15 April 1999

Dr Alan Preston
Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Alan

SUBMISSION TO THE REVIEW OF BUSINESS TAXATION

The Commonwealth Bank supports the Government's call for reform of the Australian taxation system and is pleased to provide detailed comments in response to Discussion Paper 2 "A Platform for Consultation".

In supporting the call for reform, the process must extend beyond measures to position Australia to compete on equal terms in the international sphere, to include positive steps to remove anomalies and inconsistencies within the tax law that receive so much attention from those who seek to gain unintended taxation benefits. The measures should focus on returning the basic principles of equity, efficiency and simplicity to a tax system that has lost credibility through ad hoc changes. Where tax preferences are to be provided via the tax system, concise policy on issues such as tax benefit transfers should be a feature of any reform.

The Bank's submission does not endeavour to canvass all matters raised in Discussion Paper 2, but is limited to some of the more significant issues that affect the Bank. Please contact Mr. Chris Millett (telephone no. (02) 9378 3673, facsimile no. (02) 9378 3801) to discuss any aspect of this submission.

The Bank does not require that any part of its submission be treated as confidential.

Yours sincerely

Summary of Position on Issues Addressed

Issues	Comments
Tax rate reduction	Fully supported
Removal of accelerated depreciation	Supported
Removal of balancing charge offset	Supported
Immediate write-off of small items	Not supported in current form.
Black hole expenditure	Support immediate write-off or amortisation
Goodwill	Support amortisation
Single tax rate for life company business	Retain 15% rate on superannuation business
Taxation of policy fees and underwriting profits	Support taxing of income but method proposed is unnecessarily complex
Redesigned imputation system for life policies	Not supported. Recommendation that existing structure be retained.
Transfer of contributions tax liability	Not supported
Deferred company tax	Supported subject to being able to stream foreign profits to foreign shareholders. Otherwise Option 2 is preferred
Relief of potential double tax on temporary tax preferred income	Support Option 2
Refundable imputation credits	Entity level refunds not supported
Flow through taxation of CIVs	Support exclusion from entity taxation
Definition of CIVs	Support broad definition based on “eligible investment business” in s 102M
Flow through of tax advantaged income	Support flow through of tax advantaged income to investors
Definition of distributions	Support Option 3 with the Option 2 alternative
Profit and capital distributions	Support for generic rules but there is a need for simplicity
Double taxation of on-market buy-backs	Support initiatives to prevent double taxation
Anti-avoidance provisions	Strongly support introduction of anti-avoidance platform that will focus on commerciality

Issues	Comments
Flow through of credits for foreign withholding tax	Supported
Legislated source rules	Supported provided the rules do not conflict with international practice.
Imputation credits for investment in Australia via non-resident entities	Supported
Taxation of entity groups	Proposed consolidation regime is not supported
CGT rate relief for individuals	Capping rate at 30% is supported
Scrip for scrip rollover relief	Strongly supported.
Indexation	Removal of indexation is supported
Quarantining capital losses	Support for narrowing quaranting rules and for carry-back of capital losses
Fringe benefits tax changes	Support transfer of liability to employees and narrowing of scope of FBT
Taxation of financial arrangements	Supported provided recognition of internal deals and retranslation of foreign exchange gains/losses is available for financial institutions.
Elective mark-to-market	Neither asset class nor entity-wide basis is a viable option for financial institutions
Accruals methodology	Adoption of financial accounting accruals methodology is supported for financial institutions
Debt/equity distinction	Proposed facts and circumstances test is too subjective and cannot be supported
Taxation of leases and rights	Changes become unnecessary if accelerated depreciation and balancing charge offset removed. Will restrict an opportunity for business to obtain 100% finance for assets.

Commonwealth Bank of Australia
Submission to the Review of Business Taxation

1. Tax rate reduction/benefit trade-off.

The Bank fully supports the concept of a reduction of the company tax rate to 30%. An analysis by the Bank's Research team entitled "Tax Reform - Some Implications of a Lower, Transparent Tax Rate", which supports this proposition, is attached as Appendix 1. A benefit trade-off is accepted if the Government's objective of revenue neutrality is to be accomplished. Discussion Paper 2 suggests a number of benefits that may be changed/removed in order to achieve the lower tax rate. The Bank supports the majority of these proposals in the interest of achieving a lower company tax rate. Major proposals include-

1.1 Removal of accelerated depreciation.

Discussion Paper 2 at 2.9 suggests that accelerated depreciation provides little benefit to service industries such as finance, tourism and retailing. The Committee should not overlook the point that accelerated depreciation and "balancing charge offset" are integral aspects of lease financing and the removal of these two existing taxation provisions will impact on the finance industry.

