Review of Business Taxation

A Platform for Consultation

April 1999

Electricity Supply Association of Australia Limited

(ACN Number : 052 416 083)

Contents

Chapter 1.0 - Executive Summary

As noted in the covering letter to this submission, the Electricity Supply Association of Australia Limited ("ESAA") is generally supportive of the tax reform process embarked upon by the Government.

On a more specific level, ESAA has set out in this submission comments and recommendations in relation to a number of key issues that impact upon ESAA members and result from various options and alternatives raised in the Ralph Committee's second discussion paper "A Platform for Consultation" ("PFC"). Set out below is a summary of the relevant matters that are covered in more detail in the attached Chapters.

It is imperative that any reform to Australia's tax system be made cognizant of the objective of maintaining an internationally competitive environment for capital investment. Furthermore, the issue of international competitiveness for the major users of energy has profound implications for the electricity supply industry and for the national interest. Because of Australia's natural endowment of energy resources, the relatively low price of energy has contributed significantly to the development of energy intensive industries. These industries also tend to be capital intensive so that changes being considered to the treatment of capital allowances by the Review of Business Tax could have significant implications for them and, indirectly, for the electricity supply industry. If any changes to the tax system were to have adverse implications for industries in which Australia has a competitive advantage, it would need to be seriously questioned as to whether the changes were in the national interest.

Furthermore, consideration should also be given by the Review of Business Tax to the level of taxation concessions available in overseas jurisdictions. For instance, one of the factors contributing to the success of US companies in acquiring electricity assets in Australia has been the availability of concessions in the US for expenditure that would be considered "blackhole" expenditure in Australia.

The electricity industry itself is not currently in a position to determine the extent to which changes being considered by the Review of Business Tax would have serious adverse implications for major energy using industries. However, it is important that the implications of any changes be carefully weighed in the light of any supporting analysis that those industries are able to present. The ESAA of course supports the approach set out in *A Strong Foundation* whereby the national interest represents a key objective of the tax system. In this context, it is important to keep in mind that both natural advantage and aspects of public policy, including the tax system, have been instrumental in helping foster the development of energy and capital intensive industries in Australia. If changes to the tax system were likely to begin to unwind the direction of that policy, it would be questionable as to whether the disruption would represent a change that was in the national interest.

In light of the concerns set out herein in respect to the potential adverse impacts that may arise for taxpayers and the Australian economy in respect to the matters raised in the PFC, ESAA submits that further detailed consultation be undertaken before any of the reform measures are introduced in legislative form. This will give Australian taxpayers the opportunity to fully assess the impact of the proposals on their businesses, thereby allowing them to make informed decisions as to the direction of tax reform in Australia.

1.1 Changes to the Australian Company Imputation System

ESAA believes potential adverse implications will arise for ESAA members as a result of implementing any of the three alternatives as proposed. ESAA supports the retention of the existing dividend imputation regime to the extent relevant changes are not made to the proposed alternatives. (Suggested amendments that would improve the various alternatives are set out in Chapter 2). The principal issues associated with the alternatives are as follows:

- the deferred company tax (DCT) regime will potentially have an adverse impact on the reported after tax earnings of ESAA members;
- the DCT regime will adversely impact upon certain non-resident shareholders and thus provides a disincentive for foreign investment;
- the DCT regime discriminates against "tax-exempt owners" of Federal taxpaying entities through not facilitating a refund of DCT to such "tax exempt owners";
- neither the resident dividend withholding tax (RDWT) nor the inter-entity franking proposals achieves the Government's stated objective of preventing streaming; and
- the RDWT proposals have a potentially adverse impact for tax-exempt recipients of unfranked dividends (ie. through the imposition of RDWT on such amounts which are not refundable to such entities).

1.2 Treatment of Goodwill

ESAA supports the policy option which advocates the availability of amortisation deductions for purchased goodwill, as it exists in a large number of foreign competing jurisdictions. Such an alternative would reduce the disincentive that currently exists for foreign investment into the electricity industry as a result of the current treatment of goodwill for tax purposes.

1.3 Thin Capitalisation Proposals

To the extent changes to Australia's thin capitalisation provisions are considered desirable (which ESAA rejects), ESAA supports the adoption of reasonable "safe harbour" rules at first instance. Such an approach should serve to ensure that undue administrative burden is not placed upon ESAA members in monitoring this issue. Furthermore, appropriate transitional rules would need to be adopted that did not detriment the deductibility of interest associated with existing debt funding.

1.4 Introduction of a Consolidation Regime

ESAA supports the proposal to introduce a consolidation regime, subject to more detailed information being provided in respect of the rules that would apply and confirmation of the compliance and administrative efficiencies that would result. However, based on the detail set out in the PFC concerning the operation of the proposed consolidation regime, ESAA submits that:

- There is a need for transitional rules to assist wholly owned groups restructure where ultimate ownership of the group is with a non-resident entity, thereby excluding the group from the consolidation regime.
- Companies should be able to bring their carry forward losses into a consolidated group where the conditions satisfied in Option 2 on page 562 of the PFC are satisfied.
- Companies exiting a consolidated group should be attributed with so much of the carry forward losses, franking credits and foreign tax credits as is reasonably attributed to them.
- Further, consideration should be given to the implications that may arise in overseas jurisdictions for non-residents holding relevant interests in Australian consolidated groups.

1.5 Proposed Division 58 (Taxation Laws Amendment Bill (No 4) 1998)

The proposed legislation introducing Division 58 should be withdrawn because it is competitively disadvantageous for Australian entities competing against foreign competitors for the acquisition of exempt Australian Government agencies and assets sold by such agencies. There are also significant administrative and compliance issues associated with the proposed legislation which is counter to the Federal Government's broader tax simplification strategy. Further, it is arguably unsuccessful in achieving its objective of ensuring that a distinction is not made between the structures chosen to dispose of assets owned by an exempt entity.

1.6 Proposed Division 243 (Taxation Laws Amendment Bill (No 5) 1999)

Proposed Division 243 of Taxation Laws Amendment Bill (No 5) 1999 raises several concerns for ESAA members insofar as the circumstances in which it can apply and the events which can give rise to its application. While it is acknowledged that the current draft provisions are a significant improvement on the former draft provisions, there are still present in the current form certain features which have the potential to create undue hardship for ESAA members. This hardship will take the form of recalculated capital allowance deductions attributable to the ownership of certain property. The provision, which is essentially of an anti-tax avoidance nature, still has the potential to apply to ordinary commercial arrangements in circumstances that go beyond the mischief that was originally sought to be addressed.

Set out in Chapter 8 are suggested amendments to the proposed Division 243 which seek to address the potential inequities that exist.

1.7 Treatment of Capital Contributions/Contributed Assets

ESAA supports the tax treatment provided under each of the State tax equivalents regimes in relation to this matter. In broad principle, that approach is to adopt a “tax neutral” approach to such contributions. It is submitted that such an approach be statutorily adopted within the Federal income tax regime. Such an approach would ensure tax considerations do not unduly influence investment decisions with respect to extending electricity infrastructure.

To the extent that the approach adopted under each of the State tax equivalents regimes is not considered appropriate, ESAA recommends an approach similar to that applying in the USA. That is, capital contributions should not be assessable in the recipient’s hands where the contribution received does not reasonably relate to the provision of services by the recipient to or for the benefit of the benefactor of the contribution.

1.8 Easements Over Land

ESAA submits that the costs incurred in securing easements over land for the erection of electricity infrastructure should be included in the proposed framework for the taxation of non-wasting assets and should be subject to straight line amortisation over a reasonable period, notwithstanding that the right of access conferred on an easement is generally attached to the land and usually exists for an indefinite period of time. These easement costs are a genuine, unavoidable, regular and ongoing expense for many ESAA members.

1.9 Taxation of Financial Arrangements

ESAA supports the proposal to introduce hedging rules as part of a general code for the taxation of financial arrangements. ESAA’s support, however, is conditional upon such rules matching the taxation treatment of the relevant hedge with that of the underlying transaction so as to ensure no mismatch occurs between the taxation treatment of the hedge and the underlying hedge transaction.

2.0 Taxation of Leases

ESAA does not support the general reform of the taxation of leasing on the basis that the current leasing rules provide a positive impact on the economy and can facilitate the timely development of infrastructure through an effective lower cost of funds. However, ESAA supports the reform of the existing provisions relating to tax-exempt leasing. In particular, ESAA supports the enactment of a set of principles fashioned in consultation with the industry and relevant stakeholders to replace the draconian tax treatment afforded to leases and other transactions to which Section 51AD applies, and the cumbersome approach required in practice to determine whether the Australian Taxation Office will seek to apply Section 51AD / Division 16D to a particular transaction.

2.1 Fringe Benefits Tax Matters

ESAA supports the proposal to reform the current fringe benefits tax (FBT) regime as set out in the Fringe Benefits Tax Assessment Act 1986 (Cth). This is on the basis that the current FBT regime has become overly cumbersome, leading to significant administrative costs being incurred by employers. In particular, ESAA supports the proposal to exclude entertainment and on-premises parking from the FBT regime, as well as introducing less burdensome rules for valuing car fringe benefits.

In respect to the proposal to transfer the liability for non-cash benefits from employers to employees, ESAA is sceptical that it will achieve the desired outcome of reducing the administrative costs associated with the current FBT regime. ESAA submits that this outcome will only be achieved if the valuation rules used to value the benefits in the employee's hands were less administratively burdensome than those operating under the current regime.

2.2 Abolition of Accelerated Depreciation/Reduction in the Corporate Tax Rate

The proposal to remove accelerated depreciation with a commensurate reduction in the corporate tax rate will have a significant and varied effect on ESAA members.

ESAA is not currently able to make informed comments in respect to this proposal. However, ESAA is presently undertaking a modelling exercise to quantify the effect on ESAA members of this proposal. It is anticipated that once this exercise is completed, the results will form an addendum to this submission.

Chapter 2.0 - Changes to the Australian Company Imputation System

2.1 Overview

Chapter 15 of the PFC proposes changes to the Australian company imputation system. In particular, Chapter 15 proposes three options to replace the existing company imputation system. These three options are as follows:

- impose a DCT; or
- apply a RDWT; or
- tax unfranked inter-entity distributions.

The reasons stated for the changes to the existing imputation system include the following:

- to remove tax preferences on corporate profits at the point that they are distributed to non-residents;
- to remove tax preferences on corporate profits at the point that they are distributed to residents;
- to reduce the compliance burden associated with the operation of the existing company imputation system; and
- to reduce or eliminate the scope for streaming of franking credits and thereby reduce or eliminate the need for anti-avoidance rules.

