# National Australia Bank Limited

# Response to Review of Business Taxation

# " A Platform for Consultation" Discussion Paper 2

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# National Australia Bank Limited

# Response to Review of Business Taxation

# " A Platform for Consultation " Discussion Paper 2

# Executive Summary

## Background

National Australia Bank (the National) is an international financial services group providing a comprehensive range of financial services across four continents and 15 countries. At 30 September 1998, globally, the National had:

- An asset base of over $250 billion (over half of which are deployed offshore).
- Over $400 billion in assets under administration.
- A profit after tax of $2.5 billion (over half of which was generated in offshore jurisdictions). As a general rule, the foreign profit derived by the National is exempt from tax in Australia as it has already been subject to tax at a comparable tax rate.

The National supports the reform of Australia's taxation system, including the reform of business taxation. The overriding aim of Discussion Paper 2 of Business taxation (RBT) is the improvement of the competitiveness and efficiency of Australian business. With the increasing globalisation of investment and capital flows, to achieve this aim Australia must have a business taxation system that is internationally competitive. This will allow Australian multinationals such as the National to expand in foreign markets and to raise cost effective capital from overseas investors.

This is particularly important in the context of the Government's stated objective that it wishes Australia to develop as a regional financial centre.

Set out below is a summary of the National's views on the various options outlined in the second discussion paper, "A Platform for Consultation" (Discussion Paper 2). Full details are provided in the attached Appendices. The National's support for individual options is dependant on the final approach taken on related major issues. A number of the options are linked and if the linkages are modified the National's support for individual options may need to be re-assessed.

# 1. Full Franking Proposals – ( Refer Appendix 1)

- From the National's perspective, the DCT system outlined in Discussion Paper 2 has a number of serious flaws which are likely to lead to adverse consequences for the National and its Australian resident and foreign shareholders. The National's submission is that a DCT should ***not*** be introduced in Australia. We note that the National is a member of the Deferred Company Tax Coalition and supports in principle the views set out in the submission lodged by this coalition on the full franking proposals.

- In summary, a DCT system creates the following problems:-

  - DCT will lead to a reduction in after tax profits. For the National, an international financial services group that derives significant income from offshore activities, the potential impact on after tax profits is likely to be significant. Based on existing profits and the current dividend payout ratio, a DCT, as proposed, may increase the National's tax expense by approximately $80 million per annum. It is likely that markets and investors will react negatively to a significant decrease in after tax profits. The National will also have to review its current dividend policy to reflect the impact on reported profits.
  - DCT is likely to increase the cost of raising equity capital.

  - DCT inadequately deals with timing differences between book and taxable income (referred to in Discussion Paper 2 as "temporary tax preferences"). DCT would be payable on temporary tax preferences with a potential for double taxation when the preferences reverse.

  - The payment of DCT will cause cash flow issues.

  - DCT adversely impacts companies like the National that have significant offshore operations and derive significant foreign income that has been subject to tax in a foreign jurisdiction and is exempt from tax in Australia.

  - DCT is likely to result in a significant reduction in the returns to non-resident investors in the National unless there is substantial modification to the foreign income conduit options (refer to summary on International Tax set out below). This makes Australian shareholdings for foreign investors far less attractive vis a vis other comparable tax jurisdictions.

- A DCT regime would only be a viable option if the tax did not apply to distributions of foreign earnings to both resident and non resident shareholders which have been subject to tax at a comparable rate. Such income does not represent tax preferred income. (Refer to further comments below on dividend streaming under the heading of International Tax.)

- If a full franking system is the objective, National supports the introduction of a Resident Domestic Withholding Tax (RDWT) regime as this regime does not involve some of the fundamental problems of the DCT.

- The National does not consider that the third option, which would treat all unfranked distributions as assessable (without an inter corporate dividend rebate), represents significant reform of the franking system.

## 2. International Tax – (Refer Appendix 2)

- ***Taxation of foreign income derived through companies –*** Discussion Paper 2 recognises that as a general principle where income derived by Australian multinationals from foreign investments in listed comparable tax countries flows through to foreign shareholders that income should not be subject to Australian tax (paragraph 31.10).

  Three alternative options, in order of preference, are presented that would achieve an outcome that is consistent with the above principle.

  ***Option 1 - Streaming of foreign income to foreign shareholders***

  The current anti-dividend streaming rules are a major impediment for Australian multinationals which are seeking to become internationally competitive. Foreign shareholders of Australian multinationals should be allowed to receive dividends directly from foreign subsidiaries located in foreign comparable tax countries without the imposition of Australian franking penalties. Australian multinationals should be permitted to pay unfranked dividends out of foreign income to foreign shareholders without any franking consequences and withholding tax.

  It is considered that this option is the most viable as it can be implemented through an extension of the current Foreign Dividend Account regime. In addition, it should be relatively simple to implement and administer as it should not require any major redrafting of the current tax law and it should not create any major additional compliance issues for Australian multinationals.

  ***Option 2 - Imputation credits for foreign tax***

  Australia does not recognise foreign tax (underlying tax and withholding tax) paid by Australian multinational groups in respect of foreign income derived in foreign comparable tax countries. This creates a double layer of tax on such foreign income when ultimately distributed to Australian resident individual shareholders. If full streaming of comparably taxed foreign income to foreign shareholders is not accepted, then Australian imputation credits should be allowed for foreign tax paid (underlying tax and withholding tax) on foreign income which has also been subject to comparable tax in a foreign country.

  ***Option 3 - Exemption for comparably taxed foreign source income distributed through Australian companies to Australian shareholders***

  To alleviate the double layer of taxation on foreign source income, which is derived and distributed by Australian multinationals, that income should be exempt from Australian tax in the hands of Australian resident individual shareholders. This could be considered as an alternative to full streaming of foreign profits and the recognition of imputation credits for foreign tax paid.

- ***Double tax treaties –*** many of Australia's treaties are not internationally competitive primarily because of the relatively high dividend and interest withholding tax rates. The Government should give priority to the renegotiation of major treaties such as the US treaty.

- ***Domestic thin capitalisation rules –*** The National does not support the option of introducing a "domestic thin capitalisation" rule to deny a deduction for interest incurred on borrowings used by Australian multinationals to finance Australian operations which is in excess of a fixed gearing ratio. The National considers that there are legitimate commercial reasons as to why Australian multinationals would seek to raise funds domestically to finance domestic operations, rather than raise funds offshore to finance operations in foreign countries.

- ***Deductibility of financing costs for foreign investments*** **–** the non deductibility of interest incurred on borrowings used by Australian multinationals to finance the acquisition of non portfolio investments in foreign comparable tax countries impedes international expansion. Australian multinationals should have the ability to elect to apply a foreign tax credit regime which would allow a deduction for interest on borrowings used to finance foreign investments in comparable tax countries.

- ***Self assessment for transfer pricing*** **–** the National supports in principle the introduction of a self assessment system for transfer pricing provided the rules are not too prescriptive and there is some flexibility provided in respect of arm's length pricing methodologies and documentation requirements.

## 3. Reduction in Corporate Tax Rate

- A reduction in the corporate tax rate from 36% to 30% funded by the removal of accelerated depreciation is supported. There is no economic justification for the retention of accelerated depreciation.

- The reform of business taxation must be considered as part of the overall tax reform package, including the introduction of GST. It cannot be considered in isolation. A reduction in the corporate tax rate will assist the Australian service sector to compete internationally and in attracting offshore businesses to Australia. A low corporate tax rate is also an important factor in the aim of developing Australia as a regional financial centre. Australia's corporate tax rate needs to be competitive with our neighbours, particularly Singapore (corporate tax rate of 26%) and Hong Kong (corporate tax rate of 16.5%) which are direct competitors for financial centre business.

## 4. Capital Gains Tax – (Refer Appendix 3)

The National supports the following reform initiatives in respect of capital gains tax :

- Rollover relief for scrip for scrip company reorganisations so that tax issues are not an impediment to transactions such as mergers and takeovers which are generally undertaken to improve business efficiency. Such rollover relief should apply to all shareholders including those who hold assets on revenue account;

- Where a company has assets on revenue account, as with assets held on capital account, rollover relief should be allowed where there is a transfer of assets to a wholly owned company. This would ensure that financial institutions (where assets are generally on revenue account) are not at a disadvantage when restructuring in comparison to companies in other industries. While this issue is not covered in Discussion Paper 2, it is a significant issue for financial institutions and should be part of any genuine reform process;

- Where a business holds assets on both capital and revenue account the capital losses should be allowed to be offset against the revenue gains. It is anomalous that where assets are held both on capital and revenue account, revenue losses can be offset against capital gains but not vice versa; and

- If the Government wishes to encourage long term investment, indexation should be retained as taxpayers are then only tax on real gains.

## 5. GST

- The input taxing of financial supplies will have a significant impact for the National and the financial services industry generally. It will add significantly to the cost of conducting business in Australia. This will add to cost pressures within the industry and impact end consumers. This represents an increase in the corporate tax rate of approximately 8%-10%. FID and BAD are taxes which are effectively passed on to consumers and, therefore, the removal of such taxes does not have any material impact on the operating costs of the National. On the other hand, the input taxing of financial supplies has a direct impact on the operating costs of financial institutions such as the National.

- The National supports the taxation of financial supplies. This proposal has been rejected by the Government at this stage but is currently under review in overseas jurisdictions and the proposal developed by the Australian Bankers' Association should be pursued as a viable alternative. This is a more pure method of taxation and avoids the cascading impact of the GST.

- The proposal of treating financial supplies provided to registered entities as GST free is seen as a real alternative to full taxation of financial supplies and consequently worth pursuing.

## 6. Taxation of Entity Distributions – (Refer Appendix 4)

- ***Treatment of bonus shares*** **–** the National does not support the option of treating bonus shares issued to shareholders under a bonus share plan as a distribution taxable as a dividend to the shareholder. The National supports retaining the existing tax treatment of bonus shares issued under a bonus share plan.

- ***Profits first rule*** **–** the National does not support the option of a profits first rule. Such a rule is likely to impede the management of corporate capital structures and increase the compliance burden for many Australian companies. The National considers that a general anti-avoidance rule should replace the existing specific anti-avoidance rules which seek to address dividend substitution and capital streaming arrangements.

- ***Redemption of redeemable preference shares*** **–** the National recommends that the tax law should be amended to ensure that where there is a redemption of RPS and the redemption merely represents a return of capital this should not be treated as a dividend to the shareholder.

## 7. Taxation of Financial Assets and Liabilities – (Refer Appendix 5)

- ***ABA/IBSA/AFMA joint industry submission*** - the National is an active member of the Australian Bankers' Association ('ABA') and the Australian Financial Markets Association ('AFMA') and has contributed to the joint submission to be lodged on the proposals contained in Chapters 5-7 of Discussion Paper 2 by ABA/IBSA/AFMA.

- ***Elective mark to market*** - the National supports the proposal that elective mark to market be allowed to account for gains and losses on its trading portfolios.

- ***Internal dealings*** **–** the National strongly supports the inclusion of rules which recognise internal dealings for tax purposes and believes a carve-out is needed in relation to any rules that require group companies to prepare a consolidated income tax return. The National sees the failure by Discussion Paper 2 to acknowledge the importance of allowing banks to recognise their internal dealings for tax purposes (the 1996 Issues Paper had recognised the significance of internal dealings and was prepared to recognise them in the 1996 proposals) as a serious shortcoming of the proposals.

- ***Retranslation accounting*** - the National would like to be able to adopt a retranslation basis of taxing foreign currency gains and losses on its monetary assets and liabilities which are not part of its trading portfolio.

- ***Hybrid instruments*** - the National recommends a combination of a blanket approach and the selection of a set of specified determinative factors with the development of a sound and reasonable test to distinguish debt from equity.

- ***Anti-avoidance rules*** - the National does not support the complex anti-avoidance rules proposed, particularly, the proposal to quarantine losses incurred on financial arrangements to gains made on financial arrangements.

- ***Implementation*** - Discussion Paper 2 does not contain sufficient detail about how the proposals are intended to operate. There are a lot of complex issues that will need to be addressed before it is possible to draft legislation which will be able to implement the proposals in practice. Therefore, the National would like to see further meaningful consultation with the banking and finance industry prior to detailed legislation being drafted.

## 8. Taxation of Leases – (Refer Appendix 6)

- The National supports the continuation of the existing taxation treatment of leases.

- A move to a sale and loan approach in respect of any form of operating lease is not consistent with the legal form or economic substance of the arrangement and is, therefore, considered inappropriate.

- A move to a sale and loan approach in respect of finance leases is not supported. Finance leases provide a commercially effective form of asset financing to all levels of tax paying entities, in particular, small and medium size businesses. A finance lease structure enables lower tax paying entities to obtain cheaper finance and, therefore, indirectly invest in assets that may have otherwise been commercially unattractive. The opportunity to obtain this cheaper form of financing should also be extended to tax exempt entities.

- The benefits of a “transfer of tax preferences” approach is questionable given the likely complexity of such a proposal and the compliance requirements involved. Further, if accelerated depreciation is removed, the anticipated revenue benefits are unlikely to materialise.

## 9. Depreciation – (Refer Appendix 7)

The National supports the following recommendations :

- The removal of accelerated depreciation but only as part of a package which reduces the corporate tax rate.

- The simplification and unification of the depreciation and capital allowance write-off provisions.

- The proposed deductibility over defined periods of various blackhole expenditure, in particular, capital raising costs such as prospectus and underwriting costs and acquisition due diligence costs.

- The amortisation of purchased goodwill for tax purposes.

## 10. Collective Investment Vehicles – (Refer Appendix 8)

The National makes the following recommendations :

- The definition of a CIV should be expanded to provide access for small investors to a wide range of investments including equities (both Australian and offshore), property, interest bearing securities and cash.

- All managed investments including both wholesale and retail pooled vehicles continue to operate under the “flow-through” principle. This is consistent with investment neutrality principles.

- Master funds should be treated as completely look through vehicles and therefore excluded from the entity taxation regime.

- The current taxation relativities in relation to superannuation business in life insurance companies and pooled superannuation trust vehicles should be maintained. The National opposes the taxing of these vehicles up front at the corporate tax rate and for downstream investors to deal with the complications of franking credits and loss of real investment returns.

- The tax preferences that create incentives for savings be maintained.

## 11. Taxation of Life Insurers – (Refer Appendix 9)

In order to address the neutrality issue in respect of policyholders and shareholders, the National makes the following recommendations:

- Income attributable to ordinary investment policyholders (ie. non-super/RSA and non-pension/annuity policies) should be taxed at the company rate.

- The tax rate applied at the life company level to complying superannuation and deferred annuity business should be 15 per cent.

- Income referable to the immediate annuity business of a life company should remain exempt from tax.

- Life companies, as a collective investment vehicle, should be entitled to CGT treatment in relation to the disposal of assets.

- The National accepts the recommendation that protection insurance business be taxed based on its 'underwriting profit.' Whilst this will result in a higher tax liability for the industry, it is consistent with the treatment of general insurance business and the nature of the business.

## 12. Taxation of Entity Groups – (Refer Appendix 10)

- The consolidation regime should be truly optional. The current grouping arrangements should remain in place and entity groups should have the capacity to opt into a consolidated regime.

- If a consolidated regime is introduced there are a number of significant issues which must be considered before a consolidated regime is implemented. These issues are outlined in Appendix 12.

## 13. Fringe Benefits Tax – (Refer Appendix 11)

- The National supports the exclusion of on-premises car parking and entertainment. The trade-off for this cost to the revenue would be the proposed changes to the taxing of car benefits. The exclusion of these items would lead to a significant reduction in complexity and compliance costs.

## 14. Taxation Of Individuals Entering Australia – (Refer Appendix 12)

- In view of the Government's stated objective of making Australia a regional finance centre, the National believes that Taxation Ruling TR 98/17 – "Residency Status of Individuals Entering Australia", should be reviewed. Australia should be seen as a tax jurisdiction which is attractive to highly skilled non-residents on relatively short term assignments.

