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KPMG submission to the Review of Business Taxation
(A Platform for Consultation)

KPMG Tax

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Submission to RBT.doc

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1 Executive summary

KPMG makes this submission to the Review of Business Taxation ("the Review") in relation to a range of corporate tax and funds management/life insurance issues. Our submission contains five parts:

1. Domestic issues.
2. International matters.
3. Banking and finance.
4. Funds management, life insurance and superannuation.
5. Software/electronic solutions to reduce costs of compliance.

1. Domestic issues

- *The move towards a 30% corporate tax rate*
  - KPMG supports the long term goal of a 30% corporate tax rate.
- *Blackhole and capital allowance reform*
  - KPMG proposes that goodwill be amortisable for taxation purposes over 20 years.
  - KPMG accepts the need to reduce tax preferences such as accelerated depreciation to achieve the lower corporate tax rate, provided that the other blackhole and capital allowance reforms are introduced. However, the R&D concession should be maintained.
  - KPMG proposes relief measures in respect of expenditure on indefeasible rights of use (IRU).
- *Resident dividend withholding tax as the preferred full franking option*
  - KPMG does not support the deferred company tax (DCT) option.
- *Consolidated income tax returns*
  - KPMG does not support this initiative in its current form. Based on the current proposal, an optional consolidation regime is preferred.
- *Capital gains tax reform*
  - KPMG supports scrip-for-scrip and further recommends its extension beyond the listed target and listed issuer proposal.

- Scrip-for-scrip rollover relief should not be limited to listed public companies but rather should extend to other listed public entities.

- Scrip-for-scrip capital gains tax (CGT) rollover relief should be extended to mergers/takeovers involving unlisted widely held trusts.

- The cost base in respect of shares arising from deconsolidation should be apportioned on the basis of relative valuations of the deconsolidated entities.

- Rollover relief for reorganisations involving controlled foreign companies (CFCs) should be extended not eliminated.

- KPMG submits that capital settled on, gifted or bequeathed to, or otherwise invested in discretionary trusts must be able to be passed out to beneficiaries free of income tax and CGT.

■ *Revised definition of "distribution"*

- KPMG does not support the proposal for a broad definition of "distribution", covering all benefits provided by an entity to its members and, in particular, to the application of the proposal extending to widely held entities, in respect of which there should not be any tax avoidance concerns.

■ *Share buy-backs*

- Companies should be given the option to nominate that the "slice" applies to franked profits before unfranked profits.

2. International matters

■ *Refining the package for the benefit of current and future Australian based multinationals*

- KPMG advocates either a "streaming of foreign income" or a "franked foreign profits" approach as the appropriate solutions. These solutions are not mutually exclusive.

■ *Renegotiation of Australia's double tax treaties*

- KPMG proposes the immediate commencement of treaty renegotiation to achieve a foreign dividend withholding tax rate of 5% for treaties with the seven broad-exemption listed jurisdictions.

■ *Thin capitalisation*

- KPMG rejects the domestic thin capitalisation approach as the current system already provides significant incentives to remove gearing from Australian sourced income.

- KPMG supports the introduction of a realistic safe harbour for the inbound thin capitalisation rules of at least 2:1. The special issues impacting upon financial institutions should be separately considered.

3. Banking and finance

- *Branch banking issues*

  - Australian branches of foreign banks, as in the case of Australian subsidiaries of foreign banks, should have the ability to manage their "distributions" to their head office.

  - Australian branches of foreign banks should not be subject to both notional equity requirements and thin capitalisation rules.

  - Intra bank interest withholding tax should not be increased from 5% to 10%.

  - Australian branches should be able to group/consolidate with Australian subsidiaries of foreign banks.

- *Taxation of financial arrangements*

  - It is agreed that a realisation basis of recognising foreign exchange gains and losses is appropriate for non-financial institutions and in particular, corporate taxpayers.

  - There should be recognition of internal hedges in the case of financial institutions subject to appropriate design safeguards.