Recommendation/Submission

ESAA submits that each of the options proposed as alternatives to the current company imputation system set out in the PFC create potential issues for various ESAA members. In the absence of amendments to each of the proposed alternatives, ESAA would favour retention of the existing regime. This is on the basis that:

(i) the current company imputation system is not as complex as implied in the PFC;

(ii) the disadvantages associated with the options canvassed in the PFC outweigh the benefits that they may offer; and

(iii) the existing anti-avoidance measures are sufficient to prevent improper access to imputation benefits through dividend streaming.

Further, to the extent there are any perceived difficulties or complexities associated with the current company imputation system, ESAA submits that they can be adequately dealt with as part of the Tax Law Improvement Project.

If it is considered imperative that the current company imputation system be changed, ESAA submits that the third alternative, to tax unfranked inter-entity distributions is likely to produce the least adverse implications both from an entity and shareholder perspective.

2.2 Discussion

As discussed above, there are a number of aspects of each of the options being canvassed as alternatives to the current company imputation system that are of particular concern to ESAA members. These concerns are set out in detail below.

2.2.1 Deferred Company Tax

As discussed in the PFC, the proposed DCT regime would broadly operate as follows:

- all distributions of tax-preferred profits would be taxed (at the company tax rate) at the entity level;
- company tax paid would be creditable under the imputation system to resident individual shareholders, trust beneficiaries, members of co-operatives, life insurance policyholders or partners in a limited partnership;
- DCT would apply to distributions of tax-preferred income from one entity to another, with arrangements to ensure that double taxation did not occur through the entity chain.

Based on the detail of the DCT regime provided in the PFC, ESAA has identified the following features of the DCT regime that are of particular concern to ESAA members. The concerns which have been identified are discussed on two levels:

(i) where ESAA members make distributions of tax-preferred profits; and

(ii) where ESAA members are in receipt of distributions made out of tax-preferred profits.

2.2.1(i) In respect to (i) ie where ESAA members make distributions of tax-preferred profits, the following concerns are raised:

(a) The Effect on Corporate Profits

As discussed in the PFC, one of the most identifiable implications resulting from the proposed DCT regime will be the fact that the reported after-tax profits of entities required to pay DCT will be significantly reduced. This is despite the fact that the mechanism of payment has the equivalent effect of a withholding tax.

PFC, however, goes on to state that “markets and shareholders would need to appreciate the impact of the change on those listed companies deriving significant tax-preferred income”.

ESAA submits that it is unrealistic to expect that market analysts and international and national shareholders will consider the impact that the DCT regime will have on a company's after-tax profits in analysing a company's performance. This is particularly so given that on an international comparison, only a minority of Australia's major trading partners have chosen to adopt a DCT system.

Accordingly, should the DCT regime be introduced, ESAA members in receipt of tax-preferred income will report lower after-tax profits. The reporting of lower after-tax profits will adversely affect the ability of ESAA members to attract foreign capital for business expansion. Such an effect of potentially discouraging foreign investment is contrary to the Government's tax reform objectives.

(b) Perceived Reduction in Complexity

In the PFC, a major incentive for introducing changes to the company imputation system is the perceived complexity associated with the existing company imputation system. In particular, the following aspects of the company imputation system were highlighted as being complex and incentive enough to replace the current system:

At the company level:

(i) The requirement to maintain a franking account and calculate the required franking amount; and

(ii) The requirement to ensure that the dividend streaming rules are not breached.

The company imputation system has been operating in Australia for approximately ten years. Anti-streaming rules have been in place in various forms for many years and have recently been further strengthened. Accordingly, ESAA members, their external advisers and corporate Australia at large have had adequate time to understand the operation of the company imputation system. Further, appropriate systems have been established to ensure that compliance with the company imputation system is not overly burdensome and creates no difficulties in its application. Accordingly, ESAA does not believe that the anticipated reduction in compliance costs associated with the company imputation system supports the proposals canvassed in the PFC. Further, even if the reduction in compliance costs was considered an argument in favour of reform to the company imputation system, ESAA submits that the options canvassed in the PFC do not achieve this outcome.

At the shareholder level:

(i) The fact that dividends paid are franked at varying levels, requiring shareholders to apply different gross-up rates to their dividends in order to include the amount of tax paid at the company level in their assessable income.

ESAA submits that complexity at the shareholder level is not an argument in favour of reforming the company imputation system. This is so, particularly in light of the fact that:

(i) the formula used by shareholders to gross-up unfranked dividends is simply:

$$A \times {}^{36}/_{64}$$

Where:

A = the franked amount of the dividend;

(ii) a resident company which pays a frankable dividend to a shareholder must give the shareholder, before or at the time of the payment, a statement setting out details of the dividend and its franked (or non-franked status).

On this basis, ESAA finds it hard to reconcile the statement that complexity at the shareholder level is a valid argument in favour of replacing the company imputation system. Furthermore, any perceived complexity could be resolved through a system which provides for full refunds of imputation credits.

(c) *The Effect on Non-Resident Shareholders*

As discussed in the PFC, one of the implications of imposing a DCT on distributions of tax-preferred income to non-resident shareholders is that such distributions would attract the company tax rate (36%), rather than dividend withholding tax which generally applies at a 15 per cent rate (in respect of unfranked dividends paid to "Treaty country" recipients).

ESAA submits that imposing the DCT on distributions made to non-resident shareholders will further inhibit the attractiveness of Australian entities as destinations for foreign investment capital. This will significantly reduce the ability of ESAA members to attract foreign capital for business expansion. This is on the basis that:

- Assuming a corporate tax rate of 36%, the imposition of DCT on unfranked dividends paid to non-resident shareholders will decrease the after tax return to such shareholders by 21% of the tax preferred profits of the underlying entity (the difference between the corporate tax rate (36%) and the current dividend withholding tax rate (15%) assuming a "Treaty country" dividend recipient). The tax neutrality of this approach for a non-resident non-portfolio investment is dependent on the non-resident obtaining a foreign tax credit in their home jurisdiction for such underlying taxes paid. Where such foreign tax credits are, for various reasons, not available, the efficiency of such non-portfolio investments is dramatically reduced.

- As suggested in the PFC (refer Chapter 30), as a result of the withholding on distributions of tax-preferred profits to non-residents, a company tax / dividend withholding tax switch will be required, particularly for portfolio investments. Such an approach appears to be based on a similar regime which operates in New Zealand. This switch will be to ensure that there is an increase in the creditability of Australian tax in the home country of the non-resident shareholder.

  ESAA, however, is sceptical of this approach, and in particular the perception that this will give to overseas taxing authorities. That is, it may be seen as an attempt to erode the taxing rights/tax base of overseas jurisdictions in respect to shareholders that invest in Australia.

2.2.1(ii) In respect to (ii) ie where ESAA members are in receipt of distributions made out of tax-preferred profits, the following concerns are raised:

(a) Effect on State Governments

The DCT model is essentially a tax on State Governments and other tax exempt entities that invest in entities subject to Federal income tax that would be subject to the proposed DCT regime. This is of particular concern to ESAA given that a number of ESAA members are State/Territory bodies (ie. wholly owned by the relevant State/Territory Government) that are currently exempt from Federal income tax pursuant to Division 1AB of the Income Tax Assessment Act 1936.

These proposals will have a potentially greater impact to the extent the exemption afforded by Division 1AB is removed in the future (as is anticipated) and the abovenoted entities themselves become subject to Federal income tax. In that event, the relevant State Government shareholders will be severely detrimented in respect of dividends received which are paid out of tax preferred income.

Based on the current proposals in the PFC, distributions to State Government shareholders and other tax exempt entities made out of tax-preferred profits will attract the imposition of DCT at the rate of 36%. In the absence of the DCT regime, these distributions would not have been subject to taxation. Accordingly, State Government and other tax exempt investors will be worse off to the extent of the deferred company tax paid at the corporate level.

2.2.2 Resident Dividend Withholding Tax

As discussed in the PFC, the proposed RDWT would broadly operate as follows:

- A RDWT would be levied on unfranked distributions paid from a resident entity to resident investors.
- Unfranked distributions paid to foreign investors would be subject to the existing non-resident dividend withholding tax (generally levied at the rate of 15 per cent).
- Where distributions that are paid between resident entities are subject to the RDWT and are subsequently passed to foreign investors, the RDWT would be refunded and non-resident dividend withholding tax applied to the cash dividend plus refund.

Based on the detail of the RDWT provided in the PFC, ESAA has identified the following features of the RDWT that are of particular concern to ESAA members.

2.2.2(i) The Effect on Corporate Profits

Where ESAA members are in receipt of distributions out of tax-preferred profits that attract the imposition of the RDWT, their after-tax profits will be reduced by the amount of the RDWT. That is, the after tax profits of ESAA members will be reduced by 36% in respect of that income. This is regardless of the fact that where those profits are subsequently distributed to non-residents, the RDWT may eventually be refunded.

Lower after tax profits may affect the ability of ESAA members to attract foreign investment capital.

2.2.2(ii) Effect on State Governments

The RDWT imposes the same potential issues for State Government shareholders and tax exempt recipients of distributions of tax-preferred profits, as that applying under the DCT regime.

That is, the imposition of the RDWT on distributions made to State Government shareholders and other tax exempt entities amounts to a tax on these entities, where income derived by them would otherwise be exempt from Federal income tax.

2.2.3 Taxation of Unfranked Inter-entity Distributions

As discussed in the PFC, the proposal for the taxation of unfranked inter-entity distributions would broadly operate as follows:

- Distributions of tax-preferred income to residents would be taxed in the hands of resident recipients:
  - in the case of individuals or private companies, this would be equivalent to the current treatment of taxing unfranked dividends;
  - in the case of entity shareholders, this would mean that they would be taxed on unfranked distributions, compared with having the benefit of the Section 46 rebate, which allows the distribution to flow through untaxed.
- Distributions to non-residents would continue to be subject to dividend withholding tax.

Based on the detail of the proposal to tax unfranked inter-entity distributions provided in the PFC, ESAA believes this option is the least offensive option canvassed in the PFC. This is on the basis that:

- it does not have burdensome compliance obligations; and
- it should have less of an impact on reported after tax earnings.

Recommendation/Submission

ESAA submits that each of the options proposed as alternatives to the current company imputation system set out in the PFC create potential issues for various ESAA members. In the absence of amendments to each of the proposed alternatives, ESAA would favour retention of the existing regime. This is on the basis that:

(i) the current company imputation system is not as complex as implied in the PFC;

(ii) the disadvantages associated with the options canvassed in the PFC outweigh the benefits that they may offer; and

(iii) the existing anti-avoidance measures are sufficient to prevent improper access to imputation benefits through dividend streaming.

Further, to the extent there are any perceived difficulties or complexities in the current company imputation system, ESAA submits that they can be adequately dealt with as part of the Tax Law Improvement Project.