# Full Franking Proposals Appendix 1

## Background

A system requiring the full franking of all distributions at the entity level was first proposed by the Federal Government in *A New Tax System*, released in August 1998. In *A New Tax System*, the Government proposed extending a redesigned company tax system to trusts, limited partnerships, co-operatives and life insurers.

Chapters 15 and 17 of Discussion Paper 2 set out options for the proposed company tax system including a redesigned imputation system which involves the full franking of all distributions. Discussion Paper 2 suggests that a full franking system would improve the integrity of the business tax system by collecting tax on all distributions of profits from entities, rather than allowing some untaxed distributions to be made.

We have set out below the National's views on the options.

**Option 1: Impose A Deferred Company Tax (DCT)**

Under a DCT system, distributions of tax preferred profits would be taxed at the entity level at the corporate tax rate. DCT would apply to tax-preferred profits so that all distributions of profits would be fully franked.

Discussion Paper 2 uses the term "tax preferred profits" to denote amounts distributed by entities to investors out of profits that have not been subject to mainstream company tax. This would include, for example, income derived by a company that is exempt from tax in Australia (e.g. certain categories of foreign income). It would also include timing differences (e.g. profit/loss on some treasury transactions and treatment of debt provisioning) that result in taxable income being temporarily different than accounting profit.

DCT would be a separate tax payable by entities and would not be creditable against future mainstream company tax payments. Company tax (including DCT) paid at the entity level would then be creditable to certain resident shareholders under the imputation system. Resident individuals and superannuation funds who are shareholders would be entitled to a refund of any excess imputation credits.

The National does not support the introduction of a DCT for the following reasons:

**Reduction In Reported After Tax Profits**

Discussion Paper 2 notes that a disadvantage of DCT is that the reported after tax profits of entities would be reduced for those entities that are required to pay DCT on their tax preferred income. As noted above (refer to Background), the DCT is separate from mainstream company tax and payments of DCT would not be creditable against mainstream company tax.

It is likely that DCT would cause a **significant** reduction in the National's after tax profit. This is due to the fact that the National derives significant foreign source income from its offshore operations that is not subject to tax in Australia as the income has been subject to tax at a comparable rate. As noted above the National is a truly international company with more than 50% of revenue generated, total assets and employees being outside of Australia.

The National currently pays fully franked dividends. However, the increasingly international outlook of its operations and the associated increase in the level of exempt foreign income derived, will place pressure on the National's ability to continue to fully frank its dividends. It is likely, therefore, that the potential impact of the DCT on the National will increase over time.

The potential impact of DCT on the National's after tax profit may be illustrated by a simple calculation.

| | |
|---|---|
| Australian Shareholders | 75% |
| Foreign Earnings (approximately) | 50% |
| 1998 total dividend (assume 80% franked) | $1.47billion |
| Dividend to foreign shareholders (approximately) | $0.35billion |

The reform proposals note that DCT would not be payable on the proportion of dividend payments to non residents which are made from foreign source income.

In these circumstances, assuming that National can stream foreign earnings to foreign shareholders, the DCT liability would be as follows:

36% (tax rate) @ $294m (% of total dividend unfranked) @ 75% (% of dividend to resident shareholders) = ***$80 million***

The reduction of after tax profits associated with the DCT is also likely to affect the National's dividend policy.

**Increase In The Cost Of Capital**

The DCT has the potential to increase the cost of raising capital and may place Australian companies at a competitive disadvantage in raising equity finance. From an Australian resident investor's perspective, all distributions received under a DCT regime will be subject to tax at the entity level. At the very least, from an investor's perspective, a DCT involves the accelerated payment of tax on distributions received from an entity than is currently the case.

Although resident individual and superannuation fund investors would be entitled to a refund for the DCT paid at the entity level, the issue arises as to the timing of the refund. The potential negative impact on investor returns is likely to increase the cost of equity capital.

**Double Taxation On Distribution Of Temporary Tax Preferences**

A temporary tax preference (or "timing difference") arises where an amount of income or an expense is included in profit in a different financial year for accounting purposes as compared to tax purposes.

There are a number of temporary preferences that arise from the National's operations. Some significant temporary tax preferences for the National include the treatment of financial assets and liabilities and debt provisioning. These cause temporary differences between taxable income and accounting profit.

Under the proposed DCT regime, temporary tax preferences give rise to tax preferred income that attracts a liability for DCT. When the temporary tax preferences reverse, and tax income exceeds accounting income, the tax preference will be subject to mainstream company tax. The DCT already paid on the timing difference may not be offset against the mainstream company tax payable.

It is not immediately apparent that timing differences should give rise to tax preferred income under the DCT regime. Timing differences do not give rise to additional income available for distribution to shareholders. For accounting purposes, a deferred tax liability is recognised immediately on the derivation of income which is not subject to tax until a future period. This will leave the company's distributable profits the same as if the income was subject to income tax in the year it is recognised for accounting purposes. Therefore, the premise adopted by Discussion Paper 2 that temporary tax preferences give rise to greater distributable profits is ***incorrect.***

Discussion Paper 2 notes the potential for double taxation in relation to temporary tax preferences and discusses a number of options to avoid double tax. However, it is apparent that Discussion Paper 2 does not consider that the double taxation of temporary tax preferences is necessarily a major issue. Discussion Paper 2 indicates that the circumstances in which double tax could arise "may not be common". In addition, Discussion Paper 2 notes that entities have some ability to control their distributions to prevent the double tax arising.

As noted above, there are a number of aspects of the National's operations that give rise to temporary tax preferences. There are important differences between the tax and accounting recognition of gains and losses associated with financial transactions. In addition, the National conducts an extensive leasing business where differences between tax and accounting treatment of gains and losses is common. From the National's perspective, these temporary tax preferences are a normal incident of its business activities.

**Payment Of DCT**

Discussion Paper 2 notes a number of alternatives in relation to the payment of DCT. Broadly, the following payment alternatives are discussed:

- build DCT into the turnover ratio for tax payments under the proposed Pay As You Go system;
- collect DCT based on instalments calculated on the prior year DCT liability;
- collect DCT at the time of distribution; or
- collect DCT on assessment.

Each of the above alternatives requires an acceleration in the payment of tax as compared to the current company tax system. The accelerated payment of DCT will create cash flow issues for taxpayers like the National. Discussion Paper 2 does not consider how business taxpayers are expected to fund the liability for DCT, the likely costs involved or the impact of the accelerated payment of tax on current expenditure commitments and investment decisions.

**Treatment Of Foreign Income Derived By Resident Entities**

The income derived by the National from its overseas operations is generally not subject to tax in Australia as the income has been subject to tax in other jurisdictions which have a comparable tax rate.

Under a DCT regime, foreign source income that is exempt from tax in Australia would be regarded as tax preferred income that would give rise to a DCT liability. The National questions why foreign source income should be treated as tax preferred income in the context of a DCT regime because, rather than being tax preferred income, the foreign source income is generally income on which tax has been paid outside of Australia at a comparable rate? That is, the tax preferred income which is then subject to additional tax in the form of the DCT has already been subject to tax in an offshore jurisdiction.

**Treatment Of Non-Resident Shareholders**

The DCT system proposed by Discussion Paper 2 has a potentially disastrous impact for the National's non-resident shareholders. Non-residents own approximately 25% of the National's issued shares and thus the importance of this issue for the National should not be underestimated.

Discussion Paper 2 recognises that the distribution of tax preferred income to non residents will attract the company tax rate, currently 36%, rather than the general treaty dividend withholding tax rate of 15%. Discussion Paper 2 notes that the application of DCT may increase the tax liability of foreign investors, but proposes the application of a "non resident investor tax credit" (NRITC) regime, to increase the creditability of Australian tax in the investor's local jurisdiction. For non resident portfolio investors the NRITC regime allows only a partial credit for DCT (approximately 31% of the DCT is creditable). For non portfolio investors the issue is whether they will be entitled to an underlying tax credit for the DCT.

Clearly the creditability of the DCT in the foreign investors local jurisdiction is a key issue that will determine the level of the return to be ultimately received by the foreign investor. The analysis in Discussion Paper 2 is that a non-resident investor's home country foreign tax credit regime will ensure that DCT will be available as a foreign tax credit. The National believes that there is significant doubt regarding whether DCT will be a creditable tax (underlying tax and withholding tax) in foreign jurisdictions. This is an issue that needs to be addressed by Discussion Paper 2 in more detail because it may directly impact the returns to be received by non-resident investors in the National.

We note that the above concerns will not arise if the expanded Foreign Income Account provisions are introduced as set out in Discussion Paper 2. That is, no DCT will be payable on the proportion of dividend payments to non residents which is attributable to foreign source income.

**Modifications To Proposed DCT System**

If a DCT is introduced, which is not the National's preferred approach, the DCT model discussed by Discussion Paper 2 should be modified as follows:

(i) Where Australian companies have non-resident investors and derive foreign source income that is exempt from Australian tax, the overriding feature of a redesigned imputation system should be transparency. That is, the ability to flow through the foreign income to non-resident investors without the imposition of Australian tax. Therefore, exempt foreign income derived by resident companies that is distributed to non-resident investors should not be subject to DCT/Australian tax.

    In addition, exempt foreign income that is distributed to ***resident investors*** should also be carved out of the DCT regime. This is because the foreign income should not be classified as tax preferred as the income has been subject to comparable tax in a foreign jurisdiction.

(ii) Temporary tax preferences should not be subject to DCT as they should not be regarded as giving rise to tax preferred profits.

### Option 2: Apply A Resident Dividend Withholding Tax (RDWT)

A RDWT regime is the National's preferred mechanism of achieving the Government's objective of full franking of entity distributions.
A RDWT achieves the Government's objectives of collecting tax on unfranked distributions without giving rise to the deficiencies of DCT outlined above, including the impact on the cost of capital to Australian companies, and the reduction in returns to non resident investors.

The RDWT proposed by Discussion Paper 2 requires companies to continue to maintain a franking account to distinguish between franked and unfranked dividends in order to determine the application of RDWT. Therefore, some of the existing complexities associated with paying and franking dividends will remain. However, the National believes the complexity and administrative burdens associated with maintaining a franking account are clearly preferable to a DCT regime.

Under the RDWT option, a withholding tax would be levied on unfranked distributions paid by a resident entity to resident investors. Unfranked distributions paid to non-resident shareholders would continue to be subject to non-resident dividend withholding tax ***unless*** the dividend is paid from amounts credited to the foreign income account. As National has substantial foreign earnings which can be used to pay dividends to foreign shareholders, no dividend withholding tax should be imposed on payments to foreign shareholders.

As noted above in respect of the DCT regime, we consider that the DRWT regime should not apply to distributions of foreign earnings to resident shareholders where such earnings have been taxed at a comparable rate.

### Option 3: Taxing Unfranked Inter-Entity Distributions

The third method of providing for full franking relies on the taxation of unfranked inter-entity distributions. Under this proposal, an entity receiving an unfranked distribution would be subject to tax on that distribution. There would be no further tax on the distribution when subsequently onpaid as it would now be franked by the tax payment. Discussion Paper 2 proposes a carve out from these provisions for distributions within corporate groups.

Effectively, this proposal involves an extension of the current operation of section 46F of the *Income Tax Assessment Act 1936* (the "Tax Act") from private companies to all entities. Currently, unfranked distributions received by public companies are still entitled to the section 46 dividend rebate. The rebate is denied under section 46 for unfranked dividends paid to private companies.

The reform proposed by Option 3 is relatively minor, particularly when reviewed against the objectives of Discussion Paper 2. The National believes that this minimalist reform will not necessary achieve the objectives set by the Government and, therefore, is unlikely to be adopted.

# International Taxation Appendix 2

## Background

This Appendix sets out the National's position in relation to the issues and options canvassed in Chapters 30 – 33 of Discussion Paper 2.

### Conduit Investment Through Australia

Discussion Paper 2 recognises that as a general principle where income derived by Australian multinationals from foreign investments in listed comparable tax countries flows through to foreign shareholders that income should not be subject to Australian tax (paragraph 31.10).

The National considers that the following three alternative options, in order of preference, would achieve an outcome that is consistent with the above principle.

### Streaming Of Foreign Income To Foreign Shareholders

The principle of allowing comparably taxed foreign income to be streamed to foreign shareholders of Australian companies has been adopted by Australian tax law in a limited sense under the Foreign Dividend Accounts (FDA) regime. The National supports this general principle. However, it is submitted that the principle should be applied in a broader sense.

As a general comment, the option of expanding the FDA regime to include more types of foreign income that have been subject to comparable tax is supported. The option of recording the total of such foreign income to a Foreign Income Account regardless of the percentage of foreign shareholders at the time the foreign income was derived is also supported. That is, all such foreign income should be available for distribution to foreign shareholders. **However, it is submitted that the options considered do not totally address the concerns that Australian multinationals have with the current tax law.**

The National considers that where Australian multinationals, with foreign shareholders, have non portfolio investments in listed comparable tax countries the foreign income from such investments should be allowed to be distributed to the foreign shareholders without any further Australian tax and negative Australian franking consequences. Conversely, the Australian sourced income of Australian multinationals should be allowed to be distributed to Australian resident shareholders without any adverse franking penalties.

It is considered that this option would represent the most viable as a major component of it would involve an extension of the current FDA regime. In addition, it should be relatively simply to implement and administer as it should not require any major redrafting of the current tax law and it should not create any major additional compliance issues for Australian multinationals.

Due to the effect of several anti-dividend streaming rules, it is very difficult for Australian multinationals to stream Australian tax paid profits to their Australian shareholders and foreign profits to their foreign shareholders without being penalised.

The FDA rules permit some streaming of foreign profits to foreign shareholders. However, these rules are inefficient because:

1. they apply only where the dividend would otherwise have been unfranked, meaning that where an Australian multinational has sufficient franking credits it is required to frank dividends paid out of foreign income to its shareholders; and

2. the amount of the dividend that can be paid to foreign shareholders out of a FDA is limited by the total amount of the dividend that could be paid from the FDA to all shareholders on all shares at an equivalent dividend rate.

Accordingly, the FDA regime has the effect of utilising franking credits on dividends paid out of foreign income to foreign shareholders and limiting the amount of the dividend that can be paid out of an FDA to an amount in proportion to the capital ownership interest that foreign shareholders have in the Australian company.

The FDA provisions are biased against Australian based companies which have substantial Australian taxable profits which generate franking credits. The FDA provisions also do not eliminate the potential double taxation of foreign source income derived through Australian resident companies.

The proposal to expand the FDA regime is supported, but it appears that the inefficiencies associated with the current FDA regime, as described above, will not be eliminated.

The anti-streaming rules are a major impediment for Australian multinationals seeking to become internationally competitive. The rules restrict the ability of Australian groups to expand their business operations in foreign countries and make it difficult for Australian companies to raise cost effective domestic and foreign capital to fund such expansion.

To the extent to which Australian multinationals raise capital from domestic and foreign investors and use that capital to fund the expansion of their business operations in foreign comparable tax countries, Australian shareholders of such companies are being penalised because of reduced franking capacity. Therefore, the current anti-streaming rules are biased against Australian multinationals (and their Australian shareholders) which are seeking to become internationally competitive by creating a global presence through expansion in foreign markets.

The Government must recognise that Australia only represents 2% of the world's capital markets and that Australian multinationals are competing for capital (which is a very mobile resource) in a global market place. Shareholders in foreign countries will be discouraged from investing in Australian multinationals if the total tax impost on such companies is internationally uncompetitive.

Where Australian multinationals finance foreign expansion from foreign sourced capital, the anti streaming rules effectively prevent these multinationals from servicing this capital from the foreign sourced profits so generated without incurring franking penalties.

Enabling Australian multinationals to stream foreign profits to foreign shareholders directly would allow such companies to compete effectively for foreign capital as they would be able to offer foreign based investors after tax returns similar to the after tax returns that such investors would be able to obtain by investing in companies located in their country of residence.