  - If the transaction is hedged on a pre-tax basis, it should also be hedged in an after tax sense.

  - There is no necessity to introduce quarantining of losses rules.

4. Funds management, life insurance and superannuation

- KPMG supports the proposal to provide flow through taxation treatment to collective investment vehicles (CIVs).

- KPMG supports the adoption of a broad definition of widely held trusts.

- Wholesale trusts should obtain flow through treatment.

- Wrap accounts and discretionary master trusts should be excluded from the entity regime.

- The "slice" and "profits first" rules should not apply to unit trusts.

- Collective investment vehicles should be excluded from the foreign investment fund rules ("FIF rules").

- CGT relief should be provided in respect of the mergers of unit trusts and super funds.
- Tax preferred income should flow through trusts (outside the entity taxation regime) to underlying unit holders and collective investment vehicles should be taxed upon the same basis as individual investors.
- Pooled superannuation trusts (PSTs) should maintain their current tax treatment.
- The superannuation business of a life company should maintain its current treatment.
- Superannuation funds should be able to undertake “section 275 transfers” to PSTs or life companies.

5. Software/electronic solutions to reduce costs of compliance

- KPMG supports the development of a process which harnesses the latest technology to facilitate the reduction of the costs of tax compliance and provides improvements in the administration and accountability of the Australian Taxation Office (ATO) in respect of business taxation.
- We advocate that the Review make a specific recommendation as to the appropriate strategy for software/electronic solutions for reducing the costs of compliance.

1.1 The Review process

- KPMG continues to acknowledge the efforts of the Review, particularly in relation to the focus groups strategy.
- We propose a continuing process post 30 June 1999 with the opportunity for independent review of draft legislation and public discussion.
- We undertake to continue to be an active contributor and to allocate available resources to our clients and the Review Committee as required.

2 Domestic issues

2.1 The move towards a 30% corporate tax rate

- KPMG supports the long term goal of a 30% corporate tax rate.
- An internationally competitive and stable corporate tax rate should be the ultimate goal.
- The need to reduce tax preferences such as accelerated depreciation to achieve this goal is accepted, provided that the other issues like amortisation of goodwill and blackhole costs discussed in the Review's Discussion Paper 2 are introduced.
- However, the R&D concession should be maintained as it is the Government's major industry platform for encouraging innovation.
- The rate reduction could if required, be introduced by a staged reduction of the rate to 30% to appropriately balance the revenue constraints and the transitional issues. However, behavioural impacts will be minimised if the objective is achieved in the short term.
- Appropriate transitional provisions are critical so that capital expenditure which is committed as at 1 July 2000 is not adversely impacted.

2.2 Blackhole and capital allowance reform

2.2.1 Amortisation of wasting assets, including goodwill

- KPMG agrees that the treatment of blackhole expenditure should be broadly consistent with accounting principles, both in respect of identifying what expenditure should be expensed/amortised and the amortisation period.
- KPMG proposes that goodwill be amortisable for taxation purposes over 20 years.

2.2.2 Accelerated depreciation

- KPMG accepts the need to reduce tax preferences such as accelerated depreciation to achieve the lower corporate tax rate, provided that the other blackhole and capital allowance reforms are introduced as per 2.2.1.
- However, the R&D concession should be maintained. In support of the retention of the R&D concession we note the following:
  - The key objective of the R&D concession is to encourage Australian companies to invest in R&D.

- The R&D concession allows companies to determine the nature of R&D undertaken, thus allowing companies to respond to market requirements and business conditions. The R&D concession is more efficient than other forms of assistance, such as discretionary grants, which are not available for all R&D projects. The R&D concession also has a well established infrastructure.

- Since its introduction, the R&D concession has clearly been a successful industry program and is accepted by industry as a critical factor in fostering ongoing technology development. Substantial economic benefits from the concession have arisen, particularly in areas such as employment, technology transfer, increased exports, import replacement and increased competitiveness.