If it is considered imperative that the current company imputation system be changed, ESAA submits that the third alternative, to tax unfranked inter-entity distributions is likely to produce the least adverse implications both from an entity and shareholder perspective.

Chapter 3.0 - Treatment of Goodwill

3.1 Overview

The Australian tax system allows depreciation deductions for "plant" (physical assets), but is selective in allowing depreciation or amortisation of intellectual and intangible property. In particular, under current law in Australia, the purchase cost of intellectual property bound up in business goodwill cannot be written off or amortised.

A new policy framework for taxing wasting and non-wasting assets in a simplified, fair and consistent manner is outlined in the PFC. ESAA members support the development of such a framework and note that the design features of the integrated model for capital allowances outlined in the PFC are subject to consultation.

The PFC proposes two policy options for the tax treatment of goodwill. The first option allows acquired goodwill to be depreciated but on the further sale of the business, the total goodwill less any undeducted acquired goodwill would be subject to tax. The second option is to retain the current treatment.

Recommendation/Submission

The acquisition of goodwill is a legitimate expense incurred in the acquisition of a business and should be able to be written off for tax purposes in the same way as acquired plant and equipment. Disallowing amortisation of acquired goodwill leaves Australian entities at a competitive disadvantage as compared to its competitors in countries such as the US, Japan, Canada, Germany etc when competing for the acquisition of assets.

3.2 Discussion

There are currently no provisions which allow taxpayers to deduct or amortise the cost of acquired goodwill. However, acquired goodwill is currently taxed under the capital gains tax ("CGT") provisions although we note that for businesses with net assets of less than $2.2 million, 50 per cent of the value of goodwill disposed of is exempt for CGT. This means that the Australian tax system is non-neutral in its treatment of intangible property vis-à-vis its treatment of physical assets.

The Committee suggests that there are significant practical difficulties in ascribing valuations to goodwill, particularly in cases where vendors seek to maximise the tax benefits associated with the CGT goodwill exemption by reducing the values of other business assets. However, in our experience, market forces and the competing interests of purchasers will dictate that reasonable values are in fact ascribed for goodwill. A vendor's preference is balanced out by the competing interests of the purchaser who would generally seek to minimise the value ascribed to goodwill which is amortised for accounting purposes thereby reducing reportable profits.

We stress that the electricity industry is particularly disadvantaged under the present law. Not only does the proposed Division 58 (refer Chapter 6 below) potentially limit the ability of ESAA members to claim depreciation deductions, ESAA members will also be unable to obtain goodwill deductions. Each of these factors individually results in a significant competitive disadvantage, however, the combined impact of these two factors is fundamentally detrimental to the continued development and growth of our infrastructure industries.

ESAA submits that the acquisition of goodwill is a legitimate expense incurred in the acquisition of a business and should be able to be written off for tax purposes in the same way as acquired plant and equipment. This would also be consistent with the accounting treating in Australian Accounting Standard AASB 1013 *Accounting for Goodwill* ("AASB 1013"), which requires acquired goodwill to be amortised on a straight line basis over the period during which the benefits are expected to arise but not exceeding 20 years from the date of acquisition.

As noted in *An International Perspective*, in half of the 27 countries surveyed, acquired goodwill is deductible over periods ranging from 5 to 20 years. For example:

- the US allows amortisation of acquired goodwill at the rate of 6.67 per cent per annum;
- Japan allows amortisation of acquired goodwill at the rate of 20 per cent per annum;
- Germany allows acquired goodwill to be amortised over 15 years; and
- Canada allows 75 per cent of the cost of acquired goodwill to be amortised at the rate of 7 per cent (declining balance) per annum.

ESAA further notes that many of the ESAA members are the subjects of, or bidders involved in, the acquisition of electricity infrastructure assets. It has been ESAA's experience that Australian investors are often significantly disadvantaged in establishing their tender price as a direct result of their inability to obtain amortisation deductions for acquired goodwill when compared with their competitors from the US and other countries which do permit the amortisation of goodwill. Inevitably, the sale will fall into the hands of foreign investors. Whilst the encouragement of foreign investment is desired, so too is the development of local industries and the ultimate retention of capital in Australia.

Recommendation/Submission

ESAA recommends that amortisation of acquired goodwill be allowed in Australia. ESAA notes that even if amortisation is permitted, then depending on the rate and time period over which the goodwill can be amortised, it may not necessarily extend so far as to provide Australian entities with a competitive advantage over their counterparts from other counties, but it should seek, as a minimum, to place Australian entities on a level playing field.

The approach under Option 1 proposed by the Committee is appropriate and would bring to tax, over time, the same amount of goodwill as the current system. As also recognised by AASB 1013, certain elements contributing to the future income flows of a business that are captured in acquired goodwill may have a finite life. Such elements include the service life of employees, expected actions of competitors and relevant legal and contractual provisions.

Chapter 4.0 - Thin Capitalisation

4.1 Overview

The PFC indicates that foreign controlled groups often have the flexibility to allocate a disproportionate amount of debt to Australia. Such debt could either be related party or third party debt. The PFC then states that Australia's current thin capitalisation rules are not fully effective in preventing excessive leveraging of Australian operations by foreign controlled multinationals because the rules only look to foreign related party debt and foreign third party debt, which is guaranteed or secured by a foreign related party, rather than total debt.

The PFC proposes the following two options for strengthening the thin capitalisation rules:

1. The Australian operations could be geared up to the gearing level of the worldwide group for interest deductibility purposes. If that level is exceeded, an arm's length test would determine whether the gearing level of the Australian operations is higher than that which would be expected in a comparable independent operation.

2. Under the second option, a "safe harbour" gearing ratio would be specified (possibly less than the current ratio of 2:1). If this safe harbour ratio is exceeded, then gearing up to the gearing level of the worldwide group would be permitted if it is higher than the safe harbour ratio. The PFC further intimates that it would also be possible to incorporate an arm's length test (similar to the one under Option 1) within this option.

Recommendation/Submission

ESAA submits that there is no logical reason for imposing gearing restrictions on borrowings from unrelated lenders, particularly in circumstances where Australian owned entities are not so restricted. Such rules would provide a disincentive for foreign investment into Australia.

However, if it is considered necessary to effect such changes, ESAA submits that the best option for tightening the thin capitalisation provisions without unduly affecting the cost of capital and the level of foreign investment in Australia, is to use a safe harbour ratio which is set at such a reasonable level.

Further, if the safe harbour ratio is breached, an arm's length test could be used. However, ESAA does not believe that the benefit of using a worldwide group comparative outweighs its costs and in any event, such a test would be fraught with many impracticalities. In any event, existing loan arrangements should be grandfathered.

4.2 Discussion

ESAA does not support the proposed "tightening" of the thin capitalisation provisions. Such proposals provide a clear disincentive for investment into Australia. Notwithstanding, we have set out below comments in relation to the alternative considered in the PFC if such changes are considered necessary.

As recognised in the PFC, benchmarking against the gearing level of the worldwide group would require the collection of worldwide data. Practically, such an exercise would be costly, time consuming and administratively complex. In some cases the information would be very difficult to obtain. All of these factors run counter to the dual aims of simplicity and reducing compliance costs for taxpayers.

As regards the proposed use of an arm's length test in Australia, ESAA notes that whilst this option appears reasonable, it is not without a significant compliance cost for taxpayers. The test requires a comparison of the gearing level of the Australian operations with that attainable by a comparable independent operation.

The PFC anticipates that this option would be more flexible because it would allow the financial markets to limit gearing rather than setting statutory limits. ESAA agrees that this appears to be a sensible result, particularly in cases where bids (eg for electricity infrastructure) are supported by project financing which may in itself justify a higher gearing level.

Notwithstanding the above, the exercise of determining a gearing ratio for a comparable independent operation is a purely theoretical one which will likely involve expending much time and cost. A comparable operation may in fact give rise to a range of appropriate gearing levels as is evident by the range of bid prices which have been submitted in the past for the acquisition of various electricity related infrastructure.

Further, a comparable independent operation test raises all of the issues that are associated with the existing transfer pricing provisions, such as access to comparable data. In addition, it is noted that the arm's length test is impractical and is of questionable value when one considers that the level of a taxpayer's gearing is, to an extent, referable to the rate of interest that the taxpayer is willing to pay. Therefore, a comparable independent operation could in fact have a relatively high level of gearing simply by choosing to pay a higher interest rate to its lenders.

As regards the safe harbour ratio referred to under Option 2, we submit that if a safe harbour ratio is used, it should be set at a reasonably high level so that inward investment is not discouraged. The thin capitalisation rules are primarily an anti-avoidance rule and should therefore only be targeted at cases where there is a presumption of abuse. If an unreasonable ratio is set, it would result in foreign know-how and capital being redirected to other jurisdictions which offer more favourable interest deductibility terms. Such a result would be in direct conflict with the objective of improving Australia's climate for investment and productivity through creating a more competitive business environment.

The nature of the investment activities undertaken by ESAA members will generally result in relatively high gearing ratios being sustained in the earlier years as major infrastructure projects are being financed upfront. Certainly, we have had indications from some ESAA members that should the safe harbour ratio be set at an unreasonably low level, the resulting increase to their cost of capital would be a sufficient incentive for them to not only avoid further investment in Australia but to also seriously consider divesting themselves of their current Australian investments.

Recommendation/Submission

ESAA submits that the best option for tightening the thin capitalisation provisions without unduly affecting the cost and level of foreign investment in Australia, is to use a safe harbour ratio which is reasonable. If the safe harbour ratio is breached, an arm's length test could be used. However, ESAA does not believe that the benefit of using a worldwide group comparative outweighs its costs and in any event, such a test would be fraught with impracticalities.

Should one of the two options proposed in the PFC for tightening the thin capitalisation provisions be adopted, ESAA submits that Option 2 be used with a reasonable safe harbour ratio. From a compliance viewpoint, this option would be simpler and administratively less costly than Option 1 because taxpayers who fall within the safe harbour ratio would not need to proceed with determining the worldwide group gearing level.

Whilst the rules will only apply prospectively from 1 July 2000 (potentially earlier for entities with substituted accounting periods), they could potentially apply to interest payments made after that date, even if the loan has been in place for many years. In this regard, we submit that as a minimum, grandfathering of existing loans should be made available regardless of which option is adopted.

Chapter 5.0 - Introduction of a Consolidation Regime

5.1 Overview

Chapters 25-27 of the PFC propose changes to the present tax system whereby each company in a wholly owned group is taxed as a separate entity. In particular, Chapters 25-27 propose to achieve a fairer system than that currently applying by introducing a consolidation regime. Under the consolidation regime, wholly owned groups will be taxed as single entities.