It is also noteworthy that Australia's major financial institutions are trading on price/earnings multiples of approximately 13% below those of their international peers. This impacts on the ability of Australian financial institutions to compete effectively in foreign business and capital markets.

## Recommendations

The National recommends that:

1. foreign shareholders should be allowed to receive dividends direct from foreign subsidiaries of Australian multinationals which are resident in listed countries using stapled and other share arrangements without the imposition of Australian franking penalties; and

2. Australian multinationals should be permitted to pay unfranked dividends out of foreign income to foreign shareholders without any negative Australian franking consequences and without the imposition of Australian dividend withholding tax.

The likely benefits of such a proposal are as follows:

- Increased foreign investor demand for shares of Australian multinationals.

- Increased Australian investor demand for shares of Australian multinationals because of the increased franking capacity.

- Increased capacity for Australian multinationals to raise cost effective equity capital in domestic and foreign capital markets.

- Increased capacity for Australian multinationals to continue expanding in foreign countries.

The reduction in Australian tax revenue from the introduction of streaming should be offset to some extent by the tax revenue that is likely to be collected from the increased domestic demand for shares in Australian multinationals.

**Imputation Credits For Foreign Taxes**

The National supports the proposal to allow imputation credits for non portfolio foreign dividend withholding tax for both Australian resident trusts and companies. This will largely reduce the existing disincentive for Australian multinationals to repatriate profits from foreign subsidiaries in listed countries because of the imposition of non creditable foreign dividend withholding tax.

However, this particular proposal raises a much more fundamental issue concerning the lack of recognition of imputation credits in Australia for foreign tax (underlying tax) paid by Australian multinationals with foreign operations in listed comparable tax countries. A fundamental structural flaw with the existing business tax system is the double taxation of foreign source income derived by Australian resident companies through non resident subsidiaries operating in listed comparable tax countries.

That is, such income is taxed in the foreign country at a comparable tax rate and is also subject to further Australian tax when distributed (either Australian income tax when eventually distributed to Australian resident individuals or possibly Australian withholding tax when distributed to non resident shareholders). Discussion Paper 2 recognises that Australia should not cause foreign income to be double taxed.

This issue may not be as significant if full streaming of foreign profits to foreign shareholders is permitted. The clear preference is to allow full streaming of foreign profits to foreign shareholders. However, the option of allowing imputation credits for comparable foreign tax paid could be considered as an alternative.

The Federal Government has agreed to consider the issue of reciprocal imputation credits for underlying tax with New Zealand under the Trans Tasman Closer Economic Relations treaty with New Zealand (Treasurer's Press Release No.100, 25 September 1996). It is submitted that this issue should be considered in a broader sense with other listed countries if full streaming of foreign profits to foreign shareholders is not accepted.

## Recommendation

If full streaming of comparably taxed foreign income to foreign shareholders is not accepted, then Australian imputation credits should be allowed in respect of non portfolio foreign dividends and foreign branch income derived by Australian multinationals which have been subject to comparable tax in a listed country.

**Exemption For Foreign Source Income Distributed To Australian Shareholders**

In general, exempt foreign dividend income and foreign branch income, which is derived by Australian companies, is subject to double taxation as a result of the operation of Australia's tax system. That is, the foreign income derived by Australian companies is subject to comparable tax in a foreign country and is also subject to Australian tax when distributed by Australian companies to Australian resident individual shareholders. Therefore, double taxation arises because the foreign income is taxed both in Australia and in the country of source.

The double taxation of foreign income derived by Australian companies is a major disadvantage for Australian multinationals with foreign operations in listed comparable tax countries. It restricts the ability of Australian multinationals to raise equity from Australian domestic shareholders in a cost effective manner and penalises such multinationals seeking to compete in international markets by expanding their business operations in foreign countries.

Other countries recognise the potential double taxation of foreign income and have taken steps to relieve all or some of this double layer of taxation. For example, the United Kingdom, Canada and Japan all allow a partial relief of the double layer of taxation. Singapore allows full relief on the basis that foreign income is exempt from Singapore tax when distributed to Singapore shareholders.

## Recommendation

The National submits that where Australian companies distribute exempt foreign income which has been subject to comparable tax in a listed foreign country, that income should not be subject to further Australian tax in the hands of Australian resident individual shareholders.

This option could be considered as an alternative to the option of allowing full streaming of foreign income to foreign shareholders of Australian companies or the option of allowing imputation credits for foreign tax paid.

**Revenue Cost Of Options**

We understand that Treasury officials have indicated to an industry association that a broad estimate of the revenue cost of the streaming option would be in the range of $500 million per annum. In the absence of sufficiently relevant and accurate information, it is difficult to provide a more accurate estimate of the revenue cost of each of the three options presented in this paper. Accordingly, we have assumed that the estimated revenue cost of each option would be in the range of $500 million.

It should also be noted that the options presented are likely to have spin off revenue benefits such as the likely additional tax that will be generated as a result of the favourable impact on Australian share prices and the investment of capital. These additional revenue benefits must be taken into account in assessing the potential revenue cost of the options.

The three options presented should be considered as an integral component of the overall package that achieves tax reform in a revenue neutral manner.

**Double Tax Treaties**

Many of Australia's international double tax treaties are not internationally competitive primarily because of the relatively high dividend and interest withholding tax rates that continue to be permitted under some of the tax treaties. For example, an Australian company that has operating subsidiaries in the US is subject to 15% dividend withholding tax on profits repatriated from the US. On the other hand, UK or Dutch multinationals with US subsidiaries are only subject to 5% US dividend withholding tax. There is clearly a disincentive for Australian companies to repatriate profits from countries such as the US.

As a further example, US multinationals that have Australian subsidiaries are able to repatriate Australian tax paid profits from Australia without Australian dividend withholding tax, yet an Australian multinational with US subsidiaries is subject to 15% US withholding tax on dividends received from the US. This problem is compounded by the fact that the US withholding tax is not allowed as a credit against Australian tax paid by the Australian multinational.

## Recommendation

The Government has indicated that it is prepared to give some priority to the renegotiation of tax treaties with countries in which Australian companies have major business operations, particularly the Australia/US treaty. We urge the Government to give this initiative a high priority. Many other countries have renegotiated their treaties to reduce dividend and interest withholding tax rates in order to improve the mobility of capital and investment flows.

The example below illustrates the inefficiency of the existing Australia/US treaty compared to the current UK/US treaty for multinationals with US operations.

**Example**

Assume that an Australian multinational and a UK multinational each have a US operating subsidiary and that subsidiary pays a dividend to the parent company of $100 out of profits that have been subject to full US Federal tax. Also assume that the dividend is used by the parent company to pay a dividend of $85 to its foreign shareholders.

| | ***Australian parent*** | ***UK parent*** |
|---|---|---|
| Dividend paid by US sub | $100 | $100 |
| US withholding tax | $15 (15%) | $5 (5%) |
| Home country tax on dividend | $0 | $0 |
| Dividend paid by parent | $85 | $85 |
| Home country withholding tax | $0 (15%) (assume FDA div.) | $0 (0%) |
| Total withholding tax | $15 | $5 |

The above table illustrates that the total US and Australian withholding tax on a dividend from a US subsidiary to an Australian parent company which is then paid to a foreign shareholder of the parent company is, 15% of the total dividend. In the same situation using a UK parent company the total US and UK withholding tax on a US sourced dividend is only 5%.

The National is disappointed that Discussion Paper 2 does not provide any comments on the inefficiency of Australia's tax treaty network and the need to renegotiate some of the treaties as a matter of priority.

**Improving Anti Tax Deferral Rules**

The National does not support the option to remove the active business exemption for foreign investment funds ("FIFs"). This would substantially increase the compliance burden for many Australian investors investing in foreign interests.

Discussion Paper 2 considers two options to replace the active business exemption for interests in FIFs. These options are considered in the context of non portfolio and portfolio foreign investments.

The exemption option for non portfolio foreign investments is to exempt all non portfolio foreign investments which satisfy an active income test similar to that applicable to controlled foreign companies in Part X. The National does not support this option on the basis that it may be difficult for some non portfolio investors who do not have sufficient control of the foreign entity (eg. investors with an ownership interest in the relevant FIF of, say, between 10% - 20 %) to obtain sufficient information to be able to determine whether the active income test has been satisfied.

The FIF regime is recognised as a set of overly complex provisions creating an enormous compliance burden for many Australian multinationals and other investors. In general terms, the compliance costs in relation to the FIF provisions are substantial. As a consequence, the National favours an exemption for all interests in FIFs that are resident for tax purposes in broad exemption countries (or which are subject to tax in a broad exemption country). Additionally, interests in FIFs owned through Australian CFCs which are resident in broad exemption countries should also be exempt on the basis that most, if not all, broad exemption countries have some form of anti-deferral rules which will result in the relevant share of the FIF income being subject to tax in the relevant broad exemption country on a current basis.

Currently, the existing anti deferral rules dealing with the taxation of income of foreign trusts are extremely complex. This raises the issue of whether they are all necessary to counter perceived deferral of Australian tax. An Australian resident investor who has an interest in a foreign trust needs to consider the application of the deemed present entitlement rules in sections 96B/96C, the transfer trust rules in Division 6AAA and the FIF rules in Part XI. In same cases, these provisions have effectively discouraged Australian investors investing in foreign funds simply because of the onerous compliance issues. The National favours the option of removing the deemed present entitlement rules and using the FIF measures as the sole anti tax deferral regime for taxing interests in foreign fixed trusts.

The National also favours the option of applying only the transferor trust rules to interests in discretionary trusts if an Australian resident transferor can be identified. The National would also favour the application of an interest charge regime to distributions from foreign based discretionary trusts, in the absence of an identified Australian resident transferor.

## Recommendations

The National makes the following recommendations:

1. Retain the active business exemption under the FIF regime.

2. Allow an exemption for interests in FIF which are resident in broad exemption countries (or which are subject to tax in a broad exemption country).

3. Allow an exemption for interests in FIF held through Australian CFCs which are resident in broad exemption countries.

4. Remove the deemed present entitlement rules and apply the FIF measures as the sole deferral regime for taxing interests in foreign fixed trusts.

5. Apply the transferor trust rules to interests in discretionary trusts if an Australian resident transferor can be identified, otherwise apply an interest charge regime.

**Source Of Income**

The National generally supports the need for clearer rules to determine the source of income. This is especially the case for cross border electronic commerce transactions and other transactions where the party deriving the income can initiate, negotiate and conclude the transactions over the Internet without having a physical presence in the particular jurisdiction in which the counter party is located.

## Recommendation

In order to provide a greater degree of certainty, the National supports specific source of income rules for specific types of income based on the OECD model convention source rules. The specific source rules should be periodically reviewed and revised as appropriate to ensure that they keep pace with technological developments and other commercial innovations.

**Domestic "Thin Capitalisation" Rules**

The National does not support the option of introducing a "domestic thin capitalisation" rule to deny a deduction for interest incurred on borrowings used by Australian owned multinational companies to finance Australian operations which is in excess of a prescribed limit. The National also does not support the adoption of an arm's length test for determining whether an Australian multinational's domestic gearing ratio, which exceeds the group's world wide gearing ratio, is reasonable.

These options would have a draconian effect on Australian multinationals, introduce new uncertainties for Australian multinationals and be totally inconsistent with the business taxation systems in other countries.

Discussion Paper 2 suggests that the dividend imputation system creates an incentive for Australian multinationals to pay Australian tax rather than foreign tax. Yet in the same section the Options paper raises the contradiction that Australian operations of Australian multinationals could be highly geared and the offshore operations of such entities could be lightly geared solely in order to reduce the group's overall tax liability.

To impose an arbitrarily determined fixed gearing ratio for the Australian operations of Australian multinationals is likely to impede the management of the capital structures of such entities and consequently may have a negative impact on the way that Australian multinationals operate domestically. Such measures may even cause Australian multinationals to be at a competitive disadvantage to their international peers.

There are likely to be genuine commercial reasons for Australian multinationals borrowing funds domestically including access to cheaper funds because of the better name recognition in the Australian capital markets or borrowing restrictions imposed in some of the foreign countries in which investments are held.

## Recommendation

A denial of a deduction for interest on borrowings to the extent to which the gearing of the Australian operations of Australian multinationals exceeds a prescribed gearing ratio is not supported.

**Deductibility Of Financing Costs For Foreign Investments**

The lack of an Australian deduction for financing costs incurred by Australian multinationals in respect of non portfolio investments in foreign companies located in listed countries is a major concern.

At present, Australian multinationals are not entitled to a deduction for interest incurred on borrowings used to fund direct non portfolio investments in listed countries. The rationale being that the profits repatriated from such countries are exempt from Australian tax (on the basis that such profits would have been taxed at a corporate tax rate comparable to the Australian rate).

This is a major concern for acquisitive Australian multinationals as the non deductibility or quarantining of interest may be a potential significant additional cost that may impede international expansion or may require the Australian company to raise other forms of capital which may not be as cost effective.

There may also be some genuine commercial reasons as to why Australian multinationals would seek domestic debt funding for offshore acquisitions. For example, it may be more cost effective for an Australian multinational to raise debt capital domestically rather than in the foreign country in which the investment is contemplated, or the foreign country itself may impose restrictions which make it impossible for the Australian group to borrow funds in that country.

For UK and US based multinationals this is not a concern because countries such as the UK and US have a full foreign tax credit system. Therefore, such multinationals have a competitive advantage over Australian multinationals in international capital and business markets.

## Recommendation

Australian multinationals should have the ability to elect to be subject to either an exemption system or the foreign tax credit system in respect of foreign income derived from listed comparable tax countries.

**Transfer Pricing**

The option of providing a self assessment system for transfer pricing is supported in principle by the National. A self assessment system should not be unduly prescriptive. For example, there should be sufficient flexibility for taxpayers to determine the most appropriate arm's length pricing methodologies for specific cross border related party dealings. The rules may set out generally acceptable arm's length pricing methodologies, but should not prescribe specific arm's length pricing methodologies for specific transactions or classes of transactions. There should also be sufficient flexibility in relation to record keeping requirements. The safe harbour rules contained in TR1999/1 for intra group services should also have legislative backing if a self assessment system is introduced.

## Recommendation

A self assessment system for transfer pricing is support provided the rules are not too prescriptive in relation to arm’s length pricing methodologies and documentation requirements.

# Taxation of Capital Gains Appendix 3

This Appendix sets out the National’s position in relation to issues and options canvassed in the “Taxation of Capital Gains” section of Discussion Paper 2 (Chapters 11 – 14).

## Background

Currently, the Capital Gains Tax (CGT) regime in Australia includes realised capital gains on assets as part of the assessable income of the taxpayer (no matter what form of entity). This means that capital gains are taxed at the marginal income tax rates for individuals and at the company tax rate for companies. This results in Australia having one of the harshest CGT regimes of advanced economic countries that have a capital gains tax regime (New Zealand for instance does not have a CGT regime). In many countries (USA, Germany, France etc), individuals also have the advantage of income splitting for family units which can further dramatically reduce the final tax rate for each individual.

The Australian CGT burden, therefore, has a negative impact on individuals and businesses when contemplating investment and business reorganisations. Coupled with the very high rate of tax are other impediments in the operation of the CGT provisions which result in further frustration to business and individuals in achieving their goals of business efficiency and wealth accumulation. The climate for investment and productivity and therefore the ability to boost employment and the standard of living is frustrated by the current CGT regime.

Discussion Paper 2 canvasses various options to address some of the concerns with the current CGT regime. Some of the options discussed are:

- allowing rollover relief for "scrip for scrip" business reorganisations;
- modifying the capital loss provisions so as to allow carry back of losses to offset earlier gains or allowing capital losses to be offset against ordinary income but excluding losses on shares or units in trusts;
- allowing targeted concessions on certain types of investments (e.g. venture capital and high technology start-ups); and
- lowering the CGT rate of tax by either having a capped flat rate at 30%, tapering or having a $1,000 threshold limit for individuals.