- A discussion paper released by the House of Representatives Standing Committee on Industry, Science and Resources, on 7 April 1999 indicated that R&D spending by Australian business ranks a poor 17th among OECD countries and that the halving of the R&D concession in 1996 may have contributed to this outcome.

  Accordingly, the retention of this concession is essential to Australian industry.

2.2.3 Indefeasible rights of use

- KPMG proposes relief measures in respect of IRU expenses.

- Under the existing tax law, IRU expenditure is not tax deductible in the year in which it is incurred and cannot be depreciated or amortised. The only available tax relief may be a capital loss on disposal. As IRU expenditure gives rise to a wasting asset, it should be addressed as part of blackhole expenditures identified in Chapter 1 of the Review's Discussion Paper 2.

- The proposed spectrum licence rules contained in Taxation Laws Amendment Bill (No 6) 1999 provide an appropriate model for the future tax treatment of IRU expenditure.

- Given the current and anticipated IRU expenditure of Australian telecommunications companies, a change to the law with effect from 1 July 2000 is too late. Consideration should be given to providing relief in respect of this expenditure as early as possible.

- This is a significant issue for Australian telecommunications companies which are currently significantly disadvantaged as against their foreign competitors.

2.3 Resident dividend withholding tax as the preferred full franking option

- KPMG does not consider that the DCT option is appropriate.

- Our position is supported by the following factors:

  - The adverse impact on foreign investors and the associated risk of direct or indirect retaliation from treaty partners.

  - The severe impact on sectors which currently pay unfranked dividends and have relatively high foreign ownership (eg the resources, agricultural and infrastructure sectors).

  - The charge to profits where DCT is payable and the associated apparent decline in the reported earnings of Australian companies.

  - The real possibility of unrelieved double tax at the corporate level in relation to timing differences.

- The resident dividend withholding tax (RDWT) option represents the appropriate compromise between the integrity benefits and the concerns of business.

- Should the Section 46F option be implemented in preference to RDWT, a mechanism should be incorporated to preserve the 15% tax rate for non-residents in relation to tax preferred income.

- With the introduction of a full franking regime, KPMG believes that the carry back of capital and revenue losses should be permitted as is possible in most of the broad-exemption listed countries.

2.4 Consolidated income tax returns

- KPMG does not support this initiative in its current form as there are many problems with the proposal. The consolidation regime should not have the effect of eliminating tax losses. The proposed regime should effect a change to tax administration and not of itself, introduce a change in substantive tax law. Based on the current proposal, an optional consolidation regime is preferred.

- Our conclusion has been reached following an evaluation of many issues including overseas experience, issues of equity, consistency and compliance costs:

  - The USA experience indicates that the implementation of this proposal will not result in a simplification of administration and a reduction in compliance costs.

  - The requirement for an Australian resident holding entity at the head of the group will create commercial difficulties, compliance costs and potential Australian and foreign tax exposures for those groups which are not currently so structured.

  - The proposals in relation to losses upon entry into a consolidated group which reduce the ability to carry forward and utilise tax losses as compared to the current regime are inequitable.

- The options focus on companies and do not adequately address the position of trusts, particularly the position where trusts which become part of a consolidated group as at the date of introduction have carry forward losses.

- The concept of joint and several liability could cause companies to breach debt covenants with adverse consequences and could be detrimental to other creditors. The position upon exit from the group also needs to be addressed.

- The current "grouping" provisions (eg loss transfers, CGT rollover) should be retained as an alternative to the consolidation regime, or at least retained as an interim measure so as to allow time for companies to establish appropriate consolidated groups and utilise carry forward tax losses.

- The comment that the proposals will "overcome the re-characterisation of interest expenses in order to claim a deduction against tax-exempt income" suggests that the proposals will effect an unwarranted and base broadening change in relation to the deductibility of interest.

- There is a lack of consistency between the proposed consolidated group for income tax return purposes as opposed to a "GST group". The group for income tax purposes should be based on a 90% ownership interest.