Nevertheless, the Bank supports the elimination of accelerated depreciation and its replacement with an effective life regime (Option 1).

In advocating the adoption of an effective life regime, the Bank supports the following propositions raised in Chapter 1 on Wasting Assets, -

1. The deduction should be available to the party who incurs the expenditure to produce assessable income.
2. The deduction should be based on the cost base of the taxpayer.
3. The deduction should write-off the asset over its effective life. In this regard, effective life should be measured by reference to the condition of the asset at the time of acquisition rather than to a notional life based on the premise that the asset was new.
4. There should be an option to write-off assets that have been depreciated to a nominal value where the diminishing value method is used.

The desired outcome would allow the accounting depreciation to be used for taxation purposes.

1.2 Remove balancing charge offset

The balancing charge offset does provide significant benefit to the finance industry, particularly in relation to leasing activities. However, the Bank does support its removal in the interests of achieving the tax rate reduction.

1.3 Immediate write-off for small items.

The rationale for the immediate write-off of small items is well-founded in that it obviates the need for taxpayers to establish computer records and to make annual calculations of depreciation for such assets. If the concern is one of tax minimisation as outlined in 1.73, the solution should be to adopt measures to counter this, rather than impose unnecessary compliance requirements on all taxpayers.

This proposal is not supported in its current format. Although the benefit to the Bank for this concession is relatively minor (only $500,000 pa) it does simplify compliance. A limit of $10,000 for small business and major listed companies alike is inappropriate. Any limit should more appropriately be set as a percentage of revenue. Alternatively, a pooling arrangement that allowed the assets to be written-off over a short period eg 2 to 3 years would be acceptable.

2. Life Company Taxation Reform

The Government's reform model advocates a comprehensive change to the way in which life companies and their products are taxed. Reasons advanced for change include-

(a) An attempt to overcome what officers of the ATO and Treasury perceive as widespread tax minimisation practices centred on the movement of assets between statutory funds.

The industry has attempted to address this in the past by advocating for interfund transfers to be treated as disposals. However, the ATO has not been happy to accept that solution as it is convinced that it would be used to "artificially" crystallize/accelerate loss deductions.

(b) Many fees and underwriting profits derived by life companies arise "below the line" such that they do not attract tax.

(c) Life policy bonuses should be taxed in the hands of policyholders under a revised imputation system.

The focus of this is at the individual/personal level - but again, the breadth of the proposed measures is considerably greater (and more disruptive) than is needed to achieve the desired outcome. Additionally, there are good grounds to suggest that the current regime should be allowed to continue.

2.1 Single tax rate.

Discussion Paper 2 uses the argument that changes are needed because the current system of life company tax is complex. However, the complexities are understood by the industry, which has an infrastructure in place to address them. The single rate proposal will merely change, and possibly increase, the focus of complexity without providing any benefits to the Revenue or policyholders. Interestingly, the RSA business of a life company will continue to be taxed at a 15% rate without the need for recourse to deductions or rebate benefits to achieve that rate.

Whereas it is proposed that super fund investors will receive tax rate relief (albeit in a particularly clumsy and costly manner) there is no intention that deferred annuities receive the same benefit. The Discussion Paper 2 solution to preserve the 15% rate is to migrate this block of business to a superannuation fund. Such a transfer, necessitated by no better reason than to make the reform proposals work, places funds under management at risk by causing current policyholders to have to make decisions regarding continued investment in these products. It also creates considerable costs because of the necessity to transfer large blocks of assets (several billion dollars in Commonwealth Life Limited) with attendant income tax, stamp duty and brokerage costs. If no better solution than migration can be found, then the amending legislation should provide for full roll-over relief in respect of assets required to be migrated. Taxation legislation similar to that proposed as a consequence of the Managed Investments Act will be required.

Retirement income streams themselves may be negatively impacted by the proposed system because of what will effectively be a loan of tax collections to the tax office pending refunds and also because of the expectation that the compliance costs will ultimately be passed to policyholders. The current arrangements work, are simple to administer and their continuance is supported.