In the PFC, the reasons stated for the introduction of a consolidation regime include the removal of the following perceived deficiencies in the current system:

- the tax impediments to business organisation;
- compliance costs associated with dealing with intra-group transactions and intra-group interests;
- tax avoidance achieved through manipulating dealings between group companies;
- opportunities for companies to use a chain of companies to create multiple tax losses based on one initial economic loss – loss cascading and loss duplication;
- an economic gain being taxed twice – once on the sale of the asset or interest and then again on the disposal of equity; and
- opportunities for companies to transfer assets at under or over value between themselves to create artificial tax losses where no economic loss exists.

ESAA understands that the proposed consolidation regime will broadly operate as follows:

- Wholly owned entities may choose to consolidate where there is a resident holding entity at the head of the group.
- Where wholly owned entities consolidate, all wholly owned entities of the holding entity must be included in the consolidated group, including entities acquired in the future.
- Where wholly owned entities consolidate, the wholly owned group will be treated as a single entity for taxation purposes. All transactions between the members of the consolidated group will be ignored for income tax purposes.
- Where wholly owned entities choose not to consolidate, the group entities will continue to be taxed as separate entities.
- Once the consolidation regime commences, the current tax loss and rollover relief grouping provisions will be repealed.

Based on this analysis, the following matters have been raised as being of particular concern to ESAA members:

- The need for a resident Australian holding company.
- The fact that in many instances, companies with carry forward losses will forfeit those losses upon entry to the consolidated group.
- Upon exiting the consolidated group, companies will not be attributed with any part of the carry forward losses, franking credits or carry forward foreign tax credits associated with the group.
- The impact on foreign owned consolidated groups.
- That any such regime must be administratively simple and not require that detailed records be retained in any event as has been the case for similar regimes in other jurisdictions, eg New Zealand.

Recommendation/Submission

ESAA supports the proposal to introduce a consolidation regime, subject to the regime delivering administrative simplicity. However, based on the information set out in the PFC concerning the operation of the proposed consolidation regime, ESAA submits that:

- There is a need for transitional rules to assist wholly owned groups restructure where ultimate ownership of the group is with a non-resident entity, thereby excluding the group from the consolidation regime.
- Companies should be able to bring their carry forward losses into a consolidated group where the conditions satisfied in Option 2 on page 562 of the PFC are satisfied.
- Companies exiting a consolidated group should be so much of the carry forward losses, franking credits and foreign tax credits as is reasonably attributed to them.
- Further, consideration should be given to the implications that may arise in overseas jurisdictions for the non-resident holding companies of Australian consolidated groups.

5.2 Discussion

5.2.1 The Need for a Resident Australian Holding Company

As discussed above, entities within a wholly owned group will not be able to elect to consolidate unless there is a resident Australian holding company. That is, consolidation will only be available to a group where ultimate ownership of the group is with an Australian resident company. Where there is a resident Australian holding company, all wholly owned entities of the holding entity must be included in the consolidated group.

In respect to the requirement to have a resident Australian holding company, ESAA has identified the following adverse impacts:

(i) Application to foreign owned Australian entities that are not held by a common Australian resident parent.

Some existing groups in Australia (particularly where two or more companies are each 100% subsidiaries of the same non-resident entity), will not currently be able to elect to consolidate. Accordingly, if as proposed the current grouping provisions are repealed, this will mean that such entities either:

(a) will be required to operate in a regime whereby they are at a distinct disadvantage to group entities that in effect are still able to access the benefits of the tax loss and rollover grouping provisions through consolidation; or

(b) will be required to restructure their group so as to incorporate a resident Australian holding company.

ESAA submits that (a) is an unlikely option for most companies in Australia, and accordingly, groups in Australia where there is no resident Australian holding company will be required to restructure their group so as to be in a position to consolidate. It is submitted that requiring such entities to restructure their group so as to incorporate a resident Australian holding company will give rise to potentially significant restructuring costs, both in Australia and overseas.

Recommendation/Submission

ESAA submits that transitional arrangements should be introduced to assist foreign owned entities form a consolidated group by establishing a resident Australian holding entity. Further, consideration should be given to the adverse implications that will arise in overseas jurisdictions for non-resident holding companies where their Australian group is required to restructure so as to be in a position to consolidate.

5.2.2 Forfeiture of Tax Losses on Entry

Based on Principle 4 of Chapter 26 of the PFC, a company or trust entering into a consolidated group will be able to bring its carry forward losses into a consolidated group consistent with the principles underlying the existing law. Within the consolidated group, any losses will be pooled.

However, as discussed in the PFC, the existing rules for carrying forward and transferring losses do not blend well with the proposed consolidated group tax regime. This is because these carry forward and transfer tests have as a precondition to their application satisfaction of the following tests:

(i) in respect to the carry forward of tax losses:

- the continuity of ownership test; or
- the same business test.

(ii) in respect to the transfer of tax losses:

- the continuity of ownership test or same business test; and
- the requirement to be part of a wholly owned group.

In the context of a consolidated group, it would not be uncommon for group members to fail these tests on the basis that:

- so far as the continuity of ownership test is concerned: the loss company may have been acquired by the group members after the year in which the loss was incurred;
- so far as the same business test is concerned: as the consolidated group will be treated as a single entity, the same business test will not be applied to the individual entity, but rather to the group as a whole. Accordingly, the consolidated group as a whole must be considered to be carrying on the same business as the loss entity was when the loss was incurred; and
- so far as the requirement to form part of a wholly owned group is concerned: the loss company may not have become 100% owned by the group members until after the year in which the loss was incurred.

Based on the above, should the existing law be the basis upon which carry forward losses are brought into a consolidated group, in reality this may mean that many carry forward losses may be forfeited on entry into the consolidated group.

ESAA submits that the forfeiture of these carry forward losses upon consolidation is an entirely unacceptable position. This is particularly so as in most circumstances, companies will have no other choice but to consolidate. Accordingly, ESAA supports the Committee's proposal to identify options enabling entities to carry forward losses into a consolidated group.

ESAA has reviewed the options canvassed in Chapter 26 of the PFC for enabling entities to bring carry forward losses into a consolidated group.

ESAA submits that Option 2 is the most equitable option canvassed in the PFC. That is, in the absence of allowing all carry forward losses to be brought into a consolidated group, companies should be able to carry forward their losses into a consolidated group provided that one of the following tests is satisfied:

- The continuity of ownership test in the year in which the loss was incurred and the year of transfer into consolidation. This is consistent with the current rules in respect to the transfer and carry forward of tax losses. Requiring the companies to have been part of a wholly owned group in the loss year, the income year and all intervening years would result in the denial of tax losses that would otherwise have been available to be carried forward.

- A modified same business test in the year in which the loss was incurred and a specified period immediately before entry into consolidation. If this test was satisfied, the carry forward loss would be able to be claimed by the consolidated group over a period (eg. 10 years) beginning with the year of income in which the loss was transferred.

Recommendation/Submission

ESAA submits that the rules governing whether companies can bring their carry forward losses into a consolidated group should not be based on the existing rules for carrying forward and transferring losses. Rather, a similar test to that canvassed in Option 2 on page 562 of the PFC should be adopted.

5.2.3 The Fact that Carry Forward Losses and Franking Balances are to Remain with the Consolidated Group on an Entity's Exit

Based on Principle 5 of Chapter 26 of the PFC, companies exiting a consolidated group would be unable to take with them:

- carry forward losses;

- franking credits; or

- carry forward foreign tax credits.

ESAA submits that this is an undesirable outcome of the proposed consolidation regime and that alternatives should be sought that allow accreditation to members exiting the consolidated group.

In reality, even under a consolidation regime, entities within the group will maintain separate records showing their taxable income, level of dividends, receipt of foreign income etc. These records could be used as the basis of accrediting members exiting the consolidated group with carry forward losses, franking credits and carry forward foreign tax credits. However, in that event, questions must be asked as to whether the intended objective of creating administrative simplicity would be achieved.

Recommendation/Submission

ESAA submits that entities exiting the consolidated group should be accredited with so much of the following balances as is reasonably attributable to them:

- carry forward losses;
- franking credits; and
- foreign tax credits.

5.2.4 Implications for Non-resident Holding Companies

It has been identified that adverse implications may arise in certain foreign jurisdictions in relation to the ability to obtain foreign tax credits in those jurisdictions for lower tier Australian tax paid, where the tax is paid by a representative member of a consolidated group.

It is submitted that further consideration of such implications is warranted in order to ensure Australia does not become uncompetitive as a destination for foreign capital investment in infrastructure.

Chapter 6.0 - Proposed Division 58

6.1 Overview

Division 58 introduces a new regime for the calculation of depreciation in respect of the privatisation of exempt Australian Government agencies and for assets sold by these agencies, where the purchase of the assets are associated with the purchase of a business that had previously been conducted by an exempt entity. The legislation also modifies the existing “Rule the Books” legislation contained within Division 57 of the Income Tax Assessment Act 1936. Further, the legislation is broader than the scope of the Budget announcement in the way that it applies to the outsourcing of Government functions.

In view of the competitive disadvantages that Australian entities already face with the inability to amortise acquired and created goodwill, ESAA submits that if Division 58 is enacted, as proposed in Taxation Laws Amendment Bill (No.4) 1999 (TLAB 4), it would only serve to further impact adversely on Australia’s international competitiveness.

Recommendation/Submission

The proposed legislation introducing Division 58 should be withdrawn because it is competitively disadvantageous for Australian entities competing against foreign competitors for the acquisition of exempt Australian Government agencies and assets sold by such agencies. There are also significant administrative and compliance issues associated with the proposed legislation which is counter to the Federal Government’s broader tax simplification strategy. Further, it is arguably unsuccessful in achieving its objective of ensuring that a distinction is not made between the structures chosen to dispose of assets owned by an exempt entity.

6.2 Discussion

As recognised by the Committee in the PFC, an investor’s entitlement to tax deductions should be based on the cost of the asset to the investor, without which asset prices and investment decisions could be distorted. In this regard, ESAA notes that Division 58 provides for the depreciation deduction to be calculated in accordance with either of two available methods. These are the Notional Written Down Value (“NWDV”) method, or the Pre-existing Audited Book Value (“PABV”) method.

Both of these methods substitute the arm's length cost to the purchaser with the method calculated by reference to the legislation. In most cases, this will result in a reduction in the opening undeducted cost of the plant for the purposes of calculating the depreciation deductions available to the purchaser.

The ability to choose the appropriate method will be determined by the facts of each case. There is a significant difference between the methods used for calculating the cost base for the purposes of depreciation for the acquirer of the plant. In order to determine the appropriate method, the calculation will be required to be performed for each asset owned by the exempt Australian Government agency.