These reforms would be partly paid for by removing indexation (based on the CPI) and averaging of capital gains (effectively over 5 years for "low income" individuals).

The proposals discussed in Discussion Paper 2, do not necessarily cover all the issues that the National considers to be relevant to the CGT debate. Below is a discussion of the issues relevant to the National that Discussion Paper 2 has raised as well as further issues that the National would like to see addressed as part of the overall CGT reform.

## Analysis

### Scrip for Scrip

An area of prime importance to the National is the issue of scrip for scrip rollover relief for business mergers and reorganisations. The Securities Institute of Australia released a media release dated 1 March 1999 which concluded that CGT rollover relief for share-swap mergers and company demergers would in fact be revenue positive for the Commonwealth Government within four years. This was because the freeing up of capital through the introduction of CGT rollover relief would significantly improve the Australian investment environment, encourage growth and efficiency and therefore, in time, benefit the Commonwealth revenue. It was noted that the USA, UK, Canada, Japan, Ireland and Sweden already had such forms of rollover relief as standard.

In Australia, there is already an acknowledgment by the Government that there are cases which may require the disposal of assets to different legal entities where the primary purpose behind the disposal is to either increase business efficiency or for ease of administration and not necessarily to make a realisable gain (profit). In recognition that the current CGT provisions would be an impediment to business reorganisations there is currently rollover relief available for assets being transferred into a wholly owned company by an individual or company. However, there is no CGT relief for shareholders of public companies (or non wholly owned private companies) which may either be subject to a merger with another company or demerger and the consideration received for the shares held by the shareholders of the target company involves equivalent shares in the existing acquiring company after the reorganisation ("scrip for scrip").

Under the current regime, shareholders of the target company may be reluctant to accept a scrip for scrip bid due to the possibility of a CGT liability. Also the acquiring company may be forced to increase the bid with cash so as merely to meet the CGT liability of the shareholders of the target company. This distorts the economic decision making of all parties involved in the transaction and can dissuade otherwise economical business rationalisations from taking place. The scrip for scrip rollover relief should also apply to taxpayers who have their shares on revenue account for the same reasons as listed above.

**Rollover of Revenue Assets**

An anomaly that exists for businesses that hold assets on revenue account is that if the business wishes to reorganise, in a similar fashion to a business with assets on capital account, there is no rollover relief upon the transfer of the revenue assets to a wholly owned company as there is with capital assets. This is a bias against businesses with assets on revenue account (a major industry sector affected would be financial institutions) and penalises them with potentially harsh income tax liabilities for merely trying to attempt to improve business efficiency. To be consistent across the range of assets and industries, rollover relief should be available to assets on revenue account transferred to wholly owned companies.

**Capital Loss Provisions**

Though net capital gains are included as "assessable income" and taxed at the taxpayer's marginal income tax rate there is not the same treatment afforded capital losses when incurred on the disposal of assets. Capital losses must be quarantined to be applied only against capital gains and cannot be used to be offset against either revenue gains or other assessable income. It is anomalous that in such a situation, where assets are held both on capital and revenue account, revenue losses can be offset against capital gains but not vice versa. There is a direct negative bias against taxpayers who hold assets both on revenue and capital account.

The National's business is such that a large part of its assets are on revenue account. In circumstances where the National incurs capital losses it cannot offset those losses against revenue gains made in the same period. This distorts the true after tax trading profit of the National and penalises the National for no other reason than it is a financial institution and therefore must hold a large proportion of its assets on revenue account. Where a business holds assets on both capital and revenue account the revenue gains should be allowed to be offset against capital losses.

### CGT Rate For Individuals

As a fundamental principle, wherever possible, taxation should not play a role in determining the economic efficiency of an investment.

Discussion Paper 2 outlines the option of a trade off of a lower flat CGT rate (currently proposed to be 30%) in return for the removal of indexation and averaging . Though the impact of averaging would be negligible to the majority of taxpayers, the abolition of indexation could, particularly in a higher inflationary environment for longer term held assets, see taxpayers worse off. It should also be noted that if indexation is abolished for individuals then it is assumed that it may also be abolished for companies. There is no commentary on this point in the Discussion Paper 2.

## Recommendations

With regard to capital gains tax reform, the highest priority should be given to allowing business to pursue initiatives that will enhance business efficiency and therefore add real value to the economy and not distort investment decisions. Reforms that would assist in this objective are:

- Rollover relief for scrip for scrip company reorganisations (including shares held by those taxpayers on revenue account) so that tax issues are not an impediment to investors when considering the streamlining of business and enhancing its overall efficiency;

- Where a company has assets on revenue account, as with assets held on capital account, rollover relief should be allowed where there is a transfer of assets to a wholly owned company;

- Where a business holds assets on both capital and revenue account the capital losses should be allowed to be offset against the revenue gains. It is anomalous that where assets are held both on capital and revenue account, revenue losses can be offset against capital gains but not vice versa;

- If the Government wishes to encourage long term investment, indexation should be retained so that taxpayers only pay tax on real gains.

# Taxation Of Entity Distributions Appendix 4

## Background

This Appendix provides the National's position in relation to the issues and options considered in Chapters 18 – 20 of Discussion Paper 2.

### Definition of Distribution

The National generally supports the option of a broad definition of distribution covering all benefits provided by an entity to its members. The National considers that distributions to shareholders should be subject to income tax and not fringe benefits tax.

## Recommendation

The National supports a broad definition of distribution and the introduction of a de minimus exemption (eg. $1000 per shareholder) similar to the $1000 benefits exemption threshold proposed for fringe benefits tax.

### Treatment of Bonus Shares

The National does not support the proposal to treat bonus shares issued to shareholders under a bonus share plan under which the shareholder has the ability to elect to receive bonus shares instead of franked dividends, as a distribution taxable as a dividend to the extent to which the company has distributable profits. The National considers that the current treatment of bonus shares that are offered by public listed companies should be retained. That is, where shareholders of a publicly listed company elect to receive bonus shares in lieu of franked or substantially franked dividends under a bonus share plan and this does not involve a credit to the company's share capital the bonus shares should not be treated as a distribution taxable as dividend.

## Recommendation

The National recommends that the existing tax rules for bonus share plans (that allow shareholders the choice of receiving bonus shares in lieu of fully franked or substantially franked cash dividends) should continue to apply.

### Distinguishing Profits And Capital Distributions – Profits First Rule

The National does not support the option of a profits first rule. The National considers that a profits first rule introduces an ordering rule which will force a company with profits to distribute those profits to its shareholders before it can distribute any capital to its shareholders. There appears to be no rational basis for adopting such an approach. The proposal is likely to impede the management of corporate capital structures. A profits first rule is likely to restrict balance sheet restructuring for some listed companies and for many private companies carrying on genuine trading businesses.

It is the National's view that the changes to the Corporations Law involving the abolition of par value, the consolidation of paid up capital and share premium accounts and the streamlining of the share buy back and capital reduction provisions do not justify the introduction of a profits first rule.

A profits first rule would increase the compliance burden for some companies, as they would be required to determine distributable profits by reference to the market value of their net assets. This means that where a company makes a return of capital to its shareholders it may be required to obtain valuations for some of its assets at that time.

The Government issued a Discussion Paper in July 1996 proposing a profits first rule and this proposal received widespread criticism by the corporate community. The Corporate Tax Association submitted a detailed submission to the Government opposing the introduction of a profits first rule. This submission reflected the views of many Australian companies. As a result, the Government decided not to pursue profits first rule and instead introduced a series of specific anti-avoidance rules (sections 45–45D of the Income Tax Assessment Act).

The National also considers that the existing anti-dividend substitution and capital streaming provisions contained in sections 45-45D are extremely complex, not warranted and have the potential to inhibit commercial transactions involving a genuine return of capital to shareholders. The National considers that the Government's concerns about dividend substitution arrangements and capital streaming could be more appropriately addressed by the introduction of a general anti-avoidance provision. This perhaps could be part of a reformed, more robust general anti-avoidance rule.

If the Ralph Review supports a profits first rule, the National considers that the profits first rule should not apply to returns of capital whether pro rata or selective, by public listed companies. Such companies are not in a position to engage in dividend substitution and capital streaming arrangements that would give rise to tax minimisation. Public listed companies are subject to considerable public scrutiny. Returns of capital by public listed companies require shareholder approval. In addition, public listed companies are subject to regulatory and other controls exercised by the Australian Stock Exchange, Australian Securities and Investment Commission, shareholders associations and ratings agencies.

The National also does not support the option of maintaining a separate capital account for tax purposes. This will introduce a further compliance burden for Australian companies. The National considers that the existing share capital account rules, and the associated tainting rules, are sufficient for tax purposes. These rules act as a sufficient deterrent for companies to convert profits into capital

## Recommendation

The National does not support a profits first rule. A general anti-avoidance rule should replace the existing specific anti-avoidance rules to address any concerns with dividend substitution and capital streaming arrangements.

### Buybacks, Redemptions And Liquidations

### Buybacks

In relation to the options canvassed for the taxation of share buybacks, it is proposed that the capital gains tax treatment should apply to on market buybacks and the dividend treatment should apply to off market buybacks. In general, this proposal corresponds to the current tax treatment of on market and off market buybacks.

The National raises the possibility of allowing a company the option of choosing the capital gains tax treatment for pro rata off market buybacks. In this case, all shareholders will be treated equally and there should be no opportunity for the company to stream capital or profits to particular shareholders.

## Recommendation

Publicly listed companies should have the ability to elect either the dividend treatment or the capital gains tax treatment for pro-rata off market buybacks.

### Redemptions

As a result of changes to the *Corporations Law* made by *The Company Law Review Act 1998*, redeemable preference shares (RPS) issued on or after 1 July 1998 can only be redeemed from the proceeds of an issue of new shares or out of profits. Accordingly, the legislation does not now permit redemption of RPS from a company's share capital account (the account created by the amalgamation of the share premium and paid up capital accounts). It does permit RPS issues prior to 1 July 1998 to be redeemed out of the amount standing to the credit of its share premium account on 30 June 1998.

As a consequence of the *Corporations Law* changes, amendments effective 1 July 1998 were made to the *Income Tax Assessment Act* by the *Taxation Laws Amendment (Company Law Review) Act 1998.* Those changes provide that, if RPS are redeemed out of profits, the amount received by a shareholder will be a dividend that will be assessable to an Australian resident shareholder and must be franked to the extent that the company has sufficient franking credits. Hence, a redemption of preference shares out of profits which merely represents a **return of capital** to Australian resident shareholders will be treated as an **assessable dividend**. We believe that this is an unintended consequence and limits the flexibility of Australian companies to raise capital.

Prior to the changes to the *Corporations Law* and the consequential changes to the tax law, distributions by a company to the extent to which they were made out of the company's share premium account or represented a return of paid up capital were not treated as assessable dividends to the shareholders.

The explanatory material that accompanied the consequential changes to the tax law stated that consistent with the current tax treatment of redeemable preference shares, the redemption of redeemable preference shares will not be a dividend to the extent that the redemption returns the amount paid up on the share. The effect of the changes to the tax law is inconsistent with the stated intention of the relevant changes.

While under the Corporations Law it is open for a company to redeem redeemable preference shares from the proceeds of an issue of new shares or make a buy back offer for the shares, such options may not be commercially viable and may restrict the flexibility of capital raising initiatives.

## Recommendation

The National recommends that the tax law should be amended to ensure that where there is a redemption of RPS out of profits and the redemption merely represents a return of capital this should not be treated as a dividend to the shareholders.

# Taxation Of Financial Assets and Liabilities    Appendix 5

## Background

This Appendix sets out the National's views in relation to the issues and options discussed in Chapters 5 to 7 of Discussion Paper 2.

The National is an active member of the Australian Bankers' Association ('ABA') and the Australian Financial Markets Association ('AFMA') and has contributed to the joint submission to be lodged in relation to the proposals contained in Chapters 5 to 7 of Discussion Paper 2 by ABA/IBSA/AFMA. This appendix highlights the issues that the National has identified as being the key issues. The detailed comments in relation to Discussion Paper 2, and responses to the issues raised by the Ralph team's representatives at the focus group meeting on 18 March 1999, are contained in the joint submission.

The proposals in Discussion Paper 2 are the latest in a series of discussions and consultations that have occurred between the Government of the day, the Treasury and the Australian Taxation Office since June 1991. The latest proposals were preceded by:

- the "Taxation of Financial Arrangements: A Consultative Document released in December 1993 by The Honourable J Dawkins, MP, the then Treasurer of the Commonwealth of Australia; and

- the "Taxation of Financial Arrangements – An Issues Paper" ('the 1996 Issues Paper') which was released in December 1996 by the Secretary to the Treasury and the Commissioner of Taxation.

In addition to the time spent as a member of the ABA/IBSA/AFMA working groups that made detailed submissions on both the above papers, following their respective releases, the National spent time with representatives of the Australian Taxation Office and the Treasury explaining the nature of the National's treasury operations and its asset and liability management structure in an attempt to assist the representatives to develop the proposals for the taxation of financial arrangements.

The proposals contained in Discussion Paper 2 can be summarised as follows:

- to provide an elective mark to market basis of accounting for certain transactions or assets and liabilities;

- to provide an accruals basis of accounting (referred to as the "timing adjustment method") for instruments with cash flows which are known or fixed or can be estimated with "reasonable accuracy";

- to provide a realisation basis of accounting as a default mechanism for the taxation of gains and losses in all other situations;

- to include robust disposal rules in an attempt to clearly identify when there has been a realisation; and

- to include a test which enables a particular financial instrument to be easily classified as debt or equity.

## Internal Deals

The National believes it is imperative that a bank be able to recognise internal deals when determining its taxation liability. In the 1996 Issues Paper there was an acknowledgement that banks would be able to include internal deals in their tax accounts (subject to certain safeguards). The latest proposals, without rejecting the recognition of internal deals completely, have not come out in favour of recognising banks' internal deals for tax accounting purposes.

Recognition of internal deals is vital to ensure a correct overall reflex of a major bank's taxable income.

Internal deals (which may involve very large asymmetric accounting results in any given year but which will ultimately reverse) are recognised for financial accounting purposes as a proxy for the revaluation of external assets and liabilities.

The joint ABA/IBSA/AFMA industry submission illustrates the problems that will be caused for the National if internal deals between the hedge desk and the trading desk are not accepted.

If the financial services industry's proposals in relation to internal deals are adopted there will need to be a carve-out for these in the proposed group consolidation rules to ensure that the internal deals between the internal hedge desk and the treasury trading desk do not need to be eliminated.

## Foreign Exchange Gains & Losses

In the December 1996 Issues Paper a retranslation basis was proposed for taxing foreign currency gains and losses on foreign currency denominated debt which was not traded debt. The proposals in Discussion Paper 2 do not provide for a retranslation basis of tax accounting and, therefore, will require foreign currency gains and losses to be taxed on a realisation basis. The National would not generally want to elect a mark to market basis for taxing gains and losses on foreign currency denominated debt because mark to market accounting is currently only applied where the activity generating the gain or loss is a trading activity.

The National recommends that a bank should be able to elect to adopt a retranslation basis of accounting for its foreign currency denominated monetary assets and liabilities where they are not part of its trading book. The ability to adopt a retranslation basis will avoid the distortion associated with timing differences that will arise if the realisation method is adopted.

Retranslation will align tax with current financial accounting requirements and avoid major systems and compliance problems which would arise if the National was required to mark to market foreign exchange assets and liabilities which are not traded. Retranslation accounting is not the same as mark to market accounting and hence the ability to elect to treat certain transactions or assets on a mark to market basis will not provide the National with a method of tax accounting which is consistent with its financial accounting treatment. Refer to the joint ABA/IBSA/AFMA industry submission for an explanation of the difference between a mark to market calculation and a retranslation calculation.