2.2 Taxation of policy fees/underwriting profits

It is acknowledged that all amounts that constitute income should be subject to tax and this would include income attributed to shareholders' funds that are held as solvency reserves in statutory funds. However, the changes being proposed are not required in order to achieve this.

A simple allocation or a factual actuarial allocation based on policy liabilities which, in the normal course would be readily available, can achieve the same end without the need for the added compliance complexities.

The concept is supported but a rethink of the mechanism to achieve this is needed.

2.3 Redesigned imputation system

This proposal is not supported on the grounds that what is proposed is unworkable in the context of day-to-day life company operations.

It must be recognised that life policies are surrendered every day - and frequently the surrenders are "partial". Under the proposal, the franking account position would need to be monitored daily. In addition, systems would need to be developed to calculate the bonus portion of partial surrenders. Systems would also need to be amended to report the attached franking entitlements to the policy holder.

Where tax had not actually been paid by the life company, for example, where the bonuses were paid out of unrealised gains , exempt infrastructure interest or foreign sourced income for which a foreign credit was allowed, it would be necessary for the life company to pay additional tax to achieve full franking. This would be to the detriment of the remaining investors.

Under existing arrangements, (non-superannuation) policyholders are not taxed on bonuses if their policy is held for at least 10 years. During that time the investment income has borne tax (currently at 39%) which has been collected and paid by the life company. Where a policy is surrendered before 10 years has elapsed, the policyholder is taxed on the bonuses at the marginal rate and allowed a rebate equal to 39% of the assessable bonuses. This mechanism can be triggered by investors on lower marginal rates to control/limit the effective tax burden on their savings. Overall, this is very efficient collection system and provides no room for leakages.

In the interests of encouraging longer-term national savings in a controlled and efficient environment the current insurance bond system should be allowed to continue.

If taxation of the policy bonus is to be implemented regardless of the holding period, then it is recommended that a "flat" rebate system akin to that currently employed should be used.

2.4 Contributions tax

Discussion Paper 2 advocates the removal of the ability for superannuation funds to transfer taxable contributions to life insurers or PSTs on the premise of practical difficulties and complexities.

This is not a valid basis to remove an arrangement that simplifies compliance and the Bank advocates the retention of the current transfer arrangements as they do not give rise to revenue leakage.

2.5 Timing of policyholder taxation

If policyholders are to be taxed irrespective of the holding period, it is proposed to allow policyholders to choose whether to be taxed "as they go" or at maturity. This option will add considerably to the costs and complexity of compliance.

It is proposed that in the interests of simplification there should be no choice as to taxing time. Rather, tax should be applied at point of surrender.

2.6 Taxation of bonuses - policyholder considerations

This topic has already been discussed under the heading "redesigned imputation system" at 2.3. However, if those earlier arguments to retain the current basis of assessment are not accepted, then to ensure a level playing field with other investment options the government will need to allow policyholders deductions for expenses which they incur in relation to their policies including interest on borrowings, fees etc.

Special consideration also needs to be given to the taxation status associated with benefits paid out on the death of a policyholder. Do these remain investment earnings or do they recognize (as currently) that the proceeds are those of a life policy? This has not been addressed in Discussion Paper 2. Our view is that first and foremost the policies are life policies - which means that death benefits should continue to be afforded an exempt treatment.

2.6 General Observation

The focus on "equity" across investment markets/options has given us proposals that, if implemented, will strongly favour direct investment by superannuation funds rather than investment via life policies and PSTs. Given the Government's announced intention to exempt collective investment vehicles from the entity taxation regime, the role of life companies as superannuation investment vehicles seems extremely limited. There is the risk of considerable inefficiencies in investment markets and tax collection regimes if funds found themselves forced away from life companies which are made uncompetitive by tax changes.

3. Entity Distributions

Comments on Deferred Company Tax are included with our comments on International Issues under 10.1.

3.1 Refundable credits

The general principle of refunding imputation credits to those investors who are otherwise unable to use them is supported. However, we do not support the option for entity level refunds. This would impose a significant, additional compliance burden on the distributing taxpayers, especially if life companies and certain trusts are brought into the entity regime. A key difficulty that an entity would need to overcome is proving the tax status of the recipient now claiming the refund. In our view that compliance responsibility should sit squarely with the Revenue.