- The proposal that branches are unable to be consolidated raises particular difficulties in the context of Australian bank branches of foreign banks. Under current law, such branches are able to participate in loss transfer agreements with an Australian subsidiary.

- In respect of the taxation of non-consolidated dividends, dividends received from outside a group will automatically be applied against losses of the group. This is an inequitable result which could be relieved through the mechanism of a dividends received deduction.

■ KPMG believes that with limited exceptions, the current "grouping" system works efficiently. However, if the proposed consolidation regime contained in the Review's Discussion Paper 2 is not implemented, consideration should be given to allowing rollovers of revenue assets (such transfers would be effectively ignored under a consolidation approach).

2.5 Capital gains tax reform

■ KPMG advocates an internationally competitive CGT system as the goal of the Review.

■ KPMG supports the scrip-for-scrip rollover proposal and further recommends its extension beyond the listed target and listed issuer proposal.

- Mergers, takeovers and reorganisations which facilitate business efficiency should be encouraged or, at the least, tax impediments should not discourage otherwise commercially attractive transactions.

- The Review's Discussion Paper 2, at paragraph 11.63 suggests that CGT rollover relief for scrip-for-scrip mergers/takeovers could be confined to publicly listed companies on the basis that this would avoid tax avoidance and minimisation problems that might arise if the provisions were extended to unlisted companies. This conclusion is reached on the basis that the value of such shares would be less easily determined. If scrip in a company, listed or unlisted, is exchanged for scrip in a listed public company on a takeover or merger there will be no problem in determining the value of the shares at the critical taxing point. The reason for this is as follows.

  The critical taxing point is not at the time the scrip is exchanged for scrip. Rather, it is the time at which the replacement scrip is disposed of. At that latter time, the shareholder will be holding scrip in a listed public company. There will be no doubt as to the market value of those listed public company shares and accordingly no avenue for tax avoidance/revenue leakage.

  On this basis, there is a justification for extending scrip-for-scrip rollover to all circumstances where scrip in companies, listed or unlisted, is exchanged for scrip in listed public companies on a merger/takeover. At the very least, scrip-for-scrip CGT rollover relief should extend to circumstances where scrip in listed public companies or **widely held unlisted public companies** is exchanged for scrip in listed public companies on a merger/takeover.

- Business efficiency in various industries would also be served where scrip-for-scrip CGT rollover relief was extended to the exchange of scrip in unlisted widely held public companies for scrip in other unlisted widely held public companies. There are examples of widely held unlisted public companies which have operated in a cooperative structure or in a corporate structure on a "cooperative basis" in particular geographic regions. There are strong business efficiency reasons for merging these companies. CGT is currently a major impediment to the achievement of such business efficiency. Tax avoidance issues should not be a material concern in the case of widely held unlisted public companies and the valuation of the replacement of widely held unlisted public company shares could be undertaken using recognised valuation techniques at the time of disposal.

- Scrip-for-scrip rollover relief should not be limited to listed public companies but rather should extend to other listed public entities. There does not appear to be any sound reason for differentiating between companies and other structures such as trusts particularly in the context of the Review which has sought, to the extent possible, to remove tax differentiations between various entities.

- Scrip-for-scrip CGT rollover relief should be extended to mergers/takeovers involving unlisted widely held trusts. There are various examples of inefficient widely held unlisted public trusts where there would be a strong business case for mergers/takeovers and such mergers/takeovers cannot occur due to CGT issues for unit holders. The size of the industry could generally be verified by discussions with key fund managers.

  - The Review should not be concerned in relation to revenue leakage. The above recommendations if implemented, would encourage business efficiency thereby increasing profit, share/unit prices and ultimately increasing revenue to the Government. A decision not to provide CGT scrip-for-scrip rollover relief or to significantly limit such relief is likely to restrict the amount of this increased revenue.