## General Hedges

Discussion Paper 2 does not seem to acknowledge many of the complex issues regarding hedging and the specific circumstances in which hedging rules may be required.

The National believes there is still a need to include hedge tax rules (refer to discussion in the joint ABA/AFMA/IBSA submission for specific reasons) in the proposals and does not believe that the submissions on the 1996 Issues Paper that highlighted the complex and onerous nature of the hedge tax rules should be interpreted as meaning that the taxpayers raising these concerns totally opposed the inclusion of hedge tax rules. The National believes the proposals in Discussion Paper 2 are deficient without the inclusion of hedge tax rules.

Specifically, the National believes hedge rules are needed to accommodate instruments that are used for hedging and the hedge financial accounting that results. Further, these rules need to distinguish between hedges that are used to hedge an underlying position which is on revenue account and hedges that are used to hedge underlying positions that are on capital account.

**Elective Mark To Market**

The National generally supports the election to mark to market its trading instruments.

There are three options proposed for making the election:

- Option 1: proposes a transaction by transaction approach;
- Option 2: proposes an election on an asset class basis; and
- Option 3: proposes a combination of Options 1 and 2.

Option 3 is the National's preferred approach, however, the election should be able to be made on an asset portfolio basis. It would also be important to provide sufficient flexibility to take into account genuine commercial decisions to reclassify an asset from the hedging portfolio to the trading portfolio. The National's concerns about Option 1 (see below) apply equally to this option.

The National is also generally supportive of Option 1 although we believe the safeguards listed in the proposal are too cumbersome and will create an unnecessary compliance burden. The following comments are made in relation to the specific safeguards listed at paragraph 6.52:

- There are occasions when the National is not a price maker but still trades in an instrument (eg. where the National thinks that a security is under priced in the market and, for speculative purposes, enters that market as a price taker rather than in its usual capacity as a price maker) and therefore adopts mark to market accounting for financial accounting purposes. The proposals should specifically reflect that this situation would still enable the taxpayer to elect a mark to market treatment for tax purposes.

- The third safeguard may lead to compliance difficulties because of the onerous requirement to keep separate accounting records for mark to market transactions and record each transaction at the time it is entered into;

- Management accounts should be irrelevant. It is consistency between the tax and financial accounting requirements that are important.

- The fifth safeguard is generally acceptable. It is possible (albeit in a very limited number of instances) that the National may change the purpose for which a particular instrument is held. For example, the National has an internal accounting policy which requires that a security which is classified as an investment security will always be classified as an investment security unless there is a change by FASB (US Accounting body) that impacts that investment security classification. The National's accounting policy is based on the US accounting requirements that the trading of a security that has been classified as an investment security may result in the investment security portfolio being "tainted" which would result in the investment security portfolio having to be marked to market on a retrospective basis (up to 5 years). A provision needs to be made in the rules to accommodate the possibility that a change in accounting policy could result in an instrument being reclassified from an investment basis to a mark to market basis.

Option 2 is too broad and will impinge upon legitimate and differential use of assets, especially derivatives which may be used for either trading or hedging purposes.

To the extent that it is decided that Option 2 is the preferred option the election should be on a portfolio basis rather than an asset class. An election on a portfolio basis will recognise that banks will have separate portfolios of assets and derivatives depending on the nature of the instrument and the use to which that instrument is put.

The National can not foresee a situation where it would be practical to want to make an election to adopt mark to market on an entity wide basis. Even special purpose vehicles would be likely to have non trading assets eg. intellectual property that it would not want to mark to market.

**Accruals ("Timing Adjustment") For Debt**

The proposals are broadly acceptable. See recommendations 12 to 15 in ABA/IBSA/AFMA joint submission lodged in June 1997 which are still supported by the National.

The flexibility of a compounding period up to one year (paragraph 6.31) is strongly supported.

The use of "risk free rates" (paragraph 6.15) for accruals is not supported. Accruals should be on an internal rate of return basis (using estimations for reasonably anticipatable but unknown future cashflows). Where major uncertainty exists a realisation basis should be applied.

There is still likely to be a practical problem of having to perform internal rate of return calculations to know whether the benchmark test is met (paragraph 6.36 is not clear as to whether benchmarks would be included within regulations and rulings). We recommend that de minimis rules be included within the legislation (by way of delegated legislation).

The requirement in paragraph 6.35 that a commercial accounting method could be used for tax purposes if the method is used consistently for both income and expenses are likely to be a problem because some instruments (eg. bills) may be able to be used for funding purposes and therefore accrual accounted and for trading assets and therefore marked to market. The ultimate accrual treatment should be determined having regard to the purpose for which the instrument is held.

**Transitional Rules**

The National does not support the mandatory application of the proposals to pre-existing arrangements. An option should be available for taxpayers to elect to treat existing portfolios of assets under the rules.

See discussion and recommendations 41 and 42 in the June 1997 joint industry submission.

**Anti-Avoidance Rules**

Chapters 5 to 7 appear to place an over-reliance on specific anti-avoidance rules to counter particular practices that Discussion Paper 2 believes may occur as a consequence of a realisation basis for taxing certain gains and losses. This conflicts with chapter 24 of Discussion Paper 2 which highlights that there is an "over-reliance" on specific anti-avoidance rules.

The new proposals are:

- loss quarantining (paragraph 6.120)
- foreign exchange accrual rules (paragraph 6.48)
- economic disposal rules (paragraph 6.79 etc)
- debt/equity recharacterisation prevention (paragraph 7.26)
- anti-synthetics rules (paragraph 7.41)

The National strongly opposes the proposal to quarantine losses for assets and liabilities taxed on a realisation basis and for those losses to only be available for offset against gains on similar assets and liabilities. This said, more details are needed on how the loss quarantining proposal is intended to operate. For example:

- would losses be quarantined based on all financial arrangements or on an asset class or portfolio basis;
- would it apply to an economic (consolidated) group or entity by entity; or
- would it apply to interest expenses?

The principle underlying loss quarantining is not easy to reconcile with the principles and logic underpinning the reason for adopting the "default" mechanism of realisation for taxing gains and losses on financial transactions that have not already been taxed as a timing adjustment or on a mark to market basis. Once a real loss has been incurred from a financing transaction it should be available for immediate offset against other income of the taxpayer, just as any other revenue expense would be deductible. The loss should not have to be quarantined.

If losses on financial transactions are to be quarantined the National believes that loss carry back rules would be needed to avoid completely punitive outcomes, eg. a realised gain in year 1 followed by an offsetting realised loss in year 2. See Option 2 in proposed reform of CGT loss quarantining in paragraph 12.27 of Discussion Paper 2.

In summary, the National believes the plethora of anti-avoidance rules in the proposals in Discussion Paper 2 are unnecessary. Part IVA, with the retention of a sole or dominant purpose test, should be sufficient to deal with tax avoidance.

**Disposals**

As an optimum principle, disposals should be identified having regard to their legal form, not economic substance. Economic substance rules would be uncertain, costly and difficult to apply, especially if they were based on subjective purpose rather than objective purpose.

Reliance should be placed on Part IVA to counter tax avoidance rather than new and specific anti-avoidance rules.

**Hybrids**

The National acknowledges and supports the continuing need for a debt/equity distinction.

A fundamental objective is to try and achieve an approach which will provide sufficient certainty in its application without making the administration requirements complex and unwieldy for taxpayers.

Two approaches have been suggested:

- ***a Blanket Approach*** **–** a particular hybrid instrument would be categorised as wholly debt or wholly equity.
- ***A Bifurcation Approach*** **–** the hybrid instrument would be "bifurcated" or split into separate debt and equity components.

If "bifurcation" can achieve the same level of certainty as a "blanket" approach, then it may be acceptable. However, at this stage there is little detail about how an instrument would be bifurcated in practice and therefore, the National's preferred approach is a blanket approach because it provides greater certainty and is able to be administered by internal accountants and tax professionals. A "bifurcation" approach would require the need to engage financial experts outside of the corporate tax and accounting areas of the National's business.

Two options have been proposed for determining whether a hybrid (or parts thereof) should be accorded debt or equity treatment:

- ***Option 1:*** ***weigh a number of facts and circumstances***
- ***Option 2:*** ***select a single determinative factor***

The National believes that greater certainty would be provided if a set of specified determinative factors was chosen to distinguish debt from equity. However, further consideration needs to be given to what the specific factors are that should distinguish debt from equity.

The National believes that specific anti-avoidance rules are unnecessary and they contradict the choice principle as to whether a taxpayer funds its operations through debt or equity. The critical issue is to have a properly drafted debt/equity distinction without having to introduce uncertainty through the inclusion of anti-avoidance rules.

**Synthetics**

The National believes that specific rules dealing with synthetic arrangements will be complex and costly to administer and, as currently proposed, are likely to adversely impact taxpayers who are carrying out ordinary commercial dealings. The National does not support the over-extensive and complex "45 day and holding period" rules which have created a significant compliance burden for our funds management and custodian businesses and has forced the need to acquire new systems in an environment in which systems resources are already strained sue to other strategic initiatives and commercial necessities. The National is fearful that synthetic rules will be so far reaching that once again, normal business and commercial dealings will be adversely and unnecessarily impacted.

If any synthetic rules are introduced they should definitely be based on objective purpose and not "effect" based.

## Recommendations

For the reasons outlined above, the National's key recommendations in relation to the proposals are:

- ***Internal dealings* –** the proposals include rules, subject to certain safeguards, which recognise internal dealings for tax purposes and an appropriate carve-out be provided if group companies are required to prepare a consolidated income tax return.

- ***Retranslation accounting* –** that there be an election to adopt a retranslation basis of taxing foreign currency gains and losses on its foreign currency denominated monetary assets and liabilities which are not part of its trading portfolio. This would be consistent with the requirements of Approved Accounting Standard ASRB 1012.

- ***General Hedges*** - that hedge tax rules be included in the proposals. These rules need to make a distinction between hedges that are used to hedge an underlying position which is on revenue account and hedges that are used to hedge underlying positions that are on capital account.

- ***Hybrid instruments*** - that a combination of a blanket approach and the selection of a set of specified determinative factors be used to develop a sound and reasonable test to distinguish debt from equity. This should avoid the need for complex and uncertain anti-avoidance rules.

- ***Anti-avoidance rules*** - that the proposals not be laden with clumsy and complex anti-avoidance rules proposed, particularly, the proposal to quarantine losses incurred on financial arrangements to gains made on financial arrangements.

- ***Implementation* –** that Discussion Paper 2 team continue to consult with the banking and finance industry about the detail to be included in any legislative measures. Discussion Paper 2 does not contain sufficient detail about how the proposals are intended to operate and there are a lot of complex issues that will need to be addressed before it is possible to draft legislation which will be able to implement the proposals in practice.

# Taxation of Leases Appendix 6

This Appendix sets out the National's position in relation to the issues and options canvassed in Chapters 8 to 10 of Discussion Paper 2.

## Background

Generally, the taxation treatment of leases and other rights adopts the legal form of the arrangement rather than the economic substance of the particular transaction.

In Discussion Paper 2 it is considered that the existing rules are extremely complex as they incorporate ordinary income concepts with specific statutory provisions resulting in an inconsistent treatment for similar transactions. Simplification of the tax system has been identified as one of the objectives in "A Strong Foundation".

Discussion Paper 2 also identifies the potential tax benefits obtained from some leases and rights through the structuring of payments, the transfer of tax preferences and lease assignment arrangements. It is considered that such benefits provide advantages to particular forms of business arrangements and interfere with the most efficient allocation of resources.

To overcome these perceived problems Discussion Paper 2 proposes a strategy to tax leases and rights in line with changes in value of the associated assets and liabilities. In relation to leases, two alternative proposals are considered:

- a sale and loan approach where the lessee is taken to have acquired the leased asset and a loan is made by the lessor to the lessee for the value of the asset; or

- a tax preferred leasing approach where the benefits due to the accelerated depreciation component remain available to the lessor, however the lessee would be entitled to the effective life component of the depreciation claim.

In respect of the sale and loan approach consideration is given to the possible application of this approach to:

- finance leases only; or

- both finance and operating leases with certain exclusions.

The tax preferred leasing approach would allow the lessee depreciation deductions based on the effective life of the asset and the lessor would claim the difference between the accelerated depreciation and depreciation based on effective life. The lessor would then be able to pass some or all of the benefits of the accelerated depreciation on to the lessee through lower lease payments.

Discussion Paper 2 also proposes the imposition of a balancing charge at the end of each lease arrangement. This proposal would obviously require the lessor to obtain a valuation of the leased asset at the end of the lease and return the excess over the tax written down value of the asset as assessable income. It is considered that this proposal would eliminate any tax benefits realised on the assignment of a lease.

## Analysis

The tax preferred leasing approach still provides the opportunity for the transfer of tax preferences due to the availability of accelerated depreciation. However if accelerated depreciation was removed as part of the reform process, presumably there would be little difference between the tax preferred approach and the sale and loan approach.

Further, the splitting of depreciation claims between the lessee and the lessor would result in an extremely complex regime and increase the compliance burden on taxpayers as it is also assumed that the lease payments will need to be allocated in some manner into a taxable and non-taxable component. Consideration of such an approach would appear in stark contrast to the stated objective of simplification of the tax system. Given that the inconsistency and complexity of the existing tax treatment of leases was identified in Discussion Paper 2 as reasons for reform, it is difficult to see how the transfer of tax preferences approach could in any way address these concerns.

To provide a competitive product in the market, the pricing of finance and operating leases does incorporate some of the tax benefits available to the lessor. However this enables the lessee to obtain cheaper and effective asset financing.

Many taxpayers also prefer leasing to ownership of an asset due to the various business and commercial benefits of a leasing arrangement. For example, leasing arrangements allow lessees to update assets on a regular basis without external security borrowing constraints. Leasing is a simple financial arrangement which provides lessees with flexibility and in most situations operating lease structures are off balance sheet arrangements.

The possible application of the sale and loan approach to finance and operating lease arrangements may have a detrimental flow-on impact on the existing levels of capital expenditure, as potential lessees will be unable to access this cheaper, effective form of finance.

Further, it is considered that the possible application of a sale and loan approach to operating leases ignores the economic substance of such an arrangement. As stated above, operating leases provide significant commercial benefits to many lessees including the ability to obtain off-balance sheet financing.

A low tax paying entity or tax exempt entity is not in a position to crystallise the full taxation benefits of claiming depreciation of plant which is available to other taxpayers. Accordingly, this could distort the investment decisions away from high depreciating items of plant by such entities. Again a finance lease structure enables these entities to access a range of assets which may otherwise have been unattractive.

Accordingly, given the difficulties envisaged with the transfer of tax preferences approach and the disadvantages of the sale and loan approach, the National supports a continuation of the existing taxation treatment of leases.

However, it should be noted that if either of the above proposals are adopted the reduction in the benefits of leasing may cause taxpayers to take up alternative financing (eg. loans/hire purchase) to fund their asset acquisitions. Accordingly, from a bank's perspective any negative impact on the leasing business may be offset by increases in loan business.

The Commissioner of Taxation, through the issue of a number of public rulings, has already addressed various lease payment structures that the ATO view as tax offensive. Therefore, it is questionable whether there is a need for further anti-avoidance arrangements given the ATO's existing approach to structured lease payment arrangements.

It is agreed that the existing provisions of section 51AD and Division 16D result in preferential treatment afforded to taxable entities (particularly low tax entities) compared to tax exempt entities in respect of leasing arrangements. The removal of these provisions would result in a consistent and simplified approach to leasing. With the high levels of asset privatisation occurring in Australia, it is considered that draconian provisions such as section 51AD are no longer required and are an impediment to commercial business arrangements.

## Recommendations

- The National supports the continuation of the existing taxation treatment of leases.

- The benefits of a transfer of tax preferences approach is questionable given the likely complexity of such a proposal and the compliance requirements involved. Further, the benefits of this approach are reliant on the continued availability of accelerated depreciation.