6.2.1 Notional Written Down Value

Where the vendor is an exempt Australian Government agency and the assets have been purchased from a previous exempt Australian Government agency, then there is a requirement that complex tracing rules must be followed to establish the original cost to the first exempt entity that acquired the plant.

This process will require an extensive level of compliance costs to be incurred prior to any entity being privatised or the assets sold. It is not expected that all of these entities will have the original cost records to enable the purchaser to calculate the notional written down value at the date of privatisation. In addition, the requirement to trace to the original owner will mean that assets with significant commercial value will have significantly reduced written down values.

In many circumstances it is likely that the entity will be unable to calculate the original cost to that entity or a previous entity due to the long-term nature of some of the assets that have been purchased or constructed by the tax exempt entity. This will have a significant effect on the marketability and the bidding process that needs to be undertaken for evaluating the appropriate bid price of the assets or of a business.

6.2.2 Pre-existing Audited Book Value

For the purposes of determining the PABV, the legislation requires that an entity must have had a PABV in place by 4 August 1997. For many entities, it may be that they were unable to achieve a PABV by the date of the announcement. This will effectively impose a PABV of 30 June 1996 on those particular entities.

Due to this earlier date, those entities who were unable to achieve a PABV by the date of the announcement will suffer a depreciation adjustment to the PABV to apply depreciation for the period 30 June 1996 to 30 June 1997. This will create an imbalance between those entities who were able to achieve a PABV prior to the announcement.

Further, we note that the date chosen is completely arbitrary and there is no sound basis for its selection. We note that some entities would have marked to market whilst others would not have. Some values will be vastly understated and some overstated. In ESAA's experience, valuations used as at 4 August 1997 were not undertaken with the proposed Division 58 in mind and therefore, in most cases, will not reflect the true market value.

6.2.3 Compliance Costs

There will be significant costs involved for taxpayers determining the most appropriate value to adopt for the purpose of claiming the opening depreciable value of property falling within the proposed Division 58. In ESAA's view, the NWDV method is not a realistic option. Not only does it involve significant compliance costs but also in most cases, the relevant records would be difficult to obtain which therefore leaves the PABV method, which as stated above, is completely arbitrary.

The exempt entity will also be required to perform these calculations to ensure that the information is available to potential bidders prior to the bidding process. This is due to the effect that this information will have on the bid process.

It is expected that this procedure that is required to be undertaken will result in significant compliance costs both before and after the disposal of assets by an exempt entity. This would appear to be contrary to the stated objective of reducing compliance costs for taxpayers.

6.2.4 Acquisition Costs

The budget announcement contemplated that the arrangements under the legislation would result in there being no difference between the structures chosen by a purchaser for the transfer of assets from a tax exempt vehicle. Analysis of the legislation indicates that there are significant differences between the two structures that can be chosen for the acquisition of assets.

When a taxpayer purchases assets from a tax exempt vehicle, they are able, in accordance with the legislation, to include as part of the cost base, the incidental costs incurred in the purchase of those assets. These incidental costs, while not defined in the legislation, may include:

- stamp duty;
- valuation fees;
- legal fees;
- accounting fees; and
- any other costs associated with the acquisition of the assets.

In the disposal of substantial assets, these incidental costs can represent a significant component of the purchase price.

Under the proposed treatment for the calculation of depreciation, this mechanism of purchasing the assets will result in a significantly higher cost base than if the purchaser had taken over the business structure of the tax exempt vehicle. This ability to claim depreciation on the higher value will be a significant factor in the method of acquisition.

In contrast, if an entity sale is made, these significant costs are capitalised in the purchase price of the shares or business structure and are not reflected in the asset values.

This creates a distortion in the choice that taxpayers may make as to whether they will purchase the assets outright or purchase the tax exempt vehicle.

6.2.5 Depreciation Rate Differences

In addition, the calculations prescribed in TLAB 4 for writing down the assets to a notional written down value also operate differently depending on whether the privatisation occurs by way of an asset sale or an entity sale.

In the case of an asset sale, a purchaser is able to depreciate assets after privatisation using the rates of depreciation which are applicable at the date of privatisation. These rates are accelerated rates, with the lowest rate of depreciation being 7% (straight line) irrespective of the life of the remaining life of the assets.

In contrast, if the sale occurs by way of entity sale, the purchaser is not able to use the current rates of depreciation going forward. The depreciation rates after privatisation are limited to the rates which applied to the assets at the time that the asset was originally acquired or constructed by the Government entity. In many cases, the assets were constructed in the 1950s or prior and at that time the rates of depreciation were much lower than those available today.

This difference will have a material impact on the process of privatisations in the future. Given that tax is a key expense of a business, any method which offers higher tax deductions (or lower tax liabilities) will be favoured by an investor. For this reason, ESAA would expect that future privatisations will still occur by way of asset sale if this distortion is maintained.

6.2.6 Depreciation Balancing Charge

Under the provisions of Division 42 of the Income Tax Assessment Act 1997, a depreciation balancing charge can arise on the disposal of depreciable plant. This balancing charge is intended to bring to account as assessable income the amount of depreciation that has previously been allowed to the taxpayer. This mechanism works in an effective and efficient manner to recoup those amounts previously allowed or allowable as a tax deduction.

The methodology proposed under TLAB 4 includes as assessable income a balancing charge which is calculated on the basis of the difference between the written down value of the plant at the time of disposal and the greater of the opening value at acquisition in accordance with the legislation or the actual cost of the asset.

This recoupment mechanism is fundamentally inconsistent with the underlying purposes of the balancing charge provisions. Indeed, by imposing tax on an amount which was not previously claimed as a deduction, this aspect of the new rules could be more appropriately termed a <u>capital gains tax rather than a balancing charge</u>. This is clearly inequitable.

This is because the legislation in its current form goes beyond the traditional scope of a balancing charge (ie. the **recoupment** of depreciation deductions claimed by a purchaser of plant). It rather brings to tax the excess of the purchase price over the written down value of the plant at the time of acquisition.

In circumstances where a disposal of the plant occurs after the acquisition from the tax exempt vendor, a taxpayer could be subjected to the inclusion of an assessable amount, even though no economic gain had been made on the disposal of the plant. This is clearly contrary to the principles of depreciation recoupment.

If the intent of the legislation is to prevent the ability for a secondary purchaser to acquire a higher written down value for the purposes of claiming depreciation, then we submit that related party transactions would be better dealt with through appropriate anti-avoidance measures.

6.2.7 Disadvantages for Resident Purchasers

The legislation puts in place proposals to limit the amount of depreciation that can be claimed by purchasers of assets from exempt entities. The proposals, as currently drafted, provide that a non-resident purchaser of these assets or of the associated business will achieve an economic advantage over resident bidders.

This occurs due to the manner in which non-resident purchasers are able to claim deductions for the difference between the original cost price of the assets and the purchase price of the business from the exempt entity. This puts Australian bidders at a competitive disadvantage to non-residents.

This competitive disadvantage has been recognised in the Treasurer's Press Release No 26 of 1998 in which this aspect was specifically considered. The relevant portion of the press release is reproduced below:

> *"Allowing amortisation of the acquisition cost of domestic spectrum licences is appropriate as it is consistent with the underlying wasting nature of spectrum licences, which contribute to the income earning capacity of the holder over their life. Amortisation is consistent with matching the cost of the licence to the income it generates. The current tax treatment of spectrum licences is inappropriate as they are on capital account which means there are no deductions for acquiring the licences but there will be capital losses when they expire.*
>
> *Furthermore, amortisation is consistent with the tax treatment of spectrum licences in overseas jurisdictions such as the United States and Japan. Without this change, in the forthcoming auction of spectrum licences* ***Australian resident bidders may be at a financial disadvantage compared with overseas bidders due to the differing tax treatment****." (emphasis added)*

This treatment proposed in Press Release No 26 is consistent with the approach taken in foreign jurisdictions and achieves a balance between the bidding power of both non-resident and resident consortiums. This is because, generally speaking, bidders from the United States and Japan will be entitled to depreciation based on the full value of the assets purchased as part of the privatisation process. These bidders will also be entitled to amortise any goodwill component that arises on the purchase, which provides for an additional competitive advantage for the non-resident.

It is considered that the approach adopted by the Federal Government in respect of spectrum licences is the most appropriate outcome and should be also considered in respect of the privatisation of assets owned by State Governments.

Without this approach, Australian resident taxpayers will suffer a competitive disadvantage in the bidding process. The taxation treatment of spectrum licences as outlined above is also relevant to the issue of franchise fees charged by the State Governments on the privatisation of their assets.

6.2.8 Extended Scope of the Legislation

The legislation as produced in TLAB 4 has extended the scope of the legislation beyond the intent of the original announcement as contained within the Treasurer's Press Release of 4 August 1997.

This Press Release stated that the new provisions would apply to the disposal of assets of a Government agency which were "associated with the sale of a business." It is clear from this announcement that the scope of the legislation was intended to apply to Government functions that provided a chargeable service to the public, such as energy generation and supply.

The legislation has broadened the potential application to include the outsourcing of Government functions such as car fleets, cleaning and printing services. These service centres did not provide a commercial product to the public and should not be construed as being a business operation.

The application of the provisions to these internal functional areas of Government on outsourcing will result in distortions in the privatisation process on areas that are beyond the scope of the original announcement.

Recommendation/Submission

ESAA submits that the proposed wasting assets model outlined in the PFC should be developed to include those assets proposed to be subject to the provisions of Division 58. Wasting assets (both tangible and intangible) are defined in the PFC as those that, at the time they are acquired or created, can be reasonably expected to decline in value over time. Clearly, the assets, which are the subject of the proposed provisions of Division 58, fit within this definition. Accordingly, ESAA submits that the tax treatment of those assets should be consistent with other wasting assets.

In line with the options presented in the PFC, ESAA believes that the proposed wasting assets model should have the following characteristics:

- deductions should accrue to the taxpayer bearing the economic cost of the asset;
- the cost base for deductions should be the actual cost of the asset to the taxpayer;
- the asset must be installed ready for use;
- the write-off period should be the effective life of the asset;
- the write-off method should be the diminishing value method, the prime cost method or the taxpayer's choice between these two methods; and
- in general, there should be no access to balancing charge relief on disposal of the asset.

Aside from the benefits of a simplified system for the treatment of wasting assets and the reduction of distortions to investment decisions which are currently experienced in the electricity supply industry, the simplification could ultimately be expected to yield economic growth dividends for the Australian economy. This is because the economy's resources would be allocated more efficiently towards their highest value uses, and the tax environment within which Australian entities compete relative to international entities would become less disadvantageous.