- The cost base in respect of shares arising from deconsolidation should be apportioned on the basis of relative valuations of the deconsolidated entities. Where possible, tax preferences should be allocated to the consolidated entities on the basis of where the assets (which have generated those preferences) are allocated. Where this is not possible or not appropriate such tax preferences including tax losses and tax credits should be allocated on the basis of the relative valuations discussed above.

- KPMG considers that the proposal to apply CGT to indirect transfers of assets held by non-residents is too broad in its application and results in a less internationally competitive tax system.

  - The proposed means of quarantining legitimate transactions, not motivated by tax avoidance, is too restrictive and may not extend to legitimate merger/takeover activity.

  - Transitional provisions would also be required to quarantine pre-existing assets from the proposals.

- Broader corporate reorganisation relief is required to allow economically efficient business combinations and deconsolidations to occur.

- Roll-over relief for reorganisations involving CFCs should be extended not eliminated.

- KPMG submits that capital settled on, gifted or bequeathed to, or otherwise invested in discretionary trusts must be able to be passed out to beneficiaries free of income tax and CGT.

2.6 Revised definition of “distribution”

- KPMG does not support the proposal for a broad definition of “distribution”, covering all benefits provided by an entity to its members and, in particular, to the application of the proposal extending to widely held entities.

- Compliance considerations support our position, particularly as the proposal:

  - Results in a form of domestic transfer pricing provisions; and

  - May render it impossible to comply with any of the options for a redesigned imputation system in legitimate situations where benefits are provided to members of an entity by a third party under an “arrangement” with the entity.

- The proposal for a broad definition of "distribution" gives rise to inordinate compliance difficulties when considered in conjunction with the proposed requirement that distributable profits be defined as the market value of the entity's net assets less contributed capital at the time of distribution. The proposals under which distributions will be taken to exist in respect of benefits provided by or to associates, or under arrangements with third parties, clearly give rise to insurmountable hurdles in ascertaining the time of a particular distribution and its quantum.

- Clarification is needed as to the overlay of the "slice" approach and the "profits first" rule, in respect of calculating the quantum of an entity's distributable profits, in situations where the distribution is taken to have been made by the entity although the benefits to the entity's member are provided by either an associate or a third party arranger.

2.7 Share buy-backs

- KPMG suggests that the "slice" approach for off market share buy-backs be modified.

- Companies should be given the option to nominate that the "slice" applies to franked profits before unfranked profits.

- KPMG submits that companies should be able to rely upon book values, without exception, in calculating distributable profits, whether for the purposes of application of the "slice" approach or in respect of distributions which may have otherwise contained a contributed capital component.

  Any requirement to define distributable profits by reference to the market value of the entity's net assets less contributed capital at the time of distribution gives rise to extremely onerous compliance costs and difficulties. This is particularly the case for widely held entities whose accounts are independently audited in accordance with generally accepted accounting principles and in respect of whom there should not be tax avoidance concerns. These issues are exacerbated when the proposals for a broader definition of "distribution" are considered (see below).

3 International matters

3.1 Refining the package for the benefit of current and future Australian based multinationals

- KPMG advocates either a "streaming of foreign income" or a "franked foreign profits" approach as the appropriate solutions. These solutions are not mutually exclusive.

- Various alternatives have been proposed to improve the access of Australian multinationals to foreign equity markets and relieve the advantage at the shareholder level of Australian sourced profits as against foreign sourced profits including:

  - The "streaming" of foreign income by an Australian multinational to its foreign shareholders (ie the reversal of the "franked profits first" principle).

  - Allowing "stapled stock" arrangements under which income of foreign subsidiaries is paid directly to foreign shareholders.

  - Allowing a complete or partial franking credit for foreign underlying tax ("the franked foreign profits" approach).

- The features of the "franked foreign profits" approach are:

  - It benefits Australian corporates with foreign income be they large or small and whether or not they have foreign shareholders.

  - The appropriate solution should benefit our existing and emerging multinationals and not necessarily just those multinationals with matching foreign income/total income and foreign shareholder/total shareholder fractions.