- A move to a sale and loan approach in respect of any form of operating lease is not consistent with the legal form or economic substance of the arrangement and is, therefore, considered inappropriate.

- A move to a sale and loan approach in respect of finance leases is not supported. Finance leases provide a commercially effective form of asset financing to all levels of tax paying entities. A finance lease structure enables lower tax paying entities to obtain cheaper finance and, therefore, indirectly invest in assets that may have otherwise been unattractive. Leasing structures also provide businesses, particular small to medium sized businesses, with a simple and flexible financing alternative.

# Depreciation Appendix 7

This Appendix sets out the National’s position in relation to the issues and options canvassed in Chapters 1 to 4 of Discussion Paper 2.

## Background

The decline in value of wasting assets is currently recognised in our taxation system through deductions for depreciation and capital allowance write offs.

In Discussion Paper 2 it is identified that the taxation of wasting assets impacts on investment decisions and economic performance. It is considered that there are a number of inconsistencies between the various capital allowance and depreciation write-offs, particularly in respect of the timing, method of calculation and rate of deductions available.

The views in Discussion Paper 2 do not question the entitlement of taxpayers to deduct the cost of assets used in the production of assessable income, but rather, how the deductions should be spread over the effective life of the asset. It is considered that in many instances the value of assets are written off over a period which is much shorter than the true effective life of the asset. This is referred to in Discussion Paper 2 as “accelerated depreciation” and it is perceived as providing taxpayers with cash flow advantages and negatively impacts on the “Revenue”.

It is proposed by Discussion Paper 2 that annual depreciation deductions should be more closely aligned with the annual declines in the value of a particular asset and that this can be achieved by requiring assets to be written off over their true effective life.

Discussion Paper 2 proposes an integrated and unified model for all depreciation and capital allowance write-offs. The proposed model aims to ensure that a standard approach is adopted in respect of the following:

- which taxpayer is entitled to claim depreciation/capital write-offs;
- when the claim is to commence;
- over what period the claim will be allowed; and
- the taxation consequences on disposal of the asset.

## Analysis

### Depreciation & Capital Allowances

### Who Is Entitled To Claim The Deduction

Under the existing law, entitlement to depreciation deductions for plant and building allowance depends on the taxpayer being the legal owner (or quasi owner) of the asset and the asset being used for the purpose of producing assessable income. Adopting legal ownership as a basis for determining entitlement to depreciation has caused some problems, particularly, in respect of fixtures on leased land. Legally, fixtures on leased land are owned by the landowner yet, the lessee may have incurred the capital expenditure.

Two possible alternatives are proposed in Discussion Paper 2 to rectify this problem:

1. A taxpayer who incurs the capital expenditure to produce assessable income would be entitled to claim depreciation/capital allowances; or

2. Depreciation/capital allowances should be recognised in accordance with the accounting principles in AASB 1021 'Depreciation'. Therefore, a taxpayer would recognise depreciation in relation to assets the taxpayer controls. The control of an asset would be the capacity to benefit from it in the pursuit of the taxpayer's objectives and to deny or regulate the access of others.

Clearly the first alternative provides a simple and straight forward approach to identifying the taxpayer eligible to claim the capital allowance write-off. Such an approach would also ensure that there is consistency across all taxpayers without reliance on an interpretation of a "control test". It is considered that any inequities in the current depreciation system would be adequately addressed by adopting the first proposal without the need for major changes to the existing depreciation/capital allowance regime.

**Cost Base Used For Claim**

It is also proposed that a consistent approach should be adopted in the cost base used to calculate the various capital allowance write-offs. Generally the cost base used to calculate depreciation and most capital allowances is the actual cost to the taxpayer. However, the most notable exception to this rule is in respect of building allowance which is based on the original cost of the building. It is agreed that a consistent approach based on the actual cost of the asset to the taxpayer should be adopted.

Discussion Paper 2 also raises for consideration whether the cost base used in calculating depreciation and capital allowances should be reduced by the expected scrap value of the asset. This approach is not considered appropriate as it will result in taxpayers making arbitrary estimates of the likely scrap/resale value of an asset. The possibility of identifying assets that typically retain significant value is also unacceptable as it will result in different approaches depending on the type of asset. Also, if an asset is intended to be held long term it will be difficult to identify whether the asset will retain value and, if so, to what extent.

It is considered that any potential for abuse through inflated sale prices is sufficiently addressed through the incorporation of market value rules for transfers between parties not dealing at arms length.

**When Deductions Should Commence**

The existing depreciation provisions provide for deductions to commence in the year in which the asset is installed ready for use. Some of the capital allowance provisions (eg. film investments and some agricultural expenditure) provide for deductions to commence at an earlier point in time. There is also the added difficulty of determining the appropriate deduction when the particular capital asset is partially completed but is still used for income producing purposes.

In Discussion Paper 2, two possible approaches to this issue are identified. The first is to apply the approach currently adopted in the depreciation and most capital allowance provisions of proportionate deductions commencing in the year the asset is first installed and ready for use. The alternative is to allow a standard deduction (ie. not apportioned on a daily basis) in the year the asset is first used. The first approach is considered to more equitable and while the calculation may be slightly more difficult, it has been applied for many years under the existing depreciation provisions.

## Determination Of Effective Life

For depreciation purposes taxpayers currently have the option of making their own estimate of effective life or adopting the standard effective life set by the Commissioner of Taxation in respect of various classes of assets. This approach provides simplicity and removes the compliance burden on taxpayers in determining and supporting the effective life chosen for a vast number of assets. This approach also provides taxpayers with the flexibility of determining the effective life of assets used should their circumstances be different or distinctive. The National has in the majority of cases adopted the effective life prescribed by the Commissioner.

However, it is accepted that in a number of cases the standard effective lives provided by the Commissioner are not reflective of an asset's actual effective life. Further, the categories of assets identified by the Commissioner are not extensive nor do they reflect technological advancements in asset development. The result is that taxpayers are required to make arbitrary determinations of which category an asset is most suited to and, therefore, which effective life is to be applied.

It is apparent that the Commissioner has accepted the shortcomings of his schedule of effective lives for various asset classes and has undertaken to provide a more comprehensive and updated schedule. This should however be recognised as a continual process rather than a once and for all fix. It is indicated in Discussion Paper 2 that a priority for the Commissioner is to adjust those effective lives in his schedule where there are clear anomalies. It is suggested that this alone is likely to address the so-called "accelerated depreciation" concern raised in Discussion Paper 2 without legislative change or reform.

Given that this process is intended to be revenue neutral, and not revenue raising, the existing depreciation rates should only be amended by the Commissioner if there is compensating adjustments for taxpayers through a lower corporate tax rate.

A system which does not permit a taxpayer to self-assess the effective life of an asset is not considered an acceptable alternative. Such a system is not only in stark contrast to the current trend towards a self-assessment system of taxation, but it is also questionable whether it would provide taxpayers with the certainty and predicability foreshadowed in Discussion Paper 2. If an asset does not fall within the Commissioner's schedule the taxpayer would need to seek clarification from the Commissioner. This results in an additional administrative burden for taxpayers and potential lengthy time delays and would hamper investment proposals where the after tax cost of capital investments is detrimental.

Discussion Paper 2 also includes comments in relation to the choice available to a taxpayer between diminishing value and prime cost methods of depreciating plant. Discussion Paper 2 raises a potential problem with the application of the prime cost method to secondhand plant as the depreciation rate applied is based on the effective life of the asset as if the asset was purchased new. It is considered that the perceived problem does not arise because of the differences in the two methods of depreciation, but rather is inherent in the definition of effective life which is used to determine the applicable depreciation rate.

The existing building allowance provisions are also considered in Discussion Paper 2 and it is questioned whether it is appropriate for buildings to be depreciated. The options put forward are to either retain the existing system (including the balancing charge adjustments currently before Parliament) or to incorporate buildings and structures into the general depreciation system so that the cost of the building is written off over the building's effective life. The third alternative is to maintain the existing system with a reduced write off rate, possibility 0%.

It is considered that the effective removal of the building allowance through the adoption of a zero rate would have an adverse impact on capital investment in Australia, particularly in the rental housing market. A zero rate would only be supported if it is part of a reform package which includes a reduction in the corporate tax rate.

It is recognised that the existing system of building allowance, while relatively straight forward to apply, ignores the effective life of a particular building or structure. If a consistent regime is to apply to all forms of capital asset expenditure, it is considered that the application of the depreciation system to buildings and structures would be a logical extension. However, it is considered that the current write off period for buildings (ie. 25 or 40 years) should be adopted as the Commissioner's standard effective life.

In the event that the building allowance write-off is aligned to the depreciation system, the transitional rules should apply the new measures to all acquisitions after the measures become effective. If the new measures are applied only to new constructions, the existing measures will still apply to buildings already constructed even if a sale of the building occurs after the new measures become effective. It is considered that this will prolong the existing compliance issues for taxpayers as they will still need to ascertain when a particular building/structure was constructed in order to determine the appropriate taxation treatment.

**Write Off For Small Valued Items**

Under the existing depreciation provisions an immediate deduction may be claimed for an item of plant where the cost is less than $300. The immediate deduction for items of small value is intended to reduce the compliance burden on taxpayers as they would otherwise need to depreciate the item over its effective life.

Discussion Paper 2 considers that the existing approach discriminates between various classes of taxpayers, as those taxpayers that tend to invest in low cost items rather than high-cost items obtain a tax advantage. Further, Discussion Paper 2 considers that there is the scope for tax minimisation through sale and leaseback arrangements where the tax written down value of an asset falls below $300.

The proposals considered to overcome these perceived problems are:

- to apply a limit on the number of items of the same class that may qualify for the immediate deduction; or

- to impose an annual dollar limit on the amount which may be claimed as an immediate write-off deduction.

It is suggested that the potential for tax minimisation arrangements could be effectively eliminated if a commonsense approach is adopted so that a deduction is claimed for the remaining cost of an item of plant when the tax written down value of the item reaches a minimal value. To remove any arbitrage opportunities, the minimal value should be consistent with the value applied in the immediate write-off scenario (ie. currently $300).

It is accepted that the imposition of an annual dollar limit on the amount which may be claimed as an immediate write-off would be relatively easy for taxpayers to monitor and comply with. Discussion Paper 2 indicates an annual dollar limit of $10,000. However, it is considered that if this proposal is adopted, medium to large businesses, which by virtue of there size are likely to have a larger volume of purchases, will be disadvantaged. For example a business will exceed the annual dollar limit of $10,000 after acquiring only 34 items for $300 each.

Given that the original intention of the immediate deduction was to relieve taxpayers of the onerous compliance issues of depreciating small value items, it is questionable whether this approach achieves this underlying intention as a majority of businesses are likely to exceed the limit and therefore, depreciate the excess items.

If this proposal is adopted it is strongly suggested that the annual dollar limit together with the $300 limit should be adjusted for inflation each year in line with other dollar value limits imposed in the tax legislation.

The alternative proposal of applying a limit on the number of items in the same class for which an immediate deduction is claimed would appear to address the perceived abuse of the existing provisions (eg. large dollar acquisitions immediately deducted as attributed to items individually less than $300). However it is recognised that difficulties may arise in identifying whether particular items are of the same class.

Given the above comments and the potential problems with the suggested alternatives, it is considered that the existing approach should be retained.

**Removal Of Balancing Offset Arrangements**

Discussion Paper 2 proposes the removal of the existing balancing adjustment offset arrangements as such provisions do not currently apply uniformly across all capital allowance provisions (ie. only applicable to depreciation). The removal of the offset would produce a revenue gain which it is suggested could fund an alternative measure such as the reduction in the corporate tax rate.

For the year ended 30 September 1998, the National Group applied $99.4m of assessable balancing charge adjustments against the cost of replacement or other depreciable items. Therefore, if the balancing offset arrangements were removed an additional $99.4m of assessable income would have been realised by the National Group for the 1998 income year.

The balancing charge offset arrangements provide a concession for taxpayers reinvesting into depreciable assets. However, the removal of these provisions would be acceptable only if it is accompanied by a reduction in the corporate tax rate.

**Blackhole Expenditure**

Discussion Paper 2 identifies "blackhole expenditure" as expenditure undertaken for the purpose of earning assessable income that does not currently qualify for a deduction, either immediately or as a capital allowance write-off. It is proposed that such expenditures should qualify for either a deduction or an effective life write-off or in some cases a cost base adjustment to the underlying asset.

It is proposed in Discussion Paper 2 that where expenditure produces benefits over an indeterminate life, or over the life of the entity, a practical approach would be to allow a write-off of such expenditure over an appropriately long period (eg. 10 years).

The National is particularly supportive of the approach taken in Discussion Paper 2 in identifying the current inequity in the tax system in respect of various blackhole expenditures. Given the particular importance to the National, it is pleasing to see that the current non-deductibility of prospectus and underwriting costs (and presumably other capital raising costs) are proposed to be addressed with a write-off over a statutory period.

In addition to the non-deductible expenditures identified in Discussion Paper 2, it is also considered that interest on convertible notes and due diligence costs of acquisitions and mergers should also be addressed as part of the reform process. It is inequitable that these costs should continued to be non-deductible when other blackhole expenditure is addressed in the Paper.

**Goodwill**

The existing income tax law does not provide any form of tax deduction (immediate or write-off) in respect of capital expenditure incurred on purchased goodwill. This treatment is identified in Discussion Paper 2 as inconsistent with expenditure incurred on creating internally generated goodwill which is, in most situations, claimed as an immediately deductible expense.

Further, the proposed reform of the depreciation and capital allowance provisions has the underlying aim of providing a consistent and equitable regime for writing-off of capital expenditure in respect of assets applied in the production of assessable income. It is difficult to see why capital expenditure incurred in acquiring goodwill should be excluded from this regime.

It is considered that a consistent approach should be adopted so that the capital expenditure incurred in acquiring goodwill is written off or amortised over the effective life of the goodwill or a reflective statutory period (the USA allows a write off over 5-25 years).

It is questioned in Discussion Paper 2 as to whether a write-off of the cost of goodwill is appropriate given that costs of maintaining goodwill would be deductible. Again it is difficult to apply this logic to the treatment afforded to depreciable assets and buildings where the costs of maintenance and repairs are deductible as well as a write-off of the capital cost of acquisition.

It is considered that the current denial of goodwill amortisation fails to recognise the economic substance of the arrangement as goodwill is applied by a business in the production of assessable income.

## Recommendations

- The existing system of allowing taxpayers to self-assess or to adopt the effective life provided in the Commissioner's schedule is the most effective and administratively efficient approach in the determination of an asset's effective life. As the Commissioner has given an undertaking to update and expand the schedule of effective lives, this alone is likely to address any perceived shortcomings in the existing system in respect of accelerated depreciation. Accordingly, this should only be carried out with a compensating adjustment to taxpayers such as a reduction in the corporate tax rate.

- The National supports the proposed option which entitles a taxpayer who incurs the capital expenditure to claim depreciation/capital allowances.

- The National also supports the proposal that all capital allowance claims and depreciation should be based upon the cost of the asset to the taxpayer. This approach again ensures simplicity and certainty for the taxpayer and removes the often difficult task of obtaining necessary information from previous owners in respect of the original cost of an asset.

- It is not considered that the incorporation of the expected disposal proceeds into the cost base calculation of an asset for capital allowance purposes should be adopted. The inclusion of expected sale proceeds will result in taxpayers making arbitrary estimates of likely scrap/sale values and result in inconsistency between assets of similar nature depending on their expected resale or scrap values, thus affecting investment decisions in respect of these particular assets.

- The National supports the proposal for all depreciation and capital allowances to commence, on a proportionate basis, in the year the asset is first installed ready for use. This approach has been adhered to for many years in respect of the existing depreciation provisions. The existing treatment for determining depreciation does not impose particularly onerous requirements on taxpayers and yet it provides a fair and relatively equitable approach as the depreciation deductions are matched to the application of the asset towards the production of assessable income.