Chapter 7.0 - Proposed Division 243

7.1 Overview

Based on the proposed Division 243 of the Income Tax Assessment Act 1997 (Cth) contained in Taxation Laws Amendment Bill (No 5) 1999 (TLAB 5), ESAA understands that the circumstances in which Division 243 will apply are broadly as follows:

- where "limited recourse debt" (as defined) has been used wholly or partly to finance or refinance capital expenditure;
- capital expenditure is deductible under the capital allowance rules, eg as depreciation;
- the limited recourse debt is "terminated" (as defined); and
- the limited recourse debt has not been paid in full by the debtor at the time that it is terminated.

Where Division 243 applies, it will potentially result in a recalculation of the available capital allowance deductions. Accordingly, the potential exists for ordinary commercial arrangements to be entered into which will have the effect of causing an application of Division 243.

An analysis has been prepared of the adverse impacts that the proposed Division 243 of TLAB 5 may have on ESAA members. Those adverse impacts revolve around the following aspects of Division 243s:

- the scope of the definition of 'limited recourse debt';
- the scope of when a debt arrangement is taken to have been terminated; and
- the retrospective effect of Division 243.

Recommendation/Submission

Set out below is a number of recommendations that ESAA believes will go some way in reducing the adverse impacts that the proposed Division 243 may have on ESAA members.

7.2 Discussion

As discussed above, there are a number of aspects of Division 243 that will potentially have an adverse impact on ESAA members. The aspects of the proposed Division 243 that are of particular concern to ESAA members are set out below.

7.2.1 The Scope of the Definition of 'Limited Recourse Debt'

It is submitted by ESAA that the definition of 'limited recourse debt' contained in Subdivision 243-20 is deficient for a number of reasons. This deficiency primarily revolves around the uncertainty arising for taxpayers from the unrestrained scope of the definition as currently drafted, as well as the inapplicability of certain of its provisions to debt that would not otherwise be treated as limited recourse debt.

In particular, the following aspects are of particular concern to ESAA members:

(i) Subsection 243-20(5)

Subsection 243-20(5) states that:

> *"However, an obligation that is covered by Subsection (1) is not a limited recourse debt if the creditor's recourse is not in practice limited due to the creditor's rights in respect of a mortgage or other security over property of the debtor (other than the financed property) the value of which exceeds, or is likely to exceed, the amount of the debt".*

ESAA understands that the intended application of Subsection 243-20(5) is to override the application of Subsection 243-20(1) to a debt if the creditor's recourse is not in fact limited because there is adequate security over other assets of the debtor. However, the current drafting of Subsection 243-20(5) does not provide certainty as to when the creditor's rights in respect of a mortgage or other security over property of the debtor (other than the debt property), will be considered to be so limited.

Recommendation/Submission

It is submitted that Subsection 243-20(5) should be amended to provide a taxpayer with greater certainty as to when a creditor's rights in respect of a mortgage or other security over property of the debtor (other than the financed property), will be considered to be limited.

ESAA recommends the following drafting of Subsection 243-20(5):

> *"However, an obligation that is covered by Subsection (1) is not a limited recourse debt if the creditor's rights are in respect of a mortgage or other security over property of the debtor (other than the financed property) the value of which, at the time that the debt is created equals or exceeds the amount of the debt".*

(ii) Subsections 243-20(2)(a) and (3)(a)

Issue

In considering whether a debt is a limited recourse debt pursuant to Subsections 243-20(2) and (3), regard is not to be had to other assets of the debtor that are indemnities or guarantees provided in relation to the debt.

Disregarding assets of the debtor that are indemnities or guarantees that are provided in relation to a debt has the potential to cause a debt to be treated as limited recourse where in fact the creditor's rights are not limited. This is best illustrated in the following example:

X Co is a 100% owned subsidiary of A Co. X Co borrows money from an external lender. A Co provides a guarantee or indemnity to the external lender in respect of X Co's obligations. The guarantee or indemnity provided by A Co is an asset to X Co.

Depending on the extent of the guarantee or indemnity provided by A Co, it may be the case that the external lender's rights are not in fact limited. This might be the case, for instance, where the guarantee or indemnity provided by A Co is in respect of the full amount of the loan.

Recommendation/Submission

It is submitted by ESAA that in considering whether or not the rights of a creditor as against a debtor in the event of default in payment of a debt are limited, regard should be had to assets of the debtor that are indemnities or guarantees provided in relation to the debt. That is, the words "(other than assets that are indemnities or guarantees provided in relation to the debt)" should be deleted from Subsections 243-20(2)(a) and (3)(a).

(iii) *Subsection 243-20(4)*

Issue

Pursuant to Subsection 243-20(4), the notional loan under a hire purchase agreement is to be treated automatically as a limited recourse debt arrangement.

The notional loan under a hire purchase agreement should not be treated automatically as a limited recourse debt arrangement, rather it should be subject to the same tests as any other debt. That is, the notional loan under a hire purchase agreement should not be considered to be a limited recourse debt arrangement unless it falls within Subsection 243-20(1), (2) or (3) and is not excluded through the application of Subsection 243-20(5) or (6).

This is on the basis that it is often the case that the hiree's obligations in respect of a hire purchase agreement are the subject of a guarantee or indemnity. Accordingly, depending on the extent of the guarantee or indemnity provided, it may in fact be the case that the hirer's rights in the case of default by the hiree are not limited.

Recommendation/Submission

It is submitted that the notional loan under a hire purchase agreement should not automatically be treated as a limited recourse debt arrangement. Accordingly, Subsection 243-20(4), should be removed in its entirety.

(iv) Subsections 243-20(5)

Issue

Subsection 243-20(5) operates to override the application of Subsection 243-20(1) to a debt if the creditor's rights in the event of default are not in a practical sense limited because there is adequate security over the assets of the debtor (other than the financed property).

The application of Subsection 243-20(5) is particularly relevant, for instance, where the creditor has a mortgage or security over property of the debtor but the extent of the mortgage or security is such that the creditor's rights cannot be considered to be limited.

As discussed at 7.2.1(i) above, ESAA submits that Subsection 243-20(5) does not provide certainty as to when a creditor's rights in respect of a mortgage or other security over property of a debtor (other than the financed property) will be considered to be limited. Accordingly, Subsection 243-20(5) should be amended as indicated above.

Further, the application of Subsection 243-20(5) should not be limited to Subsection 243-20(1), but should also apply to Subsections 243-20(2), (3) and (4).

Recommendation/Submission

It is submitted that Subsection 243-20(5) should be amended as set out at 7.2.1(i) above. Further, it is submitted that the application of the amended Subsection 243-20(5) should not be restricted to Subsection 243-20(1), but that it should also apply to Subsections 243-20 (2), (3) and (4).

7.2.2 The Scope of When a Debt Arrangement Will be Taken to be Terminated

(i) Issue

Subsection 243-25(1) sets out the circumstances when a limited recourse debt arrangement is taken to have been terminated. The circumstances set out in Subsection 243-25(1) are too broad and may include situations where in fact there is no termination of the debt and the asset is still being used by the debtor for income producing purposes.

One instance of the inequitable operation of Subsection 243-25(1) is where a debtor refinances a debt. There are various ways that a debt can be refinanced without there being a termination of the original debt arrangement, eg the rollover of bills under an ongoing finance facility or regular refinancing in the market place by an in-house finance subsidiary which has funded the borrower's debt. However, in some circumstances, the refinancing of a debt may be considered a termination of the debt arrangement.

ESAA submits that a recalculation resulting in an adjustment to taxable income at that time is inappropriate in cases where limited recourse debt is regularly refinanced on a commercial short term basis. The argument is that, in substance, the debtor's position has not changed, because notwithstanding that one debt is terminated, an equivalent debt remains on foot.

Recommendation/Submission

ESAA submits that it is not appropriate to penalise a debtor where, pursuant to Subsection 243-25(1), the debt arrangement is taken to have been terminated in circumstances where the financed asset is still being used by the debtor for income producing purposes. Accordingly, Subsection 243-25(1) should be deleted in its entirety and replaced with the following:

"*(1) A debt arrangement is taken to have been terminated only if both of the following conditions are satisfied:*

(a) the debtor either:

(i) disposes of the financed property; or

(ii) ceases to use the financed property for the purposes of producing assessable income; and

(b) the debtor ceases to have an obligation to repay the debt".

(ii) Issue

Subsection 243-70 broadly applies to companies that cease to be 100% subsidiaries in relation to at least one other company, the limited recourse debt to which they are party has not been paid in full by the company, and the creditor's rights in respect of the debt are transferred or assigned to another entity.

Consistent with the discussion at 8.2.2(i) above, Subsection 243-70 has the potential to apply to ordinary commercial transactions that are in no way motivated by tax considerations. That is, the situation contemplated by Subsection 243-70 should not give rise to a termination of limited recourse debt, particularly when there is continued use by the debtor of the assets for income producing purposes.

Recommendation/Submission

It is submitted by ESAA that Subsection 243-70 should be deleted in its entirety.

7.2.3 The Retrospective Effect of Division 243

Issue

Consistent with the Treasurer's announcements on 27 February 1998 (refer Press Release No 21 of 1998), Division 243 is to apply to all limited recourse debt arrangements that are terminated after 27 February 1998.

The application of these provisions (which reflect a change in policy) to the termination of a debt arrangement relating to a project entered into or committed to prior to 28 February 1998 is potentially inequitable.

ESAA does not believe that the full extent of the policy upon which the proposed Division 243 is apparently based was revealed in the Press Release dated 27 February 1998 or the original 1997/98 budget announcement. Accordingly 27 February 1998 is not the appropriate operative date. Rather, the date on which the full extent of the application of Division 243 was released would be the appropriate operative date. This is likely to be the day on which the former TLAB 4 (which lapsed at the time the Federal election was announced) was introduced.

Further, whatever the operative date, the new approach contemplated by Division 243 should only apply to the termination of debt arrangements which relate to transactions entered into after the operative date.

Recommendation/Submission

Paragraph (1) of Item 108 in Part 5 of Schedule 2 should be deleted and replaced with the following:

> (1) Division 243 of the Income Tax Assessment Act 1997 applies to the termination of debts used to finance expenditure incurred on or after [the date of introduction of these amendments] unless incurred pursuant to a contract entered into prior to that date.

Paragraphs (2) and (3) of Item 108 will also require consequential amendment.

Chapter 8.0 - Treatment of Capital Contributions/Contributed Assets

8.1 Overview

Consumers often make capital contributions when an electricity supply extension is sought. These capital contributions represent either a contribution towards all or part of the estimated cost of the supply extension or alternatively a contribution of electricity assets. Regardless of whether or not the contribution is in cash or in kind, the supplier (ie various ESAA members) typically retain ownership in the underlying asset.

