8 percent annual rate from 1968 to 1986 – but growth then slumped to an average of 1.1 percent from 1987 to 1995.
- Real venture capital commitments rose at a 29.4 percent annual average rate from 1981 to 1986 -- compared to 6.5 percent from 1987 through 1995.[19]

Recent history in the US shows that a growing percentage of venture capital funding for small firms has come from non-taxed sources, such as pension funds and non-taxable foundations. However, this trend is precisely because of the higher capital gains taxes since 1986, as individual's have withdrawn from risky business activities. Taxable sources of financing are fleeing the venture capital area as the after-tax return has been substantially reduced for those investors, while the non-tax sources have actually increased their participation in venture capital funding.[20] Non-taxable investors accounted for just over half of the venture capital funds when the capital gains tax rate was 20 percent, but by 1993 with a 28 percent rate their share of the total had risen to more than 80 percent. Commitments of taxable investment dropped by more than half and their share of the total declined from 29 percent to 15 percent.

Equity issues

Higher income earners pay the vast majority of capital gains tax in Australia. In 1996-97, individuals earning more than $50,000 paid about 80 per cent of all capital gains tax. By comparison, individuals earning more than $50,000 paid about 60 per cent of all income taxes. As a result, a reduction of capital gains tax is likely to have important equity implications.

A position that higher income earners will receive a giant tax cut if the capital gains tax rate is reduced relies on the assumption that behaviour will not change in response to a lower tax rate. It may be counter-intuitive but patterns in the United States suggests that higher income earners may pay more tax if the capital gains tax rate is lowered. This outcome might occur because 'unlocking' is primarily undertaken by the wealthy, who are avoiding CGT by holding their assets. One US study that analysed a capital gains rate reduction to 20 percent found that highest income earners would pay 16.1 percent more capital gains taxes than when the rate was 28 per cent.[21]

Empirical evidence from the US supports this argument. According to the Congressional Budget Office, the share of gains realised by upper income groups increased when the tax rate was lowered, and diminished when the

---

[19] Raymond J. Keating (Small Business Survival Committee), "Please, Steal from the GOP, Mr. President," Washington Times, January 23, 1997.
[20] National Venture Capital Association, 1993 Annual Report, 1993, pp. 6, 19.

[21] Gerald Auten and Joseph Cordes, "Policy Watch: Cutting Capital Gains Taxes," Journal of Economic Perspectives 5, no. 1 (1991): 25-28.

rate was raised. For example, the top 1 percent of returns ranked by income accounted for 50 percent of realised long-term gains in 1968 [27 percent top rate], only 33 per-cent between 1975 and 1978 [49 percent rate], and about 55 percent between 1982 and 1985 [20 percent rate].[22]

[22] US Congressional Budget Office, "How Capital Gains Tax Rates Affect Revenues," 1988, p.2.

Attachment 3: Modelling of options for CGT reform

A3.1 Reform options in the discussion paper

The discussion paper puts forward options for significant reductions of CGT rates. There are four major options for rate reductions:

1. A capping of the maximum rate to 30 per cent.
2. A reduction of all rates by 20 per cent (ie from 47% to 38%, from 30% to 24% etc).
3. A reduction of the 47% and 40% rates to 30%, and from 30% to 25% and 17% to 12%.
4. A stepped or tapered rate reduction over 6 or 10 years, where the tax rate is reduced for longer held assets.

Given the cost to revenue attributed to these reduction, and in the absence of other revenue raised by other tax reforms, rate reductions would need to be paid for through the abolition of CGT indexation.

The option to introduce a provision for $1,000 of capital gains to be tax free would not need to be funded by abolition of indexation, so it is not considered in this context.