A significant portion of the credits that will attach to distributions (especially if CIVs are carved out of the full franking regime) are currently being received by taxpayers who are required to await assessment before their benefit is realised. In those circumstances, there is strong argument for not moving from the assessment-based system - leaving net refunds to the ATO. Indeed, the motivation to early refund appears to be driven by a need to undo the effects of other aspects of Tax Reform (especially taxation of life companies) on superannuation funds.

3.2 Potential double taxation

The existence of double-tax traps in the current system necessitates skillful management of structures if they are to be avoided. This can add otherwise unnecessary complexity to ordinary commercial dealings, potentially giving rise to scrutiny for alleged tax avoidance practices. Discussion Paper 2 identifies a number of these situations, as well as other double-tax outcomes that could follow the introduction of the revised imputation system.

We fully support Discussion Paper 2 options to alleviate double taxes.

4. Collective Investment Vehicles

We applaud the Government's decision to apply flow-through taxation to cash management trusts. We also strongly support the Government's in principle decision to extend flow through taxation to other collective investment vehicles. (CIVs).

It is an accepted foundation issue of Tax Reform that similar entities should suffer the same tax treatments. However, within that concept it is argued that there is room to recognise the distinction between entities that serve merely to pool the savings/investment monies of passive investors and those that offer equity in business operations. Outsorting CIVs from the entity level taxation regime demonstrates that principle.

4.1 Flow through taxation

Unit trusts currently enjoy wide acceptance as vehicles through which investors are able to access low cost, diversified investment options that would not otherwise be available to them. Fund managers also promote this pooling approach, in the interests of creating economies of scale, through the use of asset specific wholesale vehicles into which retail funds are invested. These investment trusts are certainly not promoted in the interests of tax avoidance or minimisation, nor is there any motivation for the promoters to enter into such practices. Thus the Revenue is placed in the same position as if there had been direct investment, but with the social advantages of cost and risk reduction to the investor - which facilitates and encourages broad-based national savings.

If CIVs were to be taxed as companies, pre-tax returns (possibly carrying tax preferences) could be achieved by direct investment. However, barriers to efficient entry preclude most household savers (and even small wholesale investors) from accessing other than the simpler forms of interest bearing options on a direct basis, or else cause them to adopt an "unbalanced" investment approach to a single or small number of assets. The barriers referred to include high entry and exit costs, and an inability (due to resource limitations) to generate sufficient diversification of investment in order to eliminate risks and a general lack of financial sophistication. Unit trusts overcome these investor limitations and allow efficient, professionally managed economic outcomes.

In this regard, it is important that the definition of CIV should be wide enough to capture all entities which are simply a convenient and efficient form of pooling of passive investments and which provide the same tax outcome to investors as direct investment. We acknowledge that the application of this definition may mean that some companies may be taxed on a "flow-through" basis if they exhibit the necessary characteristics of being a pooling vehicle for investment. However, we argue that this is wholly consistent with Discussion Paper 2, at paragraph 15.2, which states that -

> "It does not make sense for exactly the same investment to attract very different tax treatment simply because it is put through a trust rather than a company. Such a result violates the tax principle that taxpayers in similar positions should be treated similarly."

4.2 Definition of CIVs

It is noted in Discussion Paper 2 at paragraph 16.13 that CIVs would be defined as -

> "widely held vehicles undertaking investments delivering flow through of annual profits to participants. Such investments (would be) less of an active business nature and much more of a passive portfolio, or intermediate, nature not involving control of business operations."

In that regard, we would contend that the definition of "eligible investment business" (which is contained in section 102M of the Income Tax Assessment Act 1936) would serve to provide parameters to determine whether a company or trust should be viewed as satisfying the "passive portfolio" status of a CIV.

Entities satisfying that test should also be tested to determine whether they are "widely held". The appropriate definition should be as broad as possible so as to ensure that it encompasses pooling vehicles that are closely held wholesale entities. The "widely held" definitions in the recently enacted trust loss provisions (Schedule 2F of the 1936 Act) would serve that purpose without the need for creating new tests.

It is important to note that any exclusion of property trusts and other wholesale unit trusts from the CIV definition would have wide ranging implications for the funds management industry. This would also contradict the philosophy of *A Strong Foundation* that advocates investment neutrality by arguing that taxpayers in similar positions should be treated similarly. It would force a major restructure of investments as the benefits of pooling are unwound and force entities such as superannuation funds which use wholesale unit trusts into direct investments. If the benefits of pooling are not available to these entities, investment earnings will be adversely impacted, as efficiencies of scale are no longer available. This in turn will adversely impact the health of the Australian economy.