  - It should be possible to complete a reliable estimate of the cost of such a proposal which will need to take into account the current level of section 23AJ exempt dividends, foreign participation in Australian companies and dividend pay-out ratios.

- The revenue cost of the proposed credit for foreign dividend withholding tax could be better applied to the "franked foreign profits" approach.

- The existing burdens of the Australian tax system as they impact upon current and future Australian multinationals are well known and include:

  - No relief at the shareholder level for foreign underlying and dividend withholding taxes.

  - Onerous transfer pricing, CFC and FIF issues.

  - Non-deductibility of funding costs for overseas expansion.

  - Inability to write-off goodwill.

  The adoption of the above recommendations will relieve these disadvantages.

3.2 Renegotiation of Australia's double tax treaties

- Australian based multinationals currently face the permanent cost of a 15% dividend withholding tax remitting profits back to Australia from countries like the US, Germany, Japan and Canada. KPMG advocates the immediate commencement of treaty renegotiation.

- The immediate goal should be a foreign dividend withholding tax rate of 5% for our treaties with the seven broad-exemption listed jurisdictions.

- The policy and rationale of the taxation of capital gains which are derived by non-residents may need to be revisited prior to the treaty renegotiation process commencing. Whilst the existing international tax environment remains, it is KPMG's view that Australia should not seek to retain its ability to tax capital gains which are derived by residents of treaty countries other than in the case of real estate interests.

3.3 Thin capitalisation

- KPMG rejects the domestic thin capitalisation approach as the current system already provides significant incentives to remove gearing from Australian sourced income.

- Domestic thin capitalisation rules would further disadvantage Australian multinationals expanding offshore.

- The inbound thin capitalisation proposal is vague and requires significant clarification.

- KPMG supports the introduction of a realistic safe harbour of at least 2:1. The special issues impacting upon financial institutions should be separately considered.

- The impact on many existing resource and infrastructure projects could be quite dramatic. As the proposal represents a fundamental shift in policy, generous grandfathering rules should be provided.

4 Banking and finance

4.1 Branch banking issues

KPMG makes the following submissions in respect of branch banking.

- Australian branches of foreign banks, as in the case of Australian subsidiaries of foreign banks should have the ability to manage their "distributions" to their head office. If it is assumed that the annual profit of an Australian branch is automatically "repatriated" to the head office of the foreign bank, all untaxed profits will be subject to tax (whether under the deferred company tax, resident dividend withholding tax or dividend rebate alternatives). This can ultimately result in double tax, especially in respect of timing differences.

- On the basis that branches would be provided with the opportunity of deciding when "distributions" are made to their head office, objective evidence of a distribution being made could be provided by a review of cash flows between the branch and other portions of the bank which will be evidenced in the accounts of the branch.

- Australian branches of foreign banks should not be subject to both notional equity requirement and thin capitalisation rules. Such requirements place the Australian branch at a competitive disadvantage compared to operating through a subsidiary.

- If the notional equity concept is retained for branches, in calculating the 4% interest expense which is not deductible, some recognition should be given to the capital retained in the branch. Capital for these purposes could include retained profits and interest free "loans" from head office.

- Intra bank interest withholding tax (that is, tax paid by an Australian branch to the foreign bank head office) should not be increased from 5% to 10%. The branch banking regime has existed in Australia for less than five years. Accordingly, a change so soon after its introduction would be incongruous with Australia's aim of being a regional financial centre.

- Where an Australian subsidiary of a foreign bank is used by the foreign bank to obtain section 128F interest withholding tax free funds for provision to the Australian branch of the foreign bank, it should not be necessary for the subsidiary to derive a profit (spread) on the on-lending of the section 128F interest withholding tax free funds to the branch.

- The role of off-shore banking units and their ongoing viability should be reviewed and clarified. An off-shore banking unit in the context of the Australian branch of a foreign bank is not viable under the current proposals.