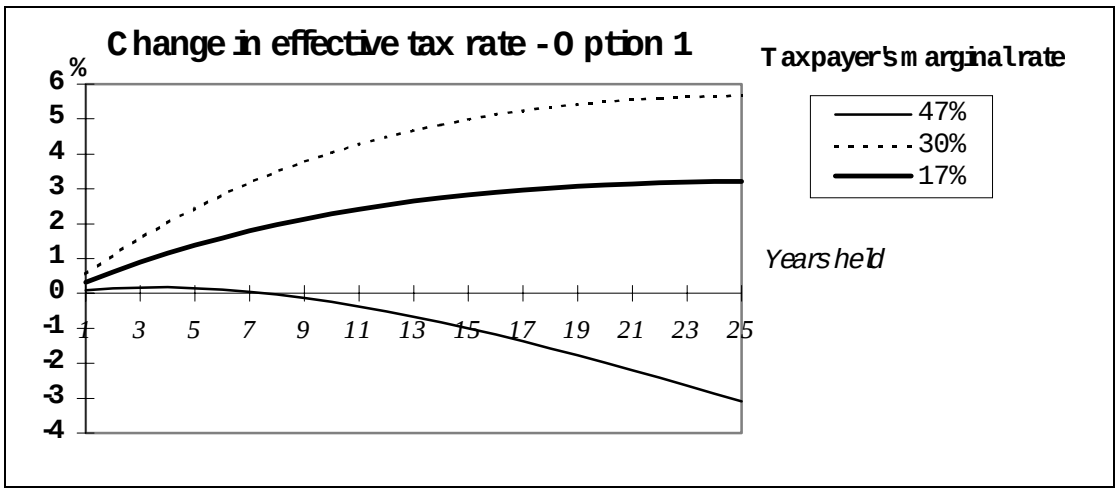
ASX has analysed the four rate reduction options identified above, to determine the change in effective tax rate for an asset worth $100,000 at the introduction of the reforms, for taxpayers on a range of marginal tax rates. Assumptions of 3 per cent real growth in value per annum and 2 per cent inflation per annum are made.

The following charts show the change in effective tax rates for taxpayers on different marginal tax rates, as assets are held for between 1 and 25 years. The marginal tax rates adopted for consideration are those proposed in *A New Tax System* (see Table A2.1 in Attachment 2).

Option 1 - A capping of the maximum rate to 30 per cent

Chart 1 shows the modelled change in effective tax rate resulting from abolition of indexation and a capped 30 per cent CGT rate (Option 1). A taxpayer currently on a 47 per cent marginal rate experiences a slight increase in effective tax rate for assets held less than 7 years, but this individual benefits if the asset is held longer than 7 years. On the other hand, lower income earners are penalised by this option. They have no rate cut to compensate them for abolition of indexation.

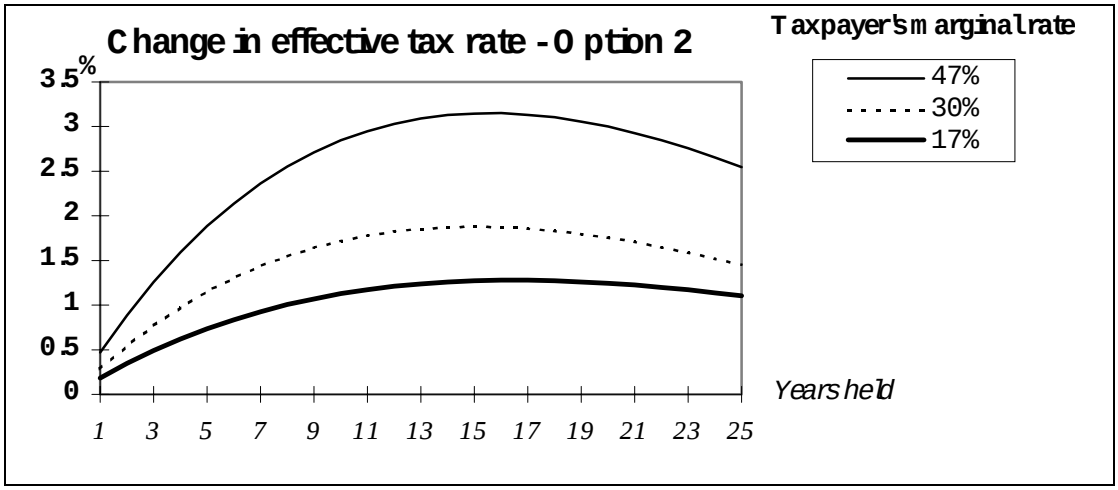
Chart 1: Impact of Option 1 (Capping the maximum CGT rate at 30 per cent).