4.3 Tax advantaged income flows

Discussion Paper 2 raises specific concerns about "tax advantaged" income flows. However, it is submitted that these concerns must be considered against the fundamental principle that the concept of flow through taxation is to ensure that investors who pool investments through CIVs are taxed in a similar manner to those who invest directly.

Following on from this principle, if the tax preferences are of a type that a taxpayer is entitled to if the investment was held directly, for example building allowance, those tax preferences should also flow through to the taxpayer if the asset is held via interests in a CIV. The existing CGT cost-base reduction provisions should be sufficient to ensure that an investor is not able to achieve a double benefit from temporary tax preferences.

5. Defining 'distribution'

Discussion Paper 2 proposes to apply a broad definition of "distribution" to cover benefits provided by an entity to its members. Where these members are also employees, options 1 and 2 canvass the interrelationship with the FBT provisions. To that end Discussion Paper 2 proposes that income tax should take precedence over FBT and that "non-commercial" benefits would be classed as "distributions".

While this proposal would give wide effect to what currently is an anti-avoidance measure in respect of private companies, it is submitted that there should be no requirement for such a provision for widely held entities, whether they are companies or trusts. In contrast to the position with closely held entities, it is argued that the "members" of widely held vehicles are not in a position to influence those entities' activities. Therefore, genuine employee benefits that are currently subject to the FBT regime should not be deemed to be distributions purely because the employee also happens to hold an equity position in the entity.

Compliance costs and related issues associated with tracing whether, from time to time, employees are members would be an additional burden on employers and against the philosophy of *A Strong Foundation*.

For CIVs it is suggested that the "distribution" concept should pay heed to the terms of the governing trust deed. This is expanded on below under "profit and capital distributions".

6. Profit and Capital Distributions

A Strong Foundation made it clear that one of the fundamental reasons for tax reform is to promote certainty and efficiencies thus reducing compliance costs. Accordingly, it is submitted that definitions of these terms need to be simple and clear, even at the risk of perceived Revenue leakage. Discussion Paper 2 recognises the need to focus on commerciality to remove uncertainties in taxation law. This is an example of such a situation.

For CIVs, it was earlier suggested that the distribution concept should pay heed to the terms of the governing trust deed. This is particularly so where redemptions are involved. To do otherwise may lead to capital being taxed as income - for example, where a redemption amount does not include a right to include income but the "slice" approach operates. In those circumstances, to the extent that a redemption may be deemed to comprise income but the trust deed does not recognise this and ultimately requires that same amount to be distributed as part of a periodic income distribution, the amount is taxed twice.

It should also be acknowledged that reductions in equity of corporates tend to occur "across the board" (ie all investors are involved) whereas unit trusts generally confer the right of redemption individually, at any time. Thus there is a significantly higher compliance burden for a CIV in determining the "slice" income component.

7. Buy-backs, Redemptions and Liquidations

We fully support the initiatives to prevent double taxation in the case of buy-backs.

8. Trusts and the New Entity Regime

It is recommended that the definition of “excluded trusts” be expanded to include all entities falling within the concept of a collective investment vehicle. This would seem to offer the simplest mechanism for introducing an entity regime while leaving selected vehicles outside that regime.

9. Anti-avoidance Provisions

We agree that the current range of specific anti-avoidance provisions is cumbersome and adds considerably to the complexity and costs of compliance. We therefore support the move to consolidate and in some cases remove specific anti-avoidance measures and to instead focus on structural flaws in the law.

We also strongly support the introduction of an anti-avoidance platform that will focus on commerciality and so remove the current uncertainties that arise from too widely drafted general and specific anti-avoidance measures.

10. Foreign source income of Australian residents

10.1 Deferred Company Tax

The introduction of the DCT proposal will impact on the level of tax borne by non-resident investors in Australian listed companies. We consider that this would be detrimental to the national interests of retaining Australian domiciled companies. We would support a DCT that allowed the streaming of comparably taxed foreign sourced income to non-resident investors. The efficiencies which would result from foreign investors being able to access foreign income and the attaching foreign tax credits without suffering further Australian tax should drive up demand for and the price of Australian equities.

Under such a system foreign investors would be indifferent to direct investment in foreign assets or indirect investment via an Australian listed company. This would attract equity to the Australian market, ensure that Australian companies maintain their Australian domicile and therefore be in the national interest.