Recommendation/Submission

Capital contributions made by consumers in respect to the extension of electricity infrastructure should not be treated as assessable income to the electricity entity. Rather, the capital contributions should be subject to the same tax treatment as that currently provided under the State Tax Equivalence Regimes (ie. non-assessable in the hands of the recipient but no entitlement to tax depreciation).

If the above position is not accepted, an approach similar to that applying in the US should apply. That is, where the capital contribution received does not reasonably relate to the provision of services by the recipient to or for the benefit of the benefactor of the contribution, but rather relates to the benefit of the public at large, then the contribution should not be assessable in the recipient's hands.

8.2 Discussion

At present, given the High Court judgment in *GP International Pipecoaters Pty Ltd v FCT*, there is a risk that the receipt of these capital contributions (whether in cash or in kind) are treated as assessable income upon receipt in the hands of the electricity entity who constructs and owns the underlying supply extension infrastructure. The cost of such infrastructure is then depreciable for tax purposes over the life of the asset. In this regard, we note that infrastructure assets generally have long lives.

This results in a significant mismatch between income recognition and the corresponding deduction allowance. Although arguably only a timing difference, the current treatment is inherently inequitable because the depreciation deductions are only available over the life of the assets despite the fact that the capital contribution receipt is fully assessable upfront and also expended upfront. Further, in the context of the regulated revenue environment operating in the electricity industry at this level, the recipient of capital contributions is excluded by the relevant State Regulators from receiving a rate of return on the value of the capital contributions.

In order to avoid adverse cash flow consequences, suppliers are likely to impose a higher capital contribution charge to their consumers than would otherwise be the case, in order to cover their upfront tax cost (ie there would be cash flow incentives to gross up the normal capital contribution for the tax payable in respect of it). Higher charges to consumers will also provide a natural disincentive for investment which is contrary to Australia's economic objectives.

Secondly, where capital contributions are treated as assessable income, there are incentives for suppliers to defer the timing of the derivation of those receipts for tax purposes. In particular, there are incentives for suppliers to restructure their arrangements with consumers to effectively cost in an equivalent amount to the capital contribution to their normal electricity charges to effectively recover the capital contribution amount without separately imposing the capital contribution upfront. This would mean that the contribution is not taxed upfront, but would be assessable on a progressive basis as it arises in the periodic electricity charges.

Both of these factors result in business decisions being unnecessarily driven by tax considerations so that optimum economic efficiency is not achieved.

The inequity of the current treatment and the possibility of entering into alternative arrangements contributed to the policy decision embodied in each of the State Government tax equivalent regimes, to statutorily adopt an alternative treatment to that provided in the Pipecoaters decision. Specifically each of the Sate regimes broadly provides a tax neutral approach whereby such contributions received are non-assessable but no tax depreciation / capital works deductions are available in respect of such amounts.

It is submitted that a similar approach should be adopted in the Federal tax regime. Such an approach would remove the existing distortions created.

If it is considered that the approach adopted under each of the State regimes is not appropriate, ESAA submits in the alternative that an approach similar to that adopted in the US should be adopted. That is, in the US, the value of such capital contributions would, prima facie, be assessable to the recipient. However, specific exemption is then provided where the capital contributions received do not reasonably relate to the provision of services by the recipient to or for the benefit of the benefactor of the contribution, but rather relates to the benefit of the public at large. This is referred to as the "Public Benefits Test".

Examples of when the Public Benefits Test should apply so as to prevent capital contributions from being assessable in the hands of the recipient include:

- Relocation payments received by a utility under a government program for placing utility lines underground where undertaken for purposes of community aesthetics and public safety and not for the direct benefit of particular customers of the utility in their capacity as customers.

- Reimbursement for the cost of relocating utility lines to accommodate the construction or expansion of a highway and not for the provision of utility services.

Recommendation/Submission

ESAA submits that the treatment of capital contributions provided under the various State regimes be statutorily adopted in the Federal regime so as to remove any tax distortions to investment decisions.

If it is considered that the approach adopted under each of the State regimes is not appropriate, ESAA submits that an approach similar to that applying in the US should be adopted. That is, capital contributions should not be assessable where a Public Benefits Test is satisfied.

Chapter 9.0 - Treatment of Easements Over Land

9.1 Overview

At present, expenditure incurred to secure easements over land for the erection of electricity infrastructure is potentially a non-deductible outgoing for which no relief is obtained until the easement is ultimately surrendered / disposed of.

Recommendation/Submission

Costs incurred in securing easements over land for the erection of electricity infrastructure should be included in the proposed framework for the taxation of non-wasting assets and should be subject to straight line amortisation over a reasonable period notwithstanding that the right of access conferred on an easement is generally attached to the land and usually exists for an indefinite period of time. These easement costs are a genuine, unavoidable, regular and ongoing expense for many ESAA members.

9.2 Discussion

Easement expenditure does not appear to fall within the Committee's definition of "blackhole expenditure". This definition includes expenditure undertaken for the purposes of earning assessable income that currently does not qualify for either deduction or write-off, but which should so qualify because it produces no enduring benefit, or the benefit will endure for a fixed period.

The period over which easement payments provide electricity entities rights of access over land for the erection of electricity lines is generally indefinite. This is because easements are property rights attached to the land and changes in ownership of the land generally do not result in extinguishment of the easement.

However, the framework for the taxation of indefeasible rights of use (non-wasting assets), outlined in the PFC is relevant to the taxation of easements. The Committee acknowledges that the current taxation treatment of such rights disadvantages taxpayers that make up-front payments for rights such as franchise fees, indefeasible rights of use over assets such as telecommunication cables, and lease premiums for leases of land.

With such rights, the grantor is taxed on the up-front payment when received, but the grantee is able to deduct the expenditure only as a capital loss at the end of the right. Other rights payments (such as prepayments of lease rentals) are deductible to the grantee over the period of the right, but the grantor is still taxed on any up-front payment on receipt.

As noted in the PFC, this tax treatment of rights payments does not accord with the income flows under the right:

> *"The tax treatment of such right payments does not accord with the income flows under the right. From the point of view of the grantee, the income in each year is the income from the right less the decline in the value of the right. The value of the right to the grantee is the net present value of the benefits from the right less the value of future payments. This is the 'mirror' of the change in the value of the underlying asset to the grantor."*

Recognising these changes in value of the right as income of both the grantor and grantee as they occur would correct the current treatment of up-front payments for indefeasible rights of use.

Recommendation/Submission

ESAA considers that, for efficiency, equity and simplicity reasons, the taxation of easements must be included in the proposed framework for the taxation of non-wasting assets. Easement expenditures are genuine and unavoidable business expenses for the acquisition of indefeasible rights of use. Further, easements expenditures are regular, frequent and ongoing expenditures, undertaken in the ordinary course of the businesses of ESAA members, albeit that the easements may last indefinitely.

As noted by the Committee in the PFC, one option under the framework for taxing non-wasting assets would be to allow the grantee of a right straight-line amortisation of the present value of the payments under the right. The grantee would then be taxed on the basis of his or her income from the right plus any increase in the value of the right less any payments for the right. This approach deems that the benefits from the right are equal in all periods, which is appropriate for easements.

Moreover, ESAA considers that the framework for taxing easements, and other indefeasible rights of use, should be relatively easy to apply and impose minimal compliance costs on taxpayers.

Chapter 10.0 - Taxation of Financial Arrangements

10.1 Overview

ESAA members, particularly those operating in the generation and retail sector of the market, are sensitive to the taxation treatment of financial derivative investments. Such instruments are, interalia, extensively used to hedge physical electricity purchases and sales.

Recommendation/Submission

ESAA recommends further detailed consultation be undertaken in relation to the adoption of appropriate legislative rules for the taxation of financial arrangements.

10.2 Discussion

The PFC comments upon the merits of introducing hedging rules as part of a general code for the taxation of financial arrangements. ESAA supports the concept of tax reform relating to the taxation of financial arrangements, but subject to further consultation with respect to specific rules. In particular, ESAA supports the development of hedging rules that match the taxation treatment of the relevant hedge with that of the underlying transaction so as to ensure no mismatch occurs between the taxation treatment of the hedge and the hedge transaction.

Recommendation/Submission

ESAA recommends further detailed consultation be undertaken in relation to the adoption of appropriate legislative rules for the taxation of financial arrangements.

ESAA supports in principle, the development of a statutory code relating to the taxation treatment of such transactions. However, ESAA's support of such a regime is conditioned upon the development of appropriate hedge rules to ensure no tax, cash flow, or economic distortions are created between the hedge and the underlying hedge transaction.

Chapter 11.0 - Taxation of Leases

11.1 Overview

In conceptual terms, the taxation treatment of lease transactions has remained largely unchanged for the past forty years (with the exception of certain anti-avoidance rules). It is recognised that leasing provides a legitimate source of asset finance for which there is no demonstrable adverse effects on the economy.

The PFC is premised on the desirability of eliminating tax preference trading by way of leasing, but with no empirical evidence of the detrimental economic impact thereof. There are a range of potential problems raised in relation to the tax treatment afforded to certain transactions under the current rules (eg lease assignments). However, these are transactions at the periphery and should not be used as a basis for implementing more general tax reform to mainstream leasing transactions

Recommendation/Submission

ESAA does not support the general reform of the taxation of leasing other than as it applies to tax exempt entities (in particular Section 51AD / Division 16D). Accordingly, ESAA advocates the retention of existing "rules" in general, but with the development of specific legislative provisions to replace Section 51AD / Division 16D.

11.2 Discussion

Mainstream equipment leasing provides a legitimate form of funding to ESAA members and the community at large. While the PFC questions why tax preference trading through leasing should be allowed, there is no empirical evidence provided on the detriment to the Australian economy that results from the current regime for the taxation treatment of conventional leasing.

It is accepted by ESAA that there may be a need for tax reform in relation to issues at the periphery, for example lease assignments. However, that should not provide a basis for a fundamental and philosophical change to the taxation treatment of leases (for example as sale / loan arrangements).

It is submitted that the existing rules potentially provide a positive impact on the economy and can facilitate the timely development of infrastructure through an effective lower cost of funds, where the benefits of ownership might not otherwise be able to be utilised by a particular taxpayer at a given point in time.

ESAA endorses the proposed reforms relating to tax exempt leasing, in particular the repeal of Section 51AD / Division 16D. It is recognised that replacement provisions will be necessary that provide adequate protection to the Commonwealth revenue base. However, any such replacement provisions should be formulated so as to provide for a less cumbersome approach to their application and administration as compared with the existing provisions.