- An assumption is made in the Review's Discussion Paper 2, that where DCT or RDWT is imposed on the Australian branch as a consequence of "distributions" from the branch to the head office, the jurisdiction in which the head office is located will allow a foreign tax credit. Such a conclusion should not be assumed and its validity will vary from country to country.

Where the foreign jurisdiction has an exemption system, no foreign tax credit may be forthcoming. Even where the foreign jurisdiction has a foreign tax credit system, the Australian tax imposed may be in excess of the tax otherwise payable in the foreign jurisdiction. That is, an excess tax credit situation may arise such that, effectively, no foreign tax credit is available in the foreign jurisdiction.

Finally, again, where the foreign jurisdiction has a foreign tax credit system, the foreign jurisdiction may not recognise tax imposed on fictional transactions such as fictional deemed distributions between branch and head office. As a consequence, no foreign tax credit may be available in the foreign jurisdiction in respect of such deemed distributions.

- Thin capitalisation rules should be drafted in conjunction with industry and should take account of the unique nature of the gearing of financial institutions.

- Under existing legislation, foreign banks operating in Australia through a branch must also operate through a subsidiary if they are to take advantage of section 128F interest withholding tax free concessions. For this and various other reasons, Australian branches should be able to group/consolidate with Australian subsidiaries of foreign banks.

4.2 Taxation of financial arrangements

KPMG makes the following submissions in respect of the taxation of financial arrangements (“TOFA”).

- It is agreed that a realisation basis of recognising foreign exchange gains and losses is appropriate for non-financial institutions and in particular, corporate taxpayers. Financial institutions should be allowed to elect (subject to revenue safeguards) to use a retranslation approach rather than a realisation approach in relation to foreign exchange gains and losses. This issue is not addressed by allowing financial institutions an election to use a mark-to-market approach in respect of financial assets and liabilities as a mark-to-market approach will revalue the entire financial asset and liability (including, say, interest rate movements) rather than merely retranslating the value of the financial asset or liability to take account of movements in the foreign exchange rate.

- The decision in the previous TOFA Issues Paper to embrace the need for internal hedges in respect of financial institutions was welcome. There should be recognition of internal hedges in the case of financial institutions subject to appropriate design safeguards.

- Consistent with various previous submissions in relation to the 1993 TOFA Consultative Document and 1996 TOFA Issues Paper, if the taxation of financial arrangements is to achieve its design feature objectives as outlined in the 1993 TOFA Consultative Document, it will be necessary to include design rules relating to hedging transactions and in particular to provide that the taxation of hedging transactions is determined on the nature and timing of the underlying transaction (that is, the transaction being hedged). In summary, if the transaction is hedged on a pre-tax basis, it should also be hedged in an after tax sense.

- In the context of the various measures and safeguards included in the TOFA proposals, there is no necessity to introduce quarantining of losses rules. Such rules are more likely to adversely affect taxpayers which have incurred losses rather than protect the revenue in preventing "adverse selection" in respect of financial assets and liabilities disposal.

- With respect to the comments in respect of economic disposal versus legal disposal, we can understand the attractiveness from a substance approach of giving due regard to economic disposal rather than legal disposal of financial assets and liabilities.

  However, we do not believe that an in substance approach can provide the best approach unless (as is the case with the legal disposal approach) it is capable of certainty of application.

  Accordingly, unless measures can be devised to provide a certainty of application, as envisaged by the design features of the 1993 TOFA Consultative Document, the legal approach should be retained.

5 Funds management, life insurance and superannuation

- KPMG supports the proposal to provide flow through taxation treatment to CIVs.

- KPMG agrees with the adoption of a broad definition of widely held trusts and proposes the following treatment of funds management/life insurance issues.

- Wholesale trusts should obtain flow through treatment. It is submitted that the same logic which applies to CIVs should apply to the wholesale trusts into which they invest. Further, if wholesale trusts are taxed as companies the "flow through" treatment for many CIVs would become effectively redundant. Finally, there could be a significant and inefficient movement of funds away from wholesale trusts if the proposals are adopted.

