16 April 1999

Mr John Ralph AO
Chairman
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

Dear Mr Ralph

Review of Business Taxation – Selected Issues

On behalf of the Association, I would like to thank you for meeting with its representatives, including myself, last Monday evening. We appreciate that the Review has a tight reporting deadline and are extremely grateful for the time that you made available to us. I hope that our discussion was of benefit to you.

In response to your comments at the meeting, we have prepared short notes on capital gains tax scrip bid rollover relief and on thin capitalisation. In addition, there are a number of outstanding items that the Association wishes to draw to the Review's attention.

Foreign Bank Taxation

To begin, we would like to reiterate our opposition to deferred company tax and the need for foreign branch banks to be able to transfer losses and assets to related entities in a manner that places them on the same competitive footing as banks that are eligible to consolidate.

There is also a need to similarly accommodate foreign bank operations that, for legitimate reasons, cannot consolidate under a single holding company in Australia. They would lose grouping benefits available under existing law.

Capital Gains Tax Rollover Relief for Scrip Bids and Demergers

A Platform for Consultation (APFC) was uncertain on the extent to which capital gains tax (CGT) is an impediment to mergers and acquisitions (paragraph 11.57). IBSA's member banks are the principal advisers in this area of business and their unanimous experience is that the failure to grant CGT rollover relief is a significant impediment to mergers and acquisitions in Australia. There is a widespread view that CGT tax rollover relief for scrip bids (and part-scrip/part cash bids) would provide a valuable stimulus to the merger activity.

During our discussion on Monday, you queried the revenue cost of granting capital gains tax (CGT) relief for scrip bids. The best information available to us is the Securities Institute of Australia (SIA) estimate (prepared by Access Economics), which shows a small initial revenue cost to Government but a long-run gain of $138 million for the annual Budget, in net present value terms. The anecdotal feedback that we have received from members suggests that this may be a conservative estimate of the revenue gain. The SIA estimates also show that relief for company demergers is revenue positive from the outset.

As we discussed, mergers and acquisitions are a vital means through which the economy adjusts to a more efficient and competitive operating structure. It makes little sense to impede this process and we agree that the wider economic benefits would also enhance the Government's revenue receipts.

Thin Capitalisation

During our discussion, you indicated that the Review would welcome industry input on the implementation of the proposed thin capitalisation regime. We wish to make some broad comments in this regard.

Banks are different from other companies because the borrowing and lending of money <u>is</u> their core business, whereas, for other companies, borrowing is a means to finance their core business. Consequently, banks are much more highly geared than companies generally and this must be recognised in the thin capitalisation rules. We note from the Review team's comments that the proposed measures are not intended to impact significantly on banks. The 'safe harbour' ratio must be carefully selected to ensure that this is the case in practice.

In this regard, the regulatory criteria that licensed banks must observe would form a good base from which to design a suitable 'safe harbour' ratio. Licensed banks are required to maintain equity capital (Tier 1 capital) of 4% of their risk-weighted assets under an international standard that is adopted by Australia. An equivalent debt equity ratio of 25:1 would form a safe harbour ratio for licensed banks that has a creditable basis, would be automatically audited on a regular basis and is well understood. A similar ratio could be adopted for merchant banks.

We note that special funding vehicles would need special consideration to avoid a double equity requirement being imposed on entities that cannot consolidate, like foreign branch banks. In addition, to achieve tax neutrality, the economic value (or capital equivalence) of parent guarantees must be taken account of in the design of the thin capitalisation rules for merchant banks.

Deductibility of Expenditure/Capital Allowances

The options to determine eligibility for deductions developed in Chapter 1 of *APFC* focus on the rights over the income stream that form an asset's value and are independent of the method of financing the asset. We earnestly request the Review to confirm in its Final Report that the method (debt or equity) of financing an asset should not limit deducibility of expenses in relation to it or the right to capital allowances, like depreciation, in respect of it.

The alternative would be to introduce a bias against certain forms of finance and create inefficiencies in the tax system and the capital market. It is important that the tax law is neutral and has a principled economic basis.

Section 51AD

IBSA is pleased that the Review has acknowledged the "Draconian" effects of section 51AD and urges the Review to recommend wholesale reform of the prevailing tax-exempt leasing legislation: namely, abolition of section 51AD and reform of Division 16D.

IBSA endorses AusCID's submission that the new provision should be based on the leasing accounting standard (AASB 1008), as it may be amended from time to time. The standard requires an assessment of the substance of a given transaction and, thus, requires an independent discretion to be exercised in respect of each transaction. Such a process could, however, become unwieldy and capricious unless an independent board is constituted to administer the discretion and workable time limits are imposed.

Trusts That Should be Excluded from the New Entity Tax System

We agree with the proposal to exclude Collective Investment Vehicles from the proposed entity tax system. In Chapter 22 of *APFC*, the question is posed as to what other forms of trust should be excluded.

Without expressing a view on the appropriate treatment of the other forms of trust discussed in Chapter 22, it seems clear that there are two forms of trust that should be excluded and could be excluded relatively easily. These are trusts where:

1. The beneficiary is "absolutely entitled" to the assets of the trust (for example, custodial and nominee holdings), and

2. The trustee holds the asset so as to provide security for an obligation of the beneficial owner of the asset (for example, trusts to secure the second payment in relation to instalment receipts).

With both categories, the existence of the trust structure is largely ignored other than for its particular commercial purpose and, subject to that, all benefits of ownership are undertaken at the direction of, or passed through to, the beneficiary. Reflecting this, the dividend rebate and capital gains tax provisions already "look through" the trust (see sections 45Z of the 1936 Act and sections 106-50, 104-10(7) and 109-15 of the 1997 Act) and, while there is no equivalent exemption from the operation of the general trust taxation rules in Division 6, the Australian Tax Office accepts market practice whereby income and gains are treated as if they were derived by beneficiaries directly (without the need for preparation of trust returns and formal distributions, for example).

As a practical matter, the sheer compliance cost of treating these forms of trust as separate entities (preparing tax returns, dividend statements, etc) makes some form of exclusion essential. Rather than relying on administrative practice, it would be preferable if there was an express exclusion from the entity rules for trusts where either the beneficiary is absolutely entitled to the assets of the trust or the assets of the trust are held as or by way of security. In that situation, any income or capital gains derived by the trustee should be deemed to have been derived by the beneficiary.

Revenue Projections

During the course of its consultations, the Review will have received new information that could cause the original revenue projections to be revised. For example, the proposals in Chapter 5 to 7 of *APFC*, dealing with the taxation of financial arrangements, appear likely to generate more revenue than anticipated in the paper. We assume that the revenue neutrality constraint will be measured against the revised projections.

I would like to thank you for the effective manner in which you have conducted the consultation process. I hope that you find our comments assist the Review in preparing its final report to Government. Please do not hesitate to contact me if you have any further queries, or if we can be of any further assistance.

Yours sincerely

Robert Webster
Executive Director