Appendix C to Chapter 9 of the PFC provides a number of alternatives to replace the existing provisions. ESAA endorses the approach advocated in the second Option which is to base the test of when a tax exempt entity has sufficient interests in the equity risks and benefits of ownership, on the respective interest of the parties in the relevant assets. Such an approach should lead to a more precise test as compared with determining effective control. In supporting such a general approach, ESAA acknowledges the critical importance of defining precisely and clearly the tests to be used in determining the respective interests of the parties in the assets concerned. In this regard, ESAA submits the need for wider consultation in order to formulate such guidelines.

Recommendation/Submission

ESAA does not endorse the proposed wholesale amendment to the taxation of ordinary leasing transactions. The existing leasing regime provides significant economic stimulation in certain circumstances, and in the context of which there is no empirical evidence of any net adverse effects on the economy.

ESAA supports the reform of existing provisions relating to tax-exempt leasing. In particular, the draconian tax treatment afforded to leases and other transactions to which Section 51AD / Division 16D applies and the administration of those provisions in practice provides undue uncertainty for taxpayers. ESAA welcomes the enactment of a set of principles fashioned in consultation with the industry and relevant stakeholders to replace Section 51AD / Division 16D but which provides appropriate protection of the revenue base.

Chapter 12.0 - Fringe Benefits Tax Matters

12.1 Overview

Chapter 38 of the PFC proposes changes to the taxation treatment in Australia of the provision by employers of non-cash benefits to employees. In particular, the major reform measures canvassed in Chapter 38 include:

- transfer of the tax liability from the employer to the employee;
- removing the FBT liability for entertainment and on-premises parking; and
- amendment of the valuation methods used to determine the value of car fringe benefits.

The reasons stated in the PFC for the reform of the taxation treatment of the provision of benefits to employees include the following:

- to remove the inequity associated with the provision of fringe benefits being taxed at the highest marginal tax rate; and
- to simplify the compliance issues associated with the assessment of non-cash benefits.

Recommendation/Submission

ESAA supports the proposal to reform the current system of assessing the provision of non-cash benefits. In particular, ESAA submits that the current FBT regime as set out in the Fringe Benefits Tax Assessment Act 1986 (Cth) has become overly cumbersome, leading to significant administrative costs being incurred by employers. The introduction of the requirement for employers to disclose the value of fringe benefits on employees' group certificates as set out in A New Tax System (Fringe Benefits Reporting) Bill 1998 has further added to the administrative costs incurred by employers in complying with the FBT regime.

12.2 Discussion

Set out in Chapter 38 of the PFC are a number of proposals designed to alleviate the deficiencies of the current FBT regime. ESAA has analysed these proposals in the context of the outcomes that they are designed to achieve (as set out above), and comments as follows:

12.2.1 The Proposal to Transfer the Tax Liability from the Employer to Employee

Under the current regime, employers are liable to pay tax on the value of non-cash benefits provided to employees or to associates of those employees. Tax is payable at the rate of 48.5% of the grossed up value of the benefits provided.

Chapter 38 of the PFC proposes to dispense with the current FBT regime and assess employees on the value of non-cash benefits provided to them.

As discussed in the PFC, one of the obvious incentives for transferring the tax liability for non-cash benefits to employees is the fact that the benefits will be assessable at the employee's marginal rate of tax. That is, the value of benefits will not be taxed at the flat rate of 48.5% (equal to the top marginal tax rate) but rather will be assessed at the scaling income tax rates applying to individuals. ESAA submits that this is a desired objective so far as improving the equity of the current regime is concerned.

Another major incentive for transferring the tax liability for non-cash benefits to employees is to reduce the compliance burden associated with the current FBT regime. ESAA submits that transferring the tax liability for non-cash benefits to employees will not achieve this outcome. This is on the basis that transferring the liability for non-cash benefits to employees is essentially reverting back to the regime which existed pre-1986. As was the case with Section 26(e) of the Income Tax Assessment Act 1936 (Cth) (the provision which governed the pre-1986 regime), the major difficulties with this regime are:

(i) Determining whether a benefit has been provided to the employee. That is, circumstances may arise where a benefit is taxable to an employee, but no real "benefit" has been received by the employee. This may arise, for instance, where an employee is required to take a pool car home so as to travel to an alternative work site the next day. Although under the FBT regime the employee is statutorily deemed to have received a benefit, in reality the employee may have received no benefit.

(ii) Prescribing a value to that benefit.

Based on the level of detail available in respect to this proposal, it can only be assumed at this stage that the obligations for monitoring the benefits provided to employees and prescribing a value to the benefits provided would remain with the employer. Further, the mechanisms used by employers to prescribe values to benefits provided to employees would be similar to the valuation methods adopted in the FBT legislation (albeit that as discussed in the PFC, some of these valuation methods may be reintroduced in a simpler form).

Accordingly, in the absence of evidence to the contrary, and in the absence of wholesale simplification of the valuation techniques currently available under the FBT legislation, ESAA submits that the proposal to transfer the liability for non-cash benefits to employees would not reduce an employer's obligations.

In addition to the reasons noted above, the proposal to transfer the liability for non-cash benefits to employees would also impose the additional cost of renegotiating and restructuring remuneration arrangements where fringe benefits are currently involved.

Recommendation/Submission

ESAA supports the proposal to transfer the tax liability of non-cash benefits from employers to employees. This will have the effect of ensuring that non-cash benefits are taxed at the employee's marginal rate of tax, not the top marginal rate of tax. ESAA, however, submits that the proposal to transfer the tax liability of non-cash benefits from employers to employees will only achieve the desired outcome of reducing the administrative costs associated with the current system if the FBT valuation rules are substantially simplified.

12.2.2 Dealing Separately with Entertainment and On-premises Parking

As discussed in the PFC, the treatment of the provision of entertainment and on-premises car parking to employees as fringe benefits significantly increases the compliance costs associated with the current FBT regime. This is particularly so in light of the fact that the situations in which such benefits are provided often do not facilitate the recording of the detailed information required to properly assess the nature of the benefit. Accordingly, employers often incur significant costs in ensuring that the data required to quantify their liability is collected throughout the FBT year.

Recommendation/Submission

Based on the burdensome administrative requirements associated with determining an employer's FBT liability in respect to entertainment and on-premises car parking, ESAA submits the following treatment should be adopted:

- Entertainment: not subject to FBT (or assessable at the employee's marginal tax rate if that option is accepted) and not deductible to the employer;

- On-premises Car Parking: not subject to FBT (or assessable at the employee's marginal tax rate if that option is accepted) and deductible to the employer.

12.2.3 Introduce New Rules to Determine the Value of Car Fringe Benefits

Under the current FBT regime, there are two methods available for determining the value to be attributed to car benefits provided to employees:

- the statutory formula method – values a car benefit by applying a statutory fraction to a specifically determined value of the car; and

- the operating cost method – values a car benefit based on the operating cost of the car during the period over which the benefit arises, apportioned between the business and non-business use during that period.

Based on ESAA's experience, the statutory formula method is more commonly accepted as the least administratively burdensome method. This is on the basis that minimal information is required to be collected throughout the FBT year to substantiate the liability of an employer.

Accordingly, in light of the administrative requirements associated with the operating cost method, employers generally tend towards using the statutory formula method, albeit that the operating cost method may give a more accurate valuation.

However, with the requirement that employers will be required from 1 April 1999 to disclose the value of benefits provided to employees on their group certificates, employees and their representatives (industrial unions etc) are requesting employers to confirm that the valuation method that they are adopting produces the most accurate result. In most instances, this will be the operating cost method.

Based on the push for more representative valuations of car benefits, ESAA supports the identification of alternatives to the current methods available to attribute a value to car benefits. ESAA, however, submits that for any alternatives to be accepted by taxpayers, it would need to be proven that the method gave a representative valuation of the car benefit and was less administratively burdensome than the current valuation methods.

Recommendation/Submission

ESAA submits that the current methods available to taxpayers to value the provision of car benefits to employees can be criticised in respect to:

- the arbitrariness of the calculations required and therefore their ability to accurately value the private benefit received by employees; and

- the administrative burden that they impose on employers.

ESAA therefore supports the identification of alternatives to the current valuation methods – the statutory formula method and the operating cost method. ESAA submits that a method based on the qualities of the two options addressed in the PFC would result in the most representative valuation method, whilst not imposing overly burdensome administrative requirements on employers. This valuation method would involve the following:

- The value would be based on the operating costs of the car, with a schedule available to employers setting out standard operating costs for standard cars available to employees.

- The private portion of the total kilometres travelled throughout the FBT year would be determined as a percentage of the total kilometres travelled. In this regard, ESAA submits that one fixed percentage should apply, regardless of the total kilometres travelled during the year.

Chapter 13.0 - Abolition of Accelerated Depreciation/Reduction in the Corporate Tax Rate

Chapter 2 of the PFC addresses the proposal to remove the availability of accelerated depreciation. One of the reform options raised in Chapter 2 is the proposal to offset the removal of accelerated depreciation with a reduction in the corporate tax rate.

ESAA submits that, in isolation, the removal of accelerated depreciation will have a significant adverse impact on ESAA members. Accordingly, the removal of accelerated depreciation will only receive the support of the ESAA to the extent that the effect on ESAA members was revenue neutral. That is, to the extent that the cost to ESAA members of the removal of accelerated depreciation was offset by comparable savings as a result of the reduction in the corporate tax rate.

Due to the tight time constraints within which taxpayers were required to respond to the Ralph Committee's proposals in the PFC, ESAA has not at this stage been able to properly assess the effect on ESAA members of the proposal to remove accelerated depreciation. ESAA, however, is currently undertaking a modelling exercise to quantify the effects of the proposal to remove accelerated depreciation and reduce the corporate tax rate.

It is anticipated that the results of this exercise should be available in the next two weeks. It is intended that an addendum to this submission be made at that time based on the results obtained from the modelling exercise.

At this stage, however, ESAA makes the following preliminary comments in respect to the proposal to remove accelerated depreciation:

- The removal of accelerated depreciation may skew investments in new electricity generation away from one type of fuel to another, probably away from coal and towards gas. This movement would reflect the capital-intensive nature of base load coal fired power stations. The ESAA does not have a view on whether such a move would represent an economic benefit to Australia as a whole. If there were any significant shifts of this type, it would have regional, social and other economic implications. Again, the RBT would need to consider these broader effects in making recommendations.

- The removal of accelerated depreciation could have an impact on the extent to which commitments to electricity investment are made in advance. This in turn could affect the reliability of electricity supply. Accelerated depreciation improves project cash flows in the early years, thus facilitating the decision on when to invest. If changes to depreciation reduce cash flow in the early years, investors would potentially delay investment decisions until a clearer picture of future demand and cash flow was obtained. Given Government and community concern with the reliability of electricity supply, the Government might be sufficiently interested in reducing risk to support continued application of accelerated depreciation.