If the proposal to allow steaming of foreign income is not accepted, then our support for a DCT is withdrawn and the introduction of a Resident Dividend Withholding Tax (RDWT) regime is supported.

10.2 Flow-through of credits for withholding tax

Discussion Paper 2 proposes as an option to allow a "flow through" of credits for foreign withholding tax. Under this proposal foreign withholding tax paid on dividends received by an Australian resident entity (company or trust) would result in an imputation credit.

This proposal would result in a reduction in the overall effective tax rate on income derived from comparably taxed offshore subsidiaries and distributed to Australian resident shareholders.

The Bank supports this proposal on the basis that it will reduce the existing bias in the Australian tax system against investment in foreign countries.

10.3 Addressing problems with the anti-tax deferral rules

Discussion Paper 2 identifies a number of "problems" with the controlled foreign company (CFC) and foreign investment fund (FIF) rules. The main "problems" are areas of potential revenue leakage perceived by the Treasury and Tax Office. Problems brought to the Tax Office's attention by the business community over a number of years via the National Tax Liaison Group Foreign Income Sub-Committee are not referred to in Discussion Paper 2.

The Bank proposes that problems in the anti-tax deferral rules be considered in an orderly and structured way with the aim of achieving a balance between the anti-tax avoidance objectives of the Treasury and Tax Office and the needs and interests of business.

Discussion Paper 2 also demonstrates that taxing trusts as if they were companies will fundamentally change the way in which the anti-tax deferral rules apply to foreign trusts and the treatment of income derived by non-residents through Australian trusts. The issues (including transitional measures) are too specialised and complex to be considered in the general context of business tax reform. It is the Bank's recommendation that they be addressed in another forum together with CFC and FIF issues raised by the business community that are still outstanding and other CFC and FIF issues arising from the business tax reform process.

10.4 CGT Roll-over Relief for Controlled Foreign Companies (CFCs)

The Bank does not support the suggestion in Discussion Paper 2 that if a tax consolidation regime is introduced in Australia, rollover elections for asset transfers between CFCs be abolished.

Roll-over relief should be available to CFCs to allow Australian groups to take advantage of foreign reorganisation reliefs to restructure offshore operations without suffering adverse Australian tax consequences.

11. Allocation of worldwide income between countries

11.1 Legislated source rules

The Bank supports the call for clarity in source rules but is concerned to ensure that unilateral rules adopted by Australia do not conflict with international practice.

11.2 Imputation credits for investment in Australia through non-resident entities

The Bank supports the idea of extending the imputation system to allow Australian imputation credits to flow to Australian shareholders through foreign entities.

12 Taxation of Entity Groups

The Bank does not support adoption of a consolidation regime in the form proposed in Discussion Paper 2 as it will not simplify the income tax system, but will introduce more complexity.

While the consolidation proposal could eliminate double taxation of the same economic gains within the same group and prevent loss duplication and value shifting between group entities, those issues can also be addressed and solutions successfully achieved through the use of specific adjustment and a commercially based general anti-avoidance provisions.

The Bank proposes -

(a) an "opt-in" system for companies within the same group, with existing grouping rules maintained for groups that do not wish to use consolidation;

(b) revision of the proposed rules regarding purchases and sales of entities by company groups;

(c) a lowering of the common ownership threshold from 100% to 75%; and

(d) exemption for all intra-group dividends, rather than the existing rebate system which can result in arbitrary double taxation of profits within a company group.

13. Taxation of Leases and Rights

Leasing is a significant industry in Australia. The Commonwealth Bank alone has leasing assets of $5 billion. The proposed changes have the potential to significantly damage the leasing industry.

The chapters on the taxation of leases and rights over wasting assets are predicated on the continued existence of accelerated depreciation and the risk to the revenue of structured lease payments. Without accelerated depreciation, the Bank does not consider that leasing involves the tax benefit transfers which form the basis of the case for reform and do not justify the significant damage that would result to the Australian leasing industry. Accordingly, given our support for the drop in tax rate and the necessity of eliminating accelerated depreciation to achieve this, the proposed changes to leases become unnecessary.

Should the 'sale and loan' approach to leasing outlined in 9.15-9.17 be adopted, we consider that it should be restricted to finance leases and not apply to operating leases. Although the distinction between an operating lease and a finance lease may be difficult to make, it is difficult to justify a lessee who is carrying no risk in relation to an asset being entitled to the depreciation deductions rather than the lessor who both owns the equipment and carries the risks/benefits of ownership. New Zealand has legislation that distinguishes the taxation treatment of finance and operating leases.