- The National supports the alignment of the building allowance and depreciation provisions so that buildings are depreciated over their effective life.

- The National believes that the immediate write off for low value items should be retained and expanded to apply to depreciated assets where the tax written down value of the asset is reduced to $300.

- The National would support the removal of the balancing charge offset arrangements <u>only</u> if it is part of a package of reform which incorporates the reduction in the corporate tax rate to 30%.

- The National is supportive of the approach taken in Discussion Paper 2 in respect of blackhole expenditure. The National would also like to see the non-deductibility of interest on convertible notes and due diligence costs included as blackhole expenses and therefore addressed as part of the reform process.

- The National considers that the taxation system in Australia, like the system adopted in the US, should include the amortisation of purchased goodwill. It is considered that this approach would provide a consistent regime of depreciating/amortising expenditure on all capital assets used in the production of assessable income.

# Collective Investment Vehicles Appendix 8

This Appendix sets out the National's position in relation to the issues and options canvassed in Chapters 16 and 22 of discussion Paper 2.

## Background

### Entity Taxation

The overall purpose of A New Tax System ("ANTS") is based on a consistent tax treatment of the various entities undertaking business activities (ie. an entity taxation regime). This would have provided a cash flow disadvantage for investors in widely held trusts, such as cash management trusts.

Simultaneously with the release of Discussion Paper 2, the Treasurer announced that Collective Investment Vehicles (CIV) including cash management trusts would be subject to "flow-through" taxation under the new entity taxation regime discussed in ANTS.

Taxing CIVs on a "flow-through" basis would result in distributions of taxable income retaining their character, eg as capital gains or interest income, instead of all such distributions being received as the equivalent of dividends (with any associated imputation credits) , as would be the case under entity taxation.

The definition of a CIV, as proposed in Discussion Paper 2 would, in all probability, be the current definition of a public unit trust. This definition would have the effect of excluding the following trusts from using the "flow-through" taxation system:

- Wholesale Investment Vehicles;
- Retail Investment Vehicles;
- Pooled Superannuation Trusts; and
- Life Insurance Superannuation Products

The impact of excluding wholesale investment vehicles from the definition of a CIV, would mean that the current and proposed National products such as the Master Fund, Asian Growth Fund and the Conservative Income Fund which invests down into wholesale trusts would be subject to the entity taxation regime.

Likewise, under the proposed system, pooled superannuation trust and life insurance superannuation products would be subject to the entity tax proposals and would attract a tax of 36 per cent when in fact the tax on a superannuation fund income is only 15 per cent. National Australia Financial Management Ltd., (a wholly owned subsidiary of the National), has $3,471 million under management in its statutory funds, which relates to superannuation business, and believe that this change would be detrimental to these products.

### Taxation Treatment of Tax Preferences

Discussion Paper 2 also addresses how tax preferences (which includes exempt foreign income, tax depreciation and building allowance distributions) should be taxed and suggests two options for taxing tax preferences. To understand the options it is necessary to address how investors currently invest in CIVs and the current taxation treatment of tax preferences.

The CIV's offered by National Australia Financial Management Ltd., are established as unit trusts in Australia. The purchase of units issued by the CIV is the usual mechanism by which an investor invests in the CIV. Each unit will have a purchase value, which equates to its cost base under the current taxation treatment.

The distribution of tax preferred income is currently tax free in the hands of the investor upon receipt. However the investor's unit cost base is reduced by the amount of tax preferred income and any tax implication is deferred until the disposal of the unit.

Discussion Paper 2 raises two options of how to treat tax preferences:

**Option 1: Not taxing tax preferred income in investors' hands.**

Distributed tax-preferred income would be non-assessable income of investors. This would effectively preserve the effect of any tax preferences.

**Option 2: Taxing Tax-Preferred Income**

Tax-preferred income distributed by CIV would be taxed in a way equivalent to distributions by entities. However, distributions of taxable income would retain their character.

## Analysis

**Investment Vehicles**

**Wholesale Investment Vehicles**

Fund managers, typically, create two major pools of assets. The first pool is referred to as the retail trust product, which is the pool of assets into which individuals directly invest. The second pool is referred to as the wholesale trust product, which is the pool into which large institutional clients (ie the majority of which are superannuation funds, approved deposit funds and savings) directly invest.

In order to obtain efficiencies and economies of scale benefits, monies held by the retail pools are invested in the wholesale pools.

National Australia Financial Management Ltd. currently uses wholesale investment vehicles within its managed investment products.

Under ANTS proposals, the net income of wholesale and retail investment vehicles will be subject to a 36 per cent tax, rather than flow through taxation to investors.

***If wholesale unit trusts were not treated as CIVs (assuming there would be no restructuring to direct investments) this would defeat Government's policy behind the application of CIVs to retail unit trusts. The same cash flow costs, which applied to individual unitholders of retail trusts, would still exist to the extent to which assets of the retail unit trust are invested in wholesale unit trusts.***

In addition, exclusion of wholesale unit trusts from the CIV definition will have wide ranging implications for the fund management industry. It would force a major restructure of investments, and in particular, force those entities which use wholesale unit trusts into direct investments. This would be detrimental for a number of reasons:-

- Wholesale investment vehicles and retail investment vehicles will be placed at a competitive disadvantage in relation to other managed investment vehicles;

- It is inconsistent with the investment neutrality principle;

- It will add operation inefficiencies to existing fund management operations;

  Fund Managers will be forced to manage numerous pools of assets, which in turn, reverse the efficiencies of scale currently being passed on to all investors. It will also adversely impact investment returns (as the benefits of pooling are unwound) hence reducing the incentive of investors to save.

- It will reduce investment options available to investors.

  The existing wholesale unit trust structure also allows small superannuation funds to access investment options that may not, due to their size, be available.

**Master Funds**

A master fund arrangement is the use of a single trust deed, which is usually subject to Corporations Law requirements of making offers to the public, to establish arrangements with investors, under which investors are absolutely entitled, as against the trustee, to separately identifiable assets held on their behalf. That is, a separate trust is created in respect of each investor.

Typically, master funds allow for the member to direct the trustee to invest in either other collective investment vehicles or indirect assets such as listed equities. The member has full power to direct the trustee to buy and sell such investments and otherwise deal with the assets as the member directs.

The National believes that the best approach in relation to such arrangements is to ignore the trust relationship and treat the investor as the sole entity/individual subject to taxation.

Master funds should therefore be treated as completely "look through" vehicles and excluded from the entity taxation regime.

**Superannuation Vehicles**

**Pooled Superannuation Trust**

A Pooled Superannuation Trust (PST) is a vehicle for pooling investments of numerous small to medium size superannuation funds to obtain lower costs and enhanced investments returns that flow from professional management.

An additional benefit for small funds is that these vehicles assume the taxation liability by paying the standard 15 per cent superannuation tax on all fund income, thereby absolving the superannuation fund from incurring the significant costs of complying with complex superannuation tax return procedures.

PST's are currently tax transparent and regulated under the Superannuation Industry (Supervision) Act (SIS).

The National supports the current "look through " approach to the taxation of PST's.

**Superannuation Managed By Life Insurance Companies**

Superannuation policies now comprise about 80% of the life insurance companies business. Life company funds operate in accordance with the Life Insurance Act and are prudentially controlled and supervised by the Australian Prudential Regulatory Authority.

Life insurance assets are deposited in Statutory Funds that have strict capital adequacy and reporting requirements. They are entirely different from discretionary private trusts.

Currently, the statutory fund, which invests superannuation monies, pays the standard superannuation tax of 15 per cent on such fund income.

Under ANTS proposals, PST and superannuation arrangements conducted in life insurance companies will be subject to a 36 per cent withholding tax, when they are only currently being taxed at 15 per cent. A complex system of franking credits will allow for a 21 per cent (ie 36 percent less 15 per cent) refund at some later point in time. The delay in receiving any refunds could be years.

The above proposed taxation arrangements would have the following effects:

- PST and superannuation arrangements conducted by life insurance companies, place those companies at a competitive disadvantage in relation to other superannuation fund investments purchased directly in their own name. These funds will continue to have their income taxed at 15 per cent and will not be subject to this complex administration system.

- The proposed system will also reduce competition in the market place by making these vehicles unattractive to investors. It will also mean that there will be fewer superannuation vehicles for investors to choose from.

- The proposed ANTS system will create cash flow disadvantages. Investments will need to be liquidated to pay the 36 per cent taxation liability, and subsequently reinvested upon receiving the 21 per cent refund. This will also generate unnecessary transaction costs and administration costs.

- The proposed ANTS system will create a permanent tax detriment to PST and life company superannuation investors who invest in growth assets. The Government's Deferred Company Tax proposals(refer Appendix 2) will ensure that the PST and life company superannuation distributions of tax preferred income will be subject to tax. Identical investments made by a superannuation fund directly will not be subject to that tax.

- Create a taxation liability on unrealised gains. The fundamental principle of the Australian tax system is that tax should be payable on realised as opposed to unrealised gains. Neither companies, trusts nor other superannuation funds will be subject to tax on unrealised gains.

- Impose an administration burden on funds thereby increasing the costs for members. Superannuation funds, whose sole investment is a life company superannuation policy or a PST investment, will be forced to lodge income tax returns to obtain the 21 per cent refund of overpaid tax. Millions of investors will lose income while their money is "loaned" to the Taxation Office. Funds who fail to lodge returns to reclaim the overpaid tax will suffer a permanent loss of assets.
- Potential disruption in the capital markets as funds are restructured to restore their taxation neutrality with other superannuation funds. There is the added exposure that these funds will realise unnecessary taxation obligations due to their restructure.

## Recommendations

National recommends that the definition of a CIV should be expanded to provide access for small investors to a wide range of investments including equities (both Australian and Offshore), property, fixed interest and cash.

The National makes the following recommendations:

- all managed investments including both wholesale and retail pooled vehicles continue to operate under the "flow-through" principle.

- Master funds should be treated as completely look through vehicles and therefore excluded form the entity taxation regime.

- current taxation relativities in relation to superannuation business in life insurance company and pooled superannuation trust vehicles should be maintained.

- the taxation of the net income of these vehicles at the corporate tax rate and for downstream investors to deal with the complications of franking credits and loss of real investment returns is opposed.

- tax preferences that create incentives for savings are maintained.

# Taxation of Life Insurers Appendix 9

This Appendix sets out the National's views in relation to the issues and options canvassed in Chapters 34 – 37 of Discussion Paper 2.

## Background

Discussion Paper 2, suggests that the current taxation system for life insurers is too complicated and inequitable. The proposed view of the discussion paper is that life insurers will be taxed:

- at the proposed company taxation rate of 30 per cent;
- amounts actually credited by the life insurer to retirement savings account (RSA) policyholders would continue to be taxed at 15 per cent;

Prior to the discussion regarding the various taxation options proposed in Discussion Paper 2, it should be recognised that the taxation of life insurance (both policyholders and shareholders) has differed from other organisations due to the following unique features:

- the very long-term commitments involved, and the over-arching statutory and regulatory framework, designed to ensure that these commitments will be honoured;
- the combination of pooled and individual savings, and the joint development of shareholder and policyholder capital in statutory funds;
- the importance of this form of saving (together with superannuation) in terms of creation of pools of long-term investment capital; and
- at times, the application of particular government policies (usually expressed in particular taxation treatment) designed to encourage long-term saving and greater self-provision against various risks - both of which reduce burdens on public budgets.

### Taxation Of Policy Holders

As a general point, it is submitted that the tax regime should follow the nature of the activity invested in, rather than the form of investment vehicle. Neutrality, and therefore economic efficiency is only achieved where the taxation system is, as far as is practical, not dictated by the vehicle through which the activity is undertaken, but rather by reference to the activity itself, whether by the direct investment of an individual, or via investment in a collective investment vehicle which, in turn, invests in the particular activity.

As noted by the Campbell Committee in its Final Report, life insurance and the role played by life companies in relation to the stability of household savings is crucial. This, together with the fact that the insurance contracts generally involve a long term arrangement by the policyholder, would suggest that any changes to the regime for the taxation of life insurance, particularly changes which have the potential of radically impacting the benefits contemplated by the policyholder should be taken into consideration. It is therefore important that the transitional arrangements in relation to any changes are given careful consideration.

**Taxation Of Shareholders**

Neutrality also dictates that shareholders in a life company should be taxed in the same manner as shareholders in other companies.

## Analysis

The superannuation and annuity policies comprise a large percentage of the life insurance company's business. It should also be recognised that the assets deposited in Statutory Funds have strict capital adequacy and reporting requirements.

Therefore, the investors that organise their superannuation arrangements via life insurance companies, should not be disadvantaged in relation to other superannuation fund investments purchased directly in their own name.

The taxation treatment of the life insurance business is an extremely complex area that has arisen due to a variety of reasons. In order for a meaningful consultation process we would encourage the immediate public release of all Treasury papers underlying the Taxation Reform proposals in the area of life insurance.

## Recommendations

In order to address the neutrality issue in relation to policyholders and shareholders the National recommends the consideration of the following issues:

- Income attributable to ordinary investment policyholders (ie. non-super/RSA and non-pension/annuity policies) should be taxed at the life company level at the prevailing corporate tax rate

- The tax rate applied at the life company level to complying superannuation and deferred annuity business should be 15 per cent.

  Non-complying superannuation fund business should be taxed at the life company level at the 47% tax rate.

  Current pension business should remain exempt from tax.

  Application of the general company tax rate to the income referable to such policies would, contrary to the objective of creating a level playing field, result in inconsistent treatment of superannuation funds investing in a life policy, as compared to superannuation funds and RSAs investing directly or via other collective investment vehicles.

- Income referable to the immediate annuity business of a life company should remain exempt from tax.

  Annuity income is already adequately dealt with via taxation at the level of the annuitant. We accept that any profit made in respect of annuity business should be taxed.

- Policyholders should not be subject to either the entity or DCT regime

Application of the entity and DCT regimes to policyholders would make life companies uncompetitive with investing directly or via other collective investment or superannuation vehicles

- Life companies, as a collective investment vehicle, should be entitled to CGT treatment in relation to the disposal of assets, including:-
    - taxation of gains/losses only when realised;
    - the allowance of indexation where assets held for more than 12 months; and
    - taxation of capital gains derived by non-superannuation business at the same rate as applicable to all other taxpayers.

The reason being that Life companies should be entitled to the same treatment in relation to the disposal of assets as other collective investment vehicles.

# Taxation of Entity Groups Appendix 10

The "Taxation of Entity Groups" section of Discussion Paper 2 discusses the proposal for consolidation of wholly-owned groups (Chapters 25-27), and the issue of loss cascading, loss duplication, double taxation, and the CGT value shifting rules outside a consolidation regime (Chapters 28-29).

## Background

Discussion Paper 2 sets out a number of problems with the current tax system in relation to the taxation of entity groups, namely:

- Tax impediments to business organisation
- High compliance costs
- Tax avoidance through intra-group dealings
- Loss cascading
- Loss duplication
- Double taxation
- Value shifting

Taxing a group as a single entity is seen as a means to solving the abovementioned problems.

Discussion Paper 2 refers to the six design principles enunciated in *A New Tax System* for a consolidated tax regime, namely:

1. Consolidation is to be optional, but if a group decides to consolidate, all its wholly owned Australian resident group entities must consolidate.

2. Consolidated groups to be treated as a single entity ie.

    - Single income tax return and single set of tax instalments,
    - Joint and several liability to pay tax
    - Consolidated franking account, consolidated carry forward losses, single accounts for foreign losses and foreign tax credits and common accounting period

3. Current grouping provisions to be repealed

4. Individual entity losses and franking account balances able to be brought into the consolidated group.

    Discussion Paper 2 canvasses some options for bringing carry-forward losses into a consolidated group.

5. Carry-forward losses and franking balances to remain with the consolidated group on an entity's exit from that group.

6. Provisions to be established for determining the cost bases of equity on exiting a consolidated group to ensure that loss cascading, loss & gain duplication and value shifting is removed in a consolidated regime.