Option 2 - A reduction of all rates by 20 per cent

Option 2, where all rates are reduced by 20 per cent, would increase tax rates for all taxpayers. It should be clearly not preferred.

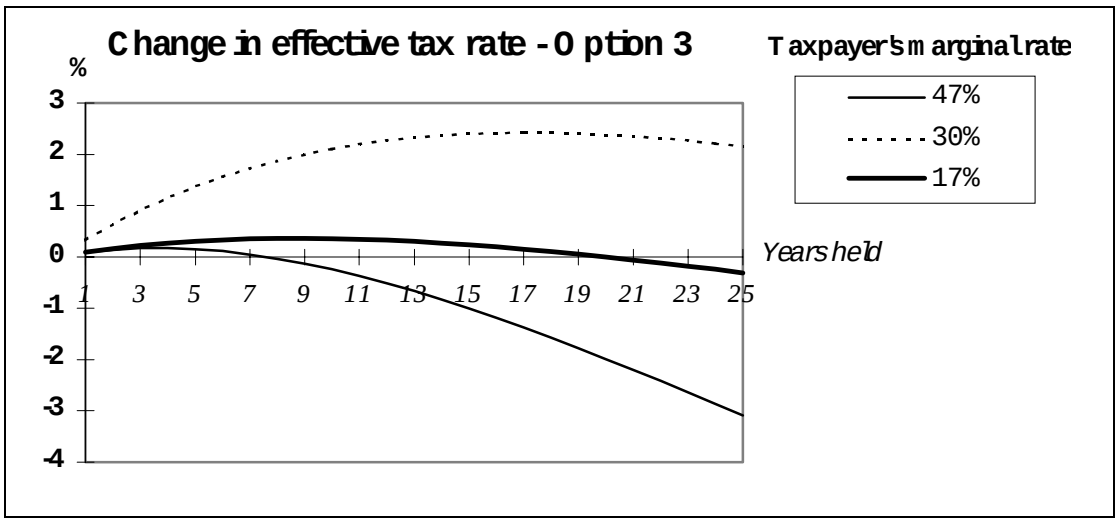
Chart 2: Impact of Option 2 (20 per cent rate reduction for all taxpayers).



Option 3 - A reduction of the 47% and 40% rates to 30%, and from 30% to 25% and 17% to 12%.

Option 3 is preferred to Option 1, as the position of lower income taxpayers is improved. However, there is still a transfer of tax burden from taxpayers on a 47 per cent rate to those on a 30 per cent rate.

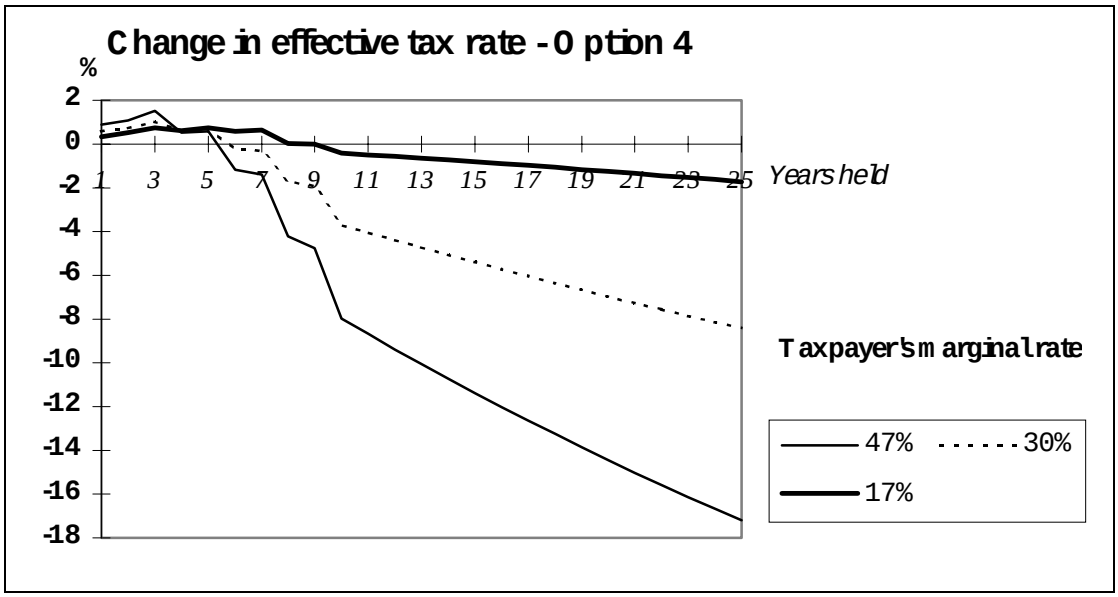
Chart 3: Impact of Option 3 (30/25/12 per cent rates).