The 'tax preferred leasing' approach which is outlined in 9.21-9.26 of Discussion Paper 2, under which both the lessor and the lessee would claim part of the depreciation deductions available on a leased asset is not supported on the basis that it would be complicated and costly to administer. If the ability to transfer tax preferences is to be preserved (and accelerated depreciation continue) the continuance of current tax treatment combined with legislation which addresses the concerns of the revenue in relation to structured lease payments is preferable to the 'tax preferred leasing' approach.

Leasing allows small businesses to obtain 100% finance for assets and for this reason measures should not be adopted that will effectively eliminate this source of financing for the small business sector.

14. Capital Gains Tax

14.1 Rate Relief for Individuals

The Bank supports the capping of the rate at 30% for individuals.

14.2 Scrip for Scrip Rollover Relief

The concept of providing scrip for scrip rollover relief is strongly supported by the Bank. Relief should be available to shareholders in overseas companies, unlisted widely held trusts and superannuation funds and also apply to corporate deconsolidations.

14.3 Indexation

Removal of indexation would simplify the treatment of capital gains and losses and is acceptable to the Bank as part of a tax rate/benefit trade-off.

14.4 Capital Losses

The Bank supports the narrowing of the quarantining rules for capital losses to losses arising from dealings in shares and unit trusts. As well, the Bank supports the carry back of losses to offset capital gains of a prior year as a means to introduce flexibility and equity into the CGT regime.

15. Fringe Benefits tax

The Bank supports the proposal to transfer the tax liability to the employee for all fringe benefits. In doing this, the liability should only arise in respect of true remuneration substitution benefits and certain items such as on-premises parking and meal entertainment benefits should be removed from FBT coverage. The current reporting requirement needs further consideration, particularly in respect of allocating car benefits where more than one employee has use of the vehicle in the financial year.

The Bank supports the reform options that will reduce compliance costs and would accept a reduction in the current concessional taxation of motor vehicles as an appropriate trade-off.

16. Black hole expenditure

The Bank supports any proposal that will allow “black hole” expenditure to be written off when incurred or over a statutory period of time.

17. Goodwill

The Bank strongly supports Option 1 which would allow acquired goodwill to be amortised.

18. Taxation of Financial Arrangements (ToFA)

The Bank is of the view that the forecast revenue gains from the proposed changes to the taxation of financial arrangements listed in Chapter 39 are significantly understated. The current taxation rules mean that the Commonwealth Bank alone currently has recognised accounting income of approximately $800 million on which a deferred tax liability has been established but for which income tax has not yet become payable. As financial markets are globalised it cannot be assumed that tax deferrals in one taxpayer will offset tax accelerations in another Australian taxpayer. There is evidence in the Bank that this is not the case. In addition a move to tax interest income on an accruals basis will bring forward significant revenue from major investment entities.

The Bank has been an advocate for reform in this area for over 8 years despite the fact that this would accelerate tax payable. The objective has been to obtain certainty of outcome and to be able to have a hedge that was effective after tax as well as before tax. To this end, the Bank supports the use of financial accounting records for calculating taxable income.

The Bank considers that the ToFA proposals contained in Discussion Paper 2 represent a major backward step from the proposals contained in the December 1996 ToFA Issues

Paper. While recognising that a number of the changes that have been made are to accommodate legitimate concerns of the corporate sector about the previous proposal, some of the more important changes do not fit into this category. The negative aspects of the current proposals are great enough to eliminate the efficiencies which were sought to be achieved by ToFA. While under current law the calculations are complex, systems are in place to achieve the necessary adjustments to financial accounting results. Accordingly, it is not the Bank's preference to swap its current system to another system with additional complexities. In other words, adoption of a proposal which continues to diverge from the financial accounts would involve swapping one compliance nightmare for another.

The Bank would continue to support ToFA subject to the Bank's concerns about the failure to recognise internal deals and concerns about the treatment of non-traded foreign exchange being addressed.