- Wrap accounts and discretionary master trusts should be excluded from the entity regime. It is submitted that they facilitate an effective reporting mechanism for investors. Any requirement to tax wrap accounts and discretionary master trusts as entities would increase complexity, potentially reduce consumer choice and cause major inefficient flows of funds.

- The "slice" and "profits first" rules should not apply to unit trusts which are exempted from the entity taxation regime. The adoption of the slice rule would require extensive systems changes to determine the income and capital component of unit prices. To facilitate daily unit pricing it would be necessary to undertake a daily market valuation of all assets which would prove to be difficult if not impossible. Further, inequities can arise from the use of the weighted average capital methodology, such that a unit holder may convert a portion of their capital acquisition price into assessable redemption proceeds.

- CIVs should be excluded from the FIF rules. Current FIF rules already impose an administrative burden on public unit trusts and any move to increase complexity would not be welcome.

- CGT relief should be provided in respect of the mergers of unit trusts and super funds. The tax effective merger of unit trusts and super funds should lead to increased efficiencies, particularly in respect of small uneconomic funds.

- Tax preferred income should flow through trusts which are outside the entity taxation regime to underlying unit holders and CIVs should be taxed upon the same basis as individual investors. Consistency of tax treatment should be maintained between individual investors and superannuation funds (who will obtain the benefits of tax free and tax deferred distributions) and trusts.

- If the taxation treatment of tax preferred income is to be altered then sufficient time would need to be given to facilitate this change. As a minimum it is submitted that property acquired prior to 1 July 2000 should be taxed on the current basis (for example the current treatment should apply to property acquired prior to 1 July 2000).

- PSTs are an efficient savings vehicle and should maintain their current tax treatment. A significant movement of funds away from PSTs would occur if the proposals were adopted.

- The superannuation business of a life company should maintain its current treatment. For consistency, the model should be that of a stand alone superannuation fund.

- Superannuation funds should be able to undertake "section 275 transfers" to PSTs or life companies. It is submitted that transferring the tax liability administration is efficient particularly for smaller funds. Many superannuation funds would be required to hold increased cash to pay their tax liabilities with consequent potential reductions in return for investors.

6 Software/electronic solutions to reduce the costs of compliance

- KPMG supports the development of a process which harnesses the latest technology to facilitate the reduction of the costs of tax compliance and provide improvements in the administration and accountability of the ATO in respect of business taxation.

- KPMG notes that the Treasurer's terms of reference of the Review encompassed the inclusion of recommendations as to the reduction of the costs of compliance. We advocate that the Review make a specific recommendation as to the appropriate strategy for a software/electronic solution for reducing the costs of compliance.

- We welcome the public endorsement by the Commissioner of Taxation, Mr Michael Carmody, of the need for a software package that enables a seamless process between business and the ATO. We concur with Mr Carmody that it would be appropriate for the ATO to take a leadership role in this regard not only to increase the integrity of the tax compliance process, but also to demonstrate to the private sector that Government is aware of and wishes to ameliorate the additional administrative burdens and costs associated with fundamental reforms to the taxation system.

- Our recommendation is that this initiative be sponsored by the ATO in a joint venture or in conjunction with a software house with technical input from the profession.

- Initiatives which may follow from the Review, such as consolidated corporate tax returns, plus other tax reform proposals foreshadowed by the Government in the *Tax Reform, Not A New Tax, A New Tax System*, (such as PAYG and the integration of GST, PAYE, FBT and company tax remittances) will create significant costs for business unless technological solutions are forthcoming.

- KPMG is already involved as a Firm in many software/electronic and e-commerce initiatives. For example, in the authentication process for business, KPMG operates as a Certification Authority to guarantee the authenticity of a business conducting e-commerce transactions. We would be ready to partner the ATO in this initiative.