## Analysis

### Compliance Costs

Discussion Paper 2 suggests that a consolidated tax regime will reduce the high compliance costs of the present system. From the ATO's perspective, the idea of a corporate group such as the National lodging a single income tax return rather than the sixty tax returns currently being lodged would be quite attractive from an administrative perspective. There would also be a reduction in the paper work required with the removal of loss transfer notices, rollover elections, etc.

However, a number of commentators have stated, based on experience of consolidated tax regimes in other jurisdictions that the compliance costs do not reduce and the rules are in fact quite complex. This is also consistent with the National's own experiences in those jurisdictions which have a consolidated tax regime (eg. New Zealand, United States). Furthermore, whilst "intra-group transactions and intra-group interests are ignored" for income tax purposes, other regulatory requirements prevent such transactions being ignored eg. stamp duty on transfers of land or shares between entities still require market value to be monitored.

### Achieving Objectives Without Consolidation

Practices such as loss cascading, loss / gain duplication and value shifting should be prevented. The National also acknowledges the benefits to arise from a consolidated tax regime – the pooling of revenue losses, capital losses and foreign tax credits, the transfer of assets within a wholly owned group without a taxing event, and a single franking account for a wholly owned group. However, the stated objectives could be achieved outside a consolidated tax regime. There are already measures in the current tax system to address the issues of loss duplication and value shifting. To an extent Discussion Paper 2 recognises this exact point by stating that:

> *"supplementing consolidation are options (in Chapters 28 and 29) - again involving structural improvement in the law – that could address loss and gain duplication and value shifting transactions for:*
>
> - *wholly owned groups of entities that do not consolidate; and*
> - *entities that are not wholly owned but which have a single majority owner or controller"* (paragraph 25.18)

The options to be applied to non-consolidated groups could presumably equally apply to consolidated groups.

### The 'Choice' To Consolidate

The notion that there is a "choice" as to whether to be taxed as a single consolidated entity or to continue to be taxed as separate entities is a misnomer. It is submitted that part of the rationale for adopting a consolidated tax regime supports the continuation of the existing grouping provisions. Discussion Paper 2 states that:

> *"transactions between entities in a wholly owned group do not give rise to true income or deductions (in the same way that self dealing by an individual does not give rise to income or deductions)."* (paragraph 213 of the Overview)

Whether a group of wholly owned entities choose to consolidate or not does not detract from the fact that the entities are still wholly owned. By repealing the existing grouping provisions (rather than improving those provisions to achieve a comparable outcome with the consolidated tax regime), the proposal seems to counter the policy design principle of neutrality and substance over form as set out in *A Strong Foundation*. It would seem that issues such as loss cascading, loss/gain duplication and value shifting can be resolved independently of a consolidated tax regime without necessarily increasing the complexity of the current provisions dealing with such issues.

**Joint & Several Liability**

The National recognises the need for joint and several liability in relation to tax liabilities in a consolidated tax regime. However, Discussion Paper 2 is silent on the issue of continued joint and several liability where an entity exits a consolidated group and what procedures (if any) would be implemented. This aspect would create a distinction between acquiring an entity and acquiring the assets and liabilities of that entity, a distinction that the proposals are trying to remove.

Furthermore, as a financial institution, the concept of joint and several liability has the potential to impact on an individual entity's ability to raise finance or the cost of that finance.

**What Makes Up A Consolidated Tax Group?**

In particular, what impact does an interposed non-resident entity or life insurance company have on the ability to consolidate entities? It has been suggested that the existence of such entities in a corporate group would prevent the Australian resident companies that are ultimately wholly owned by either the non-resident entity or the life insurance company from forming part of a consolidated group with the remainder of the corporate group.

**The Characterisation of Transactions**

Whilst a transaction may be classified as being on revenue account for one entity, it may be on capital account for another. Discussion Paper 2 states that in the event that a unified treatment for investment assets is not adopted, the character of the transaction should be determined according to the character of the transaction in the hands of the group rather than the individual entity – transactions that would otherwise be on capital account in a subsidiary's hands may be on revenue account in the group's hands.

The consolidated tax regime is intended to address the problems identified above. Changing the character of a transaction from revenue to capital or vice versa by adopting a consolidated tax regime does not appear to be a stated objective and should not arise.

**Allocation of Expense Rules**

The deductibility of expenditure (and in particular interest expense) under a consolidated tax regime has not been specifically addressed in Discussion Paper 2. We understand (based on advice from the CTA) that the ATO/Treasury appears to be heading down the path of adopting tracing rules. Once again, this issue does not appear to be one of the stated objectives of the consolidated tax regime.

### Dividend Income

On a matter related to allocation of expense rules, if intra-group dividends are not assessable income, it is essential that the tax law specifically allow a deduction for interest on funds borrowed to acquire shares in an entity. Otherwise, this may jeopardise the deductibility of such costs as no assessable income is generated.

Quite independent from the consolidated tax regime is the issue of intercompany dividends. Under a consolidated tax regime, dividends between wholly-owned group entities would be ignored. However, dividends from outside a consolidated tax group would appear to continue to be treated under the rebate system. The issue of dividend rebate wastage therefore continues to be a problem not yet resolved. The National believes that an appropriate method to resolve this issue would be to allow a deduction to resident companies equal to the amount of dividend income that they receive to restore the tax losses that would otherwise be absorbed by the dividend income.

### Same Business Test

In a carry forward capital loss context, one needs to question the relevance of the same business test, particularly where the business of the entity has nothing to do with the circumstances which gave rise to the capital loss. The same business test also acts as a distraction to purchasers by forcing them to adopt a strategy which is sub-optimum in order to preserve the losses.

### Bringing Carry-Forward Revenue Losses Into A Consolidated Regime

Discussion Paper 2 sets out a number of options in relation to this issue. The National's preferred options on this issue are either the proportionate entitlement to the losses based on the group's interest in the loss entity when the loss was incurred or quarantine the losses within the group . The latter approach would require the separate identity of the loss entity to be maintained pending the recoupment of the losses.

## Recommendations

The National sees little benefit from the proposed consolidated tax regime as compared to the current system without substantial modifications to the proposal. One of the identified benefits of a consolidated tax regime is the reduction in compliance costs. However, a number of commentators have suggested, based on consolidated tax regimes in other jurisdictions, that compliance costs do not reduce and that the regimes are quite complex. This is also consistent with the National's own experiences in other jurisdictions that have consolidated tax regimes. The National does not see significant benefits to be obtained from overhauling the present compliance system. Furthermore, whilst "intra-group transactions and intra-group interests are ignored" for income tax purposes, other regulatory requirements prevent such transactions being ignored eg. stamp duty on transfers of land or shares between entities still require market value to be monitored. Records would presumably also need to be maintained for ATO audit purposes.

However, in the event that a consolidated tax regime were to proceed, the National makes the following comments in relation to the regime proposed in Discussion Paper 2:

- Measures arising from the consolidated tax regime ie. pooling of revenue/capital losses, foreign tax credits, franking credits, loss cascading, loss/gain duplication, value shifting, could be implemented outside a consolidated tax regime. (There are already measures in the current tax system to address the issues of loss duplication and value shifting)

- The choice to consolidate should be a 'real' choice by continuing the existing grouping provisions to ensure neutrality between a consolidated group and a non-consolidated group.

- Entities exiting a consolidated group should not continue to be potentially liable for the tax liabilities of that group. Otherwise a distinction will arise between acquiring an entity and acquiring the assets and liabilities of that entity will arise.

- Further detail is required in relation to the definition of a consolidated group and in particular, the consequences of interposed non-resident companies or interposed life insurance companies.

- The characterisation of transactions in a diverse group such as the National should not be determined based on the character of the transaction in the hands of the group but at the individual entity level. Similarly, clear rules on the allocation of expenses are required.

- Costs of funding the acquisition of shares in group entities should remain deductible despite the fact that the dividends paid by that entity are ignored and, therefore, do not constitute assessable income in a consolidated tax group.

- The dividend rebate system for dividends outside a consolidated group should be replaced with a dividend deduction regime ie. allowing the recipient a deduction equal to the amount of dividend income.

- Carry forward revenue losses and capital losses upon entering a consolidated regime should be based on a proportionate entitlement to the losses based on the group's interest in the loss entity when the loss was incurred or alternatively, should be quarantined within the group.

- The same business test in a capital loss context should be removed.

# Fringe Benefits Tax Appendix 11

This Appendix sets out the National's position in relation to the issues and options canvassed in Chapter 38 of Discussion Paper 2.

## Background

Discussion Paper 2 recognises the complexity and compliance costs associated with FBT. It makes a number of suggested changes including:

- The transfer of the tax liability from the employer to the employee. This will mean an extension of the current requirement to report all fringe benefits on an employee's group certificate.
- Changing the regime for taxing car benefits. The current system is seen as too concessional. Two options are proposed. The first is that car fringe benefits be valued on the basis that there is 20% business use, except where a higher business use by the employee is substantiated. The second involves altering the percentages in the current statutory method.
- Align the income tax year and the FBT year.
- Exempt on-premises parking and entertainment benefits.

## Analysis

The transfer of the tax liability to the employee would be more equitable because the value of the fringe benefits would be taxed at the individual employee's marginal tax rate rather than all benefits being taxed at the top marginal tax rate, as is currently the case. Taxing the individual employee would eliminate some of the foreign tax credit difficulties that can arise with expatriates where their home jurisdiction taxes benefits in the hands of the employee.

The proposed changes to the current system of taxing car benefits are revenue raising measures designed to curtail the current generous tax treatment. The revenue raised from the option to value car fringe benefits on the basis that there is a 20% business use will be $600 million annually as at 2003 – 04, on the basis that the benefit is taxed in the hands of the employee. The revenue raised should be higher if FBT continues to be a tax on employers. The second option to tighten the statutory car formula would raise an additional $500 million annually as at 2003 – 04. The current system is seen as beneficial particularly for employees on the highest marginal tax rate.

The current system of taxing on-premise parking and entertainment is seen as involving heavy compliance burdens with limited revenue raised. The revenue raised from the taxation of entertainment is $305 million per annum and is $80 million per annum for on-premises parking. These could form part of a total trade-off package.

## Recommendations

The National considers that the transfer of the FBT liability to the employee as being more equitable than the current system. Where benefits are fully costed to an employee's package, those employees on a marginal tax rate of less than 48.5%, will be better off in after tax dollar terms. There is no justification for the current system where these employees, effectively, pay FBT on their benefits at 48.5%.

There would be compliance costs associated with this change but these will be marginal, to some extent, because of the current requirement to report fringe benefits on group certificates. The taxation of employees would also overcome the foreign credit problems encountered by expatriates.

The Treasurer has indicated that this proposal is unlikely to be supported. It is unfortunate that the Treasurer has expressed this view because the proposal has merit and is worthy of more analysis.

There is significant revenue involved in the current taxation system of car benefits which is quite generous. This could form the basis of significant trade-off possibilities. The proposed changes will obviously impact on employees who receive car benefits. The attractiveness of salary packaging a car will decrease significantly for higher paid employees. However, the number of employees on lower tax rates that package cars may in fact grow.

Consequently, it is difficult to determine the impact of the proposed measures for lessors and car manufacturers. However, with the proposed changes to leasing and the imposition of GST the leasing industry, in particular, will be impacted significantly.

The National does not support the alignment of the FBT and income tax years. The current system facilitates the spreading of work loads more evenly.

The National would support the exclusion of on-premises car parking and entertainment. The trade-off for this cost to the revenue would be the proposed changes to the taxing of car benefits. The exclusion of these items would lead to a significant reduction in complexity and compliance costs.

# Taxation of Individuals Entering Australia Appendix 12

## Background

In order for the National to achieve its objective to be the world's leading financial services organisation it is imperative that the National is able:

- to attract high calibre executives to the Group; and
- be able to move these executives within the Group, in particular attract them to spend time on assignment in Australia so that they are able to share their specialist knowledge of world's best practice in their specialist area of expertise.

The National currently has approximately 40 inbound expatriates on assignment in Australia. In the majority of cases these executives are transferred from the United Kingdom, the United States of America and New Zealand, the major centres in which the National operates. As the National continues to expand its operations outside Australia and implement a globalisation strategy for all aspects of its business, the National will be actively seeking to increase the mobility of executives within the Group and hence will take the opportunity to bring executives to Australia from offshore jurisdictions.

The cost of employing an expatriate is significantly higher than employing a local employee. For the year ended 30 September 1998, it cost the National approximately 2.5 to 3.5 times an individual's ordinary salary to have an individual on expatriate assignment. In the National's case this cost is particularly high because of the geographic locations in which it operates. For example, the remuneration packages that executives in the United Kingdom and the United States of America obtain are generally higher than the remuneration packages of local employees. Nevertheless, the National believes it has to compete internationally for these executives as part of its global business strategy to ensure that it continues to attract the knowledge base to Australia, albeit that these executives may only stay for relatively short periods of time (up to 3 years).

## Analysis

In order to encourage the transfer and mobility of executives within the Group, the National has a tax equalisation policy in place in respect of the remuneration an executive obtains whilst on expatriate assignment. The tax equalisation policy means that where an executive is transferred from the jurisdiction in which s/he is employed (referred to as the employee's home country) to Australia the National is required to bear any additional taxation cost that the employee would suffer in relation to employment related income over and above the taxation cost that the employee would have paid on that same level of remuneration in the employee's home country.

As a consequence of the relatively high personal income tax rates in Australia, the impact of the National's tax equalisation policy is that the National itself incurs a significant cost when an executive is transferred to Australia. In addition to this increased cost, the National also has to pay substantial on-costs such as pay-roll tax, workers compensation, the superannuation surcharge contribution and fringe benefits tax on many of the expenses the National pays in order to provide the executive with the environment s/he requires to perform his or her job whilst on expatriate assignment.

Further, many inbound expatriates do not wish to subject their accumulated wealth to tax in Australia when the income associated with that wealth is already subject to tax in the executive's home country or the country of source. However, if the executive is regarded as a resident of Australia for tax purposes, the executive's worldwide income would be subject to tax in Australia with only a credit for any foreign tax paid on that income. Again, the relatively high personal income and capital gains tax rates in Australia mean that an additional tax impost is incurred by the executive on private (non-remuneration) income. In many instances the additional tax impost makes it uneconomical for an executive to want to accept an expatriate assignment in Australia. Both the National, and the Australian economy, lose the benefit of the executive's specialist knowledge and skills if the executive decides not to take up the assignment. The problem could be easily rectified if the executive was treated as a non-resident for the duration of his or her expatriate assignment.

The test as to whether a person is a resident or non-resident has always been a question of fact and degree and requires a detailed analysis of what is now relatively old case law that was decided in an era when human capital was far less mobile than it is today.

In an attempt to provide some certainty the Commissioner of Taxation issued an Income Tax Ruling, IT 2607, in 1990 which provided some certainty for individuals on expatriate assignment about whether they would be a resident or non-resident for Australian tax purposes. As a consequence of that ruling, industry practice was to generally treat a person who intended to visit Australia for less than two years as being a non-resident for Australian tax purposes. This practice was based on the view that a person really needed to be in Australia for two years before he or she could genuinely be regarded as a resident.

In 1998 the Commissioner reviewed IT 2607 and issued Taxation Ruling TR 98/17 which has the effect of treating a person who is present in Australia for only six months as a resident for Australian tax purposes. The National disagrees with the Commissioner's view and believes the issue of TR 98/17 will impede its ability to attract key executives to Australia in the future.

## Recommendation

The National recommends that a statutory definition of residency be enacted. This would reduce compliance costs for companies like the National because it would avoid the need to review every expatriate's facts and circumstances and hence achieve certainty for both the individual expatriate and the National. The statutory rule should take into account the practice in large multi-nationals that expatriate assignments can vary in term. In the National's case the average term of an expatriate assignment is between two and three years.