18.1 Internal Deals

Paragraphs 6.71-6.73 of Discussion Paper 2 discuss internal hedges in a manner which suggests that recognition of these hedging transactions are viewed negatively. It acknowledges that not recognising internal hedges "could entail internal timing mismatches" where one unit of an organisation which is taxed on a mark-to-market basis hedges an exposure of another unit which is taxed on an accruals basis. The Paper then apparently advocates continuing to ignore these hedges leaving taxpayers to organise their own internal affairs. This completely overlooks the fact that the banking industry organises its own affairs in this area precisely through these internal transactions and does it this way because this is the most cost efficient and least distortionary method.

These internal transactions have won recognition from a financial accounting viewpoint (despite theoretical objections to recognising transactions that an entity does with itself) precisely because the recognition of these transactions reflects the economic substance of the transactions.

More detailed comments in respect of the issues are contained in the submission made by the Australian Bankers' Association, International Banks and Securities Association of Australia and the Australian Financial Markets Association. The Bank supports the recognition of internal deals being limited to financial institutions.

18.2 Accounting for Foreign Currency Gains and Losses

The Bank submits that retranslation should be included as an alternative means of returning foreign currency gains and losses for financial institutions. This is the most appropriate means of recognising foreign currency gains and losses on foreign currency debt. The arguments in favour of re-translation have been set out previously in the 1996 Issues Paper and such an approach would accord with financial accounting treatment. The Bank understands the concerns raised by the corporate sector which may have led to the dropping of compulsory retranslation, but does not consider that these primarily cash-flow reasons should prevent the adoption of best practice by other taxpayers.

The availability of a mark-to-market election is not an adequate alternative to retranslation. As well as the fact that these two methods will produce divergent results, the transactions in question would not qualify for the mark-to-market election under the Bank's preferred transaction basis because they would not meet the safeguard requirement of being marked-to-market for financial accounting purposes.

The Bank does not support the accrual of gains and losses on foreign currency debt transactions using forward exchange rates. This method would be very costly to implement for taxpayers, like the Bank, with a substantial number of foreign currency denominated debt transactions. The method would involve the development of a new system (the calculations required by this method are complex and significantly diverge from any that are currently produced by accounting systems) and would suffer the information verification problems inherent in any system which is established purely to calculate tax.

18.3 Elective Mark-to-Market

Discussion Paper 2 suggests a number of alternative approaches to the basis for electing into the mark to market system. The alternatives are that the election could be made on a transaction, asset class or entity basis or that some combination of these approaches be allowed. From the Bank's perspective neither the asset class nor entity-wide bases are viable options. Either of these approaches would result in substantial disparity between the transactions which would be marked to market for taxation purposes and those marked to market for accounting purposes. For example, Commonwealth Government Bonds are held in both investment portfolios (which are accounted for on an accruals basis) and trading portfolios (where financial accounts are prepared on a mark to market basis). If the election for mark to market was only available on an asset class or entity basis, very substantial variations in the income for financial accounting and taxation purposes would still be evident along with the compliance costs of making these adjustments.

The transaction basis of electing for the mark to market system contains a number of "safeguards" that are designed to prevent adverse selection. The need for "safeguards", given the elective nature of the regime, is accepted but greater clarity is required of what is covered by each "safeguard".

18.4 Accruals Issues

It is the Bank's preference to be able to use its financial accounting accrual methodologies for taxation purposes. The conditions for using these methodologies are set out in paragraph 6.35 of Discussion Paper 2. The major concern is that the requirement that there is no significant variation from the benchmark will jeopardise the compliance cost savings of adopting financial accounting methodologies. For this test to be acceptable it needs to be designed in such a manner that compliance with it does not involve testing each transaction against the benchmark. The Bank has difficulty in seeing how this will be achieved and submits that any accrual methodology which is used consistently for financial accounting purposes and which is in accordance with generally accepted accounting principles should be accepted. This largely achieves the revenue objective in moving to an accruals methodology and the additional revenue to be gained by the not significantly different test is unlikely, in our opinion, to outweigh the compliance costs associated with complying with this test.

18.5 Hybrids - Debt/Equity Distinction

The Bank supports the approach taken in the ABA/AFMA/IBSA submission for the treatment of debt/equity hybrids. It considers that the proposed facts and circumstances test (7.16-7.20 of Discussion Paper 2) is too subjective and lacks the degree of certainty required from a test which has such a large impact on tax treatments. The use of a single quantitative determinative factor (7.21-7.24 of Discussion Paper 2) has some appeal but will not always produce appropriate results. We consider that supplementing this single determinative factor in the manner proposed by the ABA/AFMA/IBSA submission will improve the appropriateness of the test.

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