Option 4 - A stepped or tapered rate reduction over 6 or 10 years, where the tax rate is reduced for longer held assets.

There are several ways to implement a stepped rate reduction identified in the discussion paper; the option for a 10 year stepped reduction, with a 10 per cent rate for all taxpayers with an asset held for 10 years or more. Option 4 raises some important revenue issues. While the discussion paper only projects out revenue to 2003-04, if taxpayers respond to a stepped rate by holding on to assets for more than 10 years, then the cost to revenue could be very large. Again the highest income earners benefit most from the proposed rate structure.

Chart 4: Impact of Option 4 (Stepped rate reduction over 10 years).



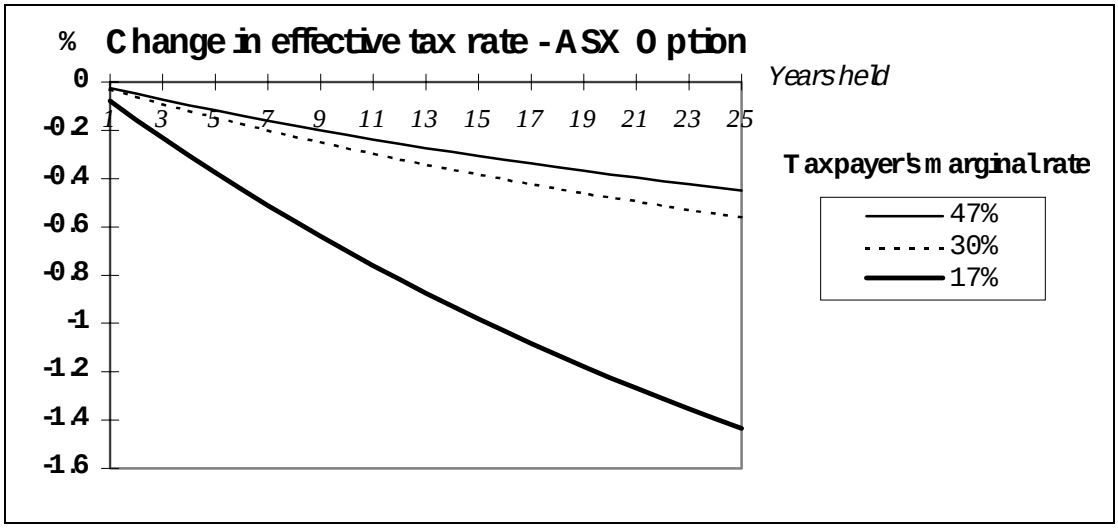
A3.2 Unlocking effects and an ASX rate reduction option

In our submission, ASX argues that there could be significant unlocking effects from CGT rate reductions. The rate cuts modelled in Chart 5 are:

- from 47 per cent to 40 per cent
- from 30 per cent to 25 per cent
- from 17 per cent to 12 per cent

Chart 5 models tax rate outcomes assuming that there is a 15 per cent increase in the CGT taxable base due to unlocking of taxable assets in response to rate cuts. **Notably, this modelling assumes that indexation remains, as unlocking pays for the rate cuts.**

Chart 5: Impact of ASX Option, with unlocking effect.



If unlocking is sufficiently large, a set of rate cuts could be implemented at a much lower cost to revenue than is indicated in the discussion paper.

The chart shows that the revenue cost attributable to taxpayers currently at 47 and 30 per cent tax rates is very small, while taxpayers in the lowest income bracket (who contribute a minor part of the taxable base) benefit marginally better. For all taxpayers, the reduction in effective tax rate is always less than 1 per cent for assets held for less than